

Tax Letter

Rental Real Estate and Passive Loss Rules

Dear Clients and Friends

First, nearly all rental real estate activities are pre-summed “Passive Activities”. Income came from these Passive Activities are taxable to the fullest extent. However, losses came from these Passive Activities (PAL) are subject to deduction limitations. For individual tax payers the annual maximum deductible amount of PAL derived from rental of real estate is \$25,000. This maximum amount is further subject to income level phase out and “Active Participation” requirement. The income level phase out is set at 50% of any amount of Adjusted Gross Income (AGI) in excess of \$100,000. Therefore, when AGI is \$150,000 or more, none of the PAL can be deducted in the current year. It is OK to carry over the non deductible PAL into future year and/or years.

Second, what is “Active Participation” ? To qualify, the Taxpayer must owe at least 10% of the rental real property and have “substantial Involvement” in managing the rental activities. In most cases, “Substantial Involvement” is a subjective determination and relatively easy to achieve. For example, it could be making decision in the approval of tenants, making arrangement for someone to provide repair services, and deciding on the amount and terms of the rental agreement.

Third, what can a taxpayer do to avoid this deduction limits ? To avoid the PAL deduction limit, an individual taxpayer must qualify as a “Real Estate Professional”. To be a “real Estate Professional”, a taxpayer must (a) “Materially Participate” in the rental real estate activity or activities, and (b) satisfy the following requirements: (i) more than 50% of the taxpayer’s personal services during a tax year are performed in real property trades or businesses, and (ii) spends more than 750 hours of services during a tax year in real property trades or businesses.

Fourth, what is “Material Participation”? According to Treasury Regulation 1.469-5T, a taxpayer can be considered “Materially Participate” in any real estate activity by meeting one of the following tests:

- 1) By spending more than 500 hours working in a real estate activity during a tax year.
- 2) The taxpayer is the only one (among all persons concerned) who substantially participate in the activity by spending more than 100 hours in that particular activity.
- 3) The taxpayer met the “Material Participation” requirement for a particular real estate activity for 10 tax years prior to the current year.

Finally, participation from both spouses may be combined to meet the “Material Participation” requirement regardless whether they file a joint return or not. Further, a taxpayer can elect to combine all (more than one) rental real properties and treat them as a “single activity” to meet the “Material Participation” requirement.

If a taxpayer decided to make this “single activity” election, an election statement must be file with the IRS according to IRC Section 469(c)(7)(A). The election statement will be submitted to the IRS as part of the taxpayer’s regular income tax return for that tax year. Once made, any changes to the election or revoking the election IRS approval will be necessary.

To decide whether a taxpayer should elect to group more than one or all rental real properties as a “single activity” is another story.

Sincerely,

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An Accountancy Corporation