

Rental Real Estate: Exception to the Passive Activity Loss Rules Relating to Real Estate Transactions

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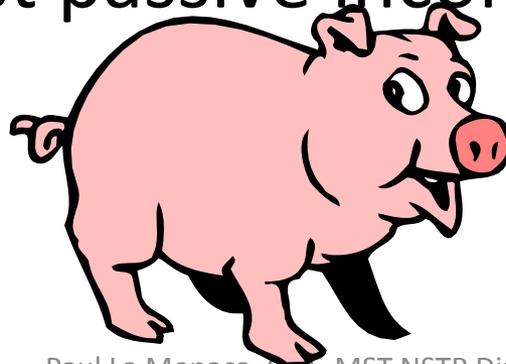


IRC 469 Passive Activity Loss Limitations

- General Rule: **PALs** not allowed



- Suspended & *carried forward* indefinitely
- Offset against passive income only: **PIG**



IRC 469 Issues

- *Passive* Activity Defined
- PAL cannot offset other sources of income
- Offset a **PAL** with a **PIG**
- *Exception* : special \$25,000 active participation for rental real estate



Special \$25,000 Allowance

- Natural person
- **10%** ownership at all time during tax year
- Active interest *entire* year
- Phased out based on *modified AGI*
- *Modified AGI* defined



AGI Limitation Issues

- Phase-out of Special **\$25,000** Allowance
- Modified AGI ***greater than \$100,000***
- Loose **50 Cents** for each **\$1 over \$100,000** with total phase-out at **\$150,000**



Real Estate Professional Exception

- The Special \$25,000 Allowance Limitation **does not apply**: can have *more than \$25,000* of *active real estate losses*
- **\$100,000** Modified AGI test **does not apply**
- **\$100,000-\$150,000** *phase-out rules* **do not apply**



Real Estate Professional Exception

- **Active** participation in **each** specific rental
- Meets *time tests*:
 - **>50%** of personal service in **real property trades or businesses**, and
 - **>750** hours in real estate trades or businesses
- **5%** or greater ownership interest of a real estate trade or business



Real Estate Trade or Business Defined

- IRC Sec. **469(c)(7)(C)** *Any Real Property:*
- ***Development, redevelopment, construction, reconstruction,***
- ***Acquisition, conversion, rental, operation, management, leasing, or***
- ***Brokerage trade or business***



Example #1

- Laura owns **5% or more** of a real estate sales office in which she ***materially participates for more than 750*** hours
- She owns 3 rental properties in which she ***actively participates***
- Net rental losses of the 3 properties is **(\$26,000)** and her modified AGI is **\$151,000** before the losses
- Deduct the full \$26,000 in the current tax year

Example #2

- John acquires old homes and contracts 3rd parties to renovate and ready for resale. John is a single member LLC and files a Schedule C as a real estate trade or business.
- He owns 2 rental properties that generate (\$26,000) of losses in which he actively participates in the management: his modified AGI is \$151,000 before the losses. Since he is a real estate professional the **\$25,000 limitation** and modified AGI tests do not apply.

Tax Court Rulings

- Agarwal vs. Commissioner **T.C. Summary Opinion 2009-29**: Real estate Agent Sole-proprietor Schedule C, ruled a Real Estate Professional (real estate sales license) Issue of the common use of the term “brokerage”
- Bahas vs. Commissioner **T. C. Summary Opinion 2010-115**: Employee of a real estate office ruled not a real estate professional (issue of **5%** or more ownership interest)



Research & References

- IRS Audit Techniques Guide (ATG)
- Pub. 925 Passive Activity and At-Risk Rules
- Pub. 527 Residential Rental Property
- Instructions for Schedule E Form 1040

