The Real Estate Professional: Exception to the Passive Activity Loss Rules

Speakers

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IRC 469 Passive Activity Loss Limitations

- General Rule: **PALs** not allowed
- Suspended & *carried forward* indefinitely
- **PALs** offset against passive income generator (**PIG**)
IRC 469 Issues

- Passive Activity defined
- Material Participation
- Grouping Activities
- Releasing losses through dispositions
- Modified AGI defined
- Married Filing Separately
Special $25,000 Allowance

• Natural person
• **10%** ownership at all time during tax year
• “Active” Participation
• Modified **AGI** limitation
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 Qualification

- **Material** participation in each specific rental
- **Material** participation in separate Real Property Trade or business
  - 50% rule
  - 750 hours rule
  - 5% ownership rule
Real Estate Trade or Business Defined

IRC Sec. 469(c)(7)(C) Any Real Property:

• Development or redevelopment;
• Construction or reconstruction;
• Acquisition and/or conversion;
• Rental Activity that is not a Passive Activity;
• Property management;
• Brokerage activities.
Example – Laura

- Owns **5% or more** of a real estate sales office
- Works full time as a broker
- She owns 3 rental properties and:
  - She finds the tenants;
  - Approves tenants and leases;
  - Approves and oversees repairs & improvements
- Net rental losses are **$31,000** and her modified AGI is **$160,000** before the losses
- Deduct the full **$31,000** in the current tax year
Example – John

• 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. This is his main source of income.

• He owns 2 rental properties that generate ($28,000) of losses in which he materially participates in the management: his modified AGI is $175,000 before the losses. Since he is a real estate professional the $25,000 limitation and modified AGI tests do not apply.
Tax Court Ruling
Agarwal vs Commissioner

• T.C. Summary Opinion 2009-29: Real estate Agent; Sole-proprietor Schedule C; filed as a Real Estate Professional (real estate sales license)
• Losses claimed were $40,000 and AGI was in excess of $150,000
• Issue of the common use of the term “brokerage”
Tax Court Ruling
Bahas vs Commissioner

- **T. C. Summary Opinion 2010-115**: Employee of a real estate office also a licensed real estate sales person
- W-2 earnings included 6% share of corporate profits
- Rental losses exceeded $25,000 and AGI exceeded $150,000. She filed as a Real Estate Professional
- IRS denied under 5% ownership rule
- Court concurred
Research, Reference & more Information

• IRS Audit Techniques Guide (ATG)
• Pub. 925 Passive Activity and At-Risk Rules
• Pub. 527 Residential Rental Property
• Instructions for Schedule E Form 1040
• Come to the NSTP booth in the Exhibit Hall and NSTP table in main corridor