Passive Aggressive Planning
Passive Activity Rules for Investors

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Federal tax law contains several meaningful and problematic fault lines. Among the most notable is the capital gain-ordinary income fault line. Another significant one is the passive activity rules, which real estate investors and professionals commonly encounter.

Takeaway

Passive activity rules are ever-present and complicated, and they play a major role in real estate professionals' investment decisions.

Passive activity rules have existed since 1987, when Congress decided to enact rules separating those who materially participate in their business or investment activities from those who do not. The rules provide that if someone materially participates in an investment activity, losses from the activity can offset profits from ordinary income. If the person does not materially participate, then losses from the activity can only offset profits from passive sources and cannot be offset against ordinary profits.

In any given year, if passive losses exceed the passive profits for the year, the remaining losses are suspended, to be carried forward and used to offset future generated profits, or perhaps captured when the asset or activity is sold. Suspended losses can only be carried forward, not backward. For real estate professionals, these passive activity rules may play a major role in investment decision-making.

Rental Real Estate

Congress decided in 1987 that rental real estate is passive regardless of whether the taxpayer materially participates. However, some exceptions are provided for real estate professionals who meet higher standards of material participation. For a real estate activity to avoid the passive activity characterization and have income treated as ordinary income, the real estate professional must materially participate in the real estate activity as determined by two rules:

- the real estate professional must perform more than half of the services in a real estate trade or business as a material participant, and

- more than 750 hours must be performed in the particular real property trade or business.

The net effect of these material participation dual rules for real estate professionals is that rental real estate is not passive and losses are not subject to the passive loss limitations if the taxpayer materially participates. But real estate professionals have the added burden of satisfying the new excess business loss limitations enacted in 2017, as discussed below.

Defining Real Property Trade or Business

"Real property trade or business" is defined as "real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."

Most commonly, taxpayers qualify as being in the real estate business if they work as real estate brokers and agents, general and specialty contractors, land developers, and property managers.

Qualified real estate professionals can treat unrelated real estate rentals as non-passive activities. The rental real estate does not have to be related or directly tied to the real estate business to qualify as non-passive if the taxpayer and/or the taxpayer's spouse materially participates.

Employee status could pose a problem unless the taxpayer has more than a 5 percent ownership interest in the business. In a 2009 Tax Court case, the taxpayer was a licensed real estate agent in California and worked full-time at Century 21. She claimed to be a real estate professional on her tax return. The IRS challenged her by claiming she did not own more than 5 percent of the business and, therefore, was not a real estate professional. The Tax Court held that she was self-employed and worked as an independent contractor, so she could treat her rental real estate properties for which she materially participated as non-passive activities.

Aggregation of Properties

Taxpayers may aggregate all real estate rental properties as a single rental activity when measuring the seven tests of material participation (discussed below).

This could help taxpayers test material participation and meet the hours requirements. Material participation in one rental will qualify as material participation in all of the rental real estate.

The election to aggregate is binding for all future years.

Special Rule Landlords of Small Properties

When Congress created the passive loss limitation statute in 1987, it created a safe harbor of sorts for small landlords.

Taxpayers who own at least 10 percent of a property and actively participate by providing management services pertaining to the property in question are allowed to deduct $25,000 in net passive losses annually.

The safe harbor is subject to a phase-out for higher income levels.

Seven Material Participation Tests

The abundance of passive loss limitation rules adds to their complexity, but they're intended to help prevent abuse and accomplish the tax policy's intent: limit losses that offset ordinary income, except for a few who work in the business.

The IRS has created the seven tests to annually determine whether a taxpayer is materially participating in the activity. The taxpayer:

- must have worked more than 500 hours in the activity;
- performs substantially all of the work in the activity;
- works more than 100 hours in the activity, more than anyone else who works in the activity;
- significantly participated in the activity (worked more than 100 hours), and the total amount of hours worked in all significant participation activities exceeds 500 hours for the year;
- materially participated in the activity for any five of the previous ten taxable years (do not have to be consecutive years);
- materially participated in the activity, which is a personal service activity, for any of the three taxable years preceding the current tax year; or
- is involved with the activity on a regular, continuous, and substantial basis based on all facts and circumstances. This applies only if the taxpayer works more than 100 hours, and the hours spent managing the real estate activity (for the 100-hour test) are countable only if:
    - no other person who performs management services is compensated for the services, and
    - no other person spends more time performing management services than the taxpayer.

The focus is on the taxpayer's regular, continuous, and substantial involvement in the activity.

For short-term rentals, which are measured by average rental periods of no more than seven days, rental activity is treated as a business and is exempt from the passive loss limitation rules only if the activity can satisfy one of the seven material participation tests. Rental real estate is not passive if the rental activity is not passive and if extraordinary personal services (for example, hospital rooms for medical care) are provided as part of the rental.

Investor-type services are not subject to passive limitation rules, so they are excluded from the 750-hour and 500-hour tests for material participation.

If the taxpayer materially participates in a rental business, the rental income derived from that activity is not passive. This rule targets an individual attempting to generate passive income to offset passive losses through self-rent activities.

Record-keeping could be challenging for the real estate professional. As with business expenses, contemporaneous records, daily logs, diaries, etc. are often the best form of proof. The Tax Court has many decided cases where individuals lost because of poor or insufficient record-keeping or documentation. When proving material participation in an activity, no hours exist unless they can be proven (i.e., documented).

Self-Rentals

Self-rental property may generate a loss that cannot be deducted for tax purposes.

When property is rented to oneself or to a business in which one materially appreciates, how the real estate rental activity is treated (i.e., as passive or non-passive) depends on whether it produces income or a loss.

If the self-rental produces income, it is non-passive. If there's a loss, the self-rental produces passive losses. Some focused planning is required to avoid this self-rental tax trap.

Rules Limiting Deduction of Excess Business Losses

Tax legislation in 2017 added rules that limit a noncorporate taxpayer from deducting excess business losses against non-business income. This new limitation is in addition to the passive loss limitation rules. For a deduction to be limited, the business loss generally must be in excess of:

- the taxpayer's deductions for the tax year attributable to a trade or business, over
- the sum of the taxpayer's gross income or gain for the tax year attributable to trades or businesses, plus $250,000 (or $500,000 for a joint return).

For partnership or Subchapter S corporations, the limitation is applied at the partner or shareholder level.

Congress intended for the new excess business loss limitations to apply after the passive loss limitations are applied. Further, the excess business loss limitation is just that – a limitation on losses. The rule does not change the character of income (e.g., capital gain, or recaptured Section 1250 gain or regular Section 1231 gain).

One uncertainty about the new excess business loss limitations is the interplay with a taxpayer's earned income. Earned income is treated differently for various tax provisions, but it is included as trade or business income for some purposes. How the new excess business loss limitations characterize earned income remains to be seen.

Disallowed losses under this new provision are treated as a net operating loss that is carried over to the following year and future years, indefinitely. The 2017 legislation clarified this interpretation for future carryovers. Nevertheless, the 2017 tax legislation limited net operating loss carryover to 80 percent of taxpayer's income.

Ever-present, Complicated, and Beneficial

Passive loss limitations affect real estate investors and professionals about as much as any tax provision. The rules are ever-present, but they are not easy to understand.

For the real estate professional, the rules offer the opportunity to reduce taxes. Significantly, rentals generating a loss do not have to be tied to the real estate business and can be treated as non-passive.

Nothing in this publication should be construed as legal or tax advice. For specific advice, consult an attorney and/or a tax professional.

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