



OFFSETTING ORDINARY INCOME WITH RENTAL PROPERTY LOSSES.

- How to Become a Real Estate Professional for Tax Purposes.

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CONTENTS

<u>Introduction</u>	3
<u>Passive Loss Rules for Real Estate Professionals.</u>	3
<u>What is a Real Estate Professional?</u>	4
<u>Material Participation: A Higher Standard.</u>	5
<u>The “50% and 750 Hours” Rules.</u>	5
<u>The Material Participation Test.</u>	6
<u>Why You Need Skilled and Aggressive Tax Audit Representation.</u>	8

Introduction

Investors who qualify as real estate professionals get a big tax break, and the designation doesn't require a real estate license or professional certification. If qualified, a real estate professional allows individuals to offset ordinary income (e.g., W-2 income) with rental property losses. But because this tax-saving strategy is so popular, it's important to take steps to ensure that you will survive a tax audit.

IRC 467 *limits an investor's ability to use passive losses to offset ordinary or earned income. As a general rule, investors may only offset passive income (e.g., rents) with passive losses, but taxpayers who "actively participate" in their real estate investments (i.e., select or approve tenants, negotiate leases, manage property repairs and capital improvements) are entitled to a maximum \$25,000 offset under IRC 467(i). Note that per IRC 467(i)(3), the \$25,000 loss will be reduced by 50% if the taxpayer's adjusted gross income exceeds \$100,000.*

Passive Loss Rules for Real Estate Professionals

IRC 467(c)(7) establishes rules for real estate investment losses for real estate professionals. For taxpayers who qualify, all real estate investment losses may be applied without limitation. It's no wonder that so many real estate investors designate themselves as real estate professionals!

What is a Real Estate Professional?

[IRC Sec. 469\(c\)\(7\)\(C\)](#) defines a real estate professional as someone who spends the majority of their time in one or more of the following real estate fields:

- > Real property development or redevelopment
- > Construction or reconstruction
- > Acquisitions
- > Rental or leasing
- > Operation or management
- > Brokerage trade or business

To qualify for an unlimited real estate investment deduction under [IRC Sec. 469\(c\)\(7\)\(B\)](#), a taxpayer must also demonstrate that they “materially participated” in the real property business for more than 750 hours and that they devoted more than 50% of their labor to those activities during the taxable year.



Material Participation – A Higher Standard.

The “material participation” standard that allows taxpayers to deduct all real estate investment losses is much stricter than the “active participation” requirement for a \$25,000 offset under [IRC 467\(i\)](#). In Part II, we will review the time tests and the requirements of “material participation,” and we will provide tips to increase the likelihood that your deductions will survive an audit.

The “50% and 750 Hours” Rules.

THE TAXPAYER *The taxpayer must demonstrate that they devoted more than half of their labor in a taxable year working in a real property business. The rationale is that if you claim to make your living in real estate, you should be able to show that you spent at least half of your time working in the field. The taxpayer must also show that “materially participating” in the real property business required more than 750 hours during the year. A taxpayer usually uses industry averages, receipts, and time logs to prove their hours.*

Taxpayers with time-intensive careers struggle to meet these criteria. Courts are skeptical when, for example, full-time teachers, lawyers, and doctors claim that they spend more than 2,080 hours (52 weeks x 40 hours per week) working on their rental business. In the recent [Escalante v. Commissioner](#) case, a teacher’s reconstructed time logs failed to account for time spent preparing for class, attending faculty and parent-teacher meetings, and participating in other school functions. The Court found that the teacher’s failure to account for all activities undermined the claim.

Tax Courts will likely reject “ballpark estimates,” so we highly recommend keeping detailed time records to prove time spent on all work activities. In [Merino v. Commissioner](#), the court rejected the taxpayer’s summary, which he acknowledged that he prepared “using his estimates and his memory as to how much time he spent on certain tasks with respect to the real estate rental activity.”

The Material Participation Test.

If a taxpayer meets both the “50% and the 750 hours” requirements, then the “material participation” test will be applied to determine whether the taxpayer’s activities are active or passive.

TREAS. REG. SECTION 1.469-5T sets forth seven ways to establish that a taxpayer materially participates in any real estate activity:

1. The taxpayer participates in the activity more than 500 hours during the year.
2. The taxpayer’s participation in the activity constitutes substantially all of the participation by all of the individuals (including non-owners), for the year.
3. The taxpayer’s participation is more than 100 hours during the year, and no one else (including non-owners) puts more hours into the activity than the taxpayer.
4. The activity is a trade or business activity in which the taxpayer significantly participates, and the taxpayer’s aggregate participation in all such activities during the year exceeds 500 hours.
5. The activity is a personal service activity in which the taxpayer materially participated for any three tax years preceding the current tax year, or for any five of the preceding ten taxable years (they need not be consecutive).
6. The activity is a personal service activity and the taxpayer materially participated in the activity for any three taxable years preceding the taxable year (they need not be consecutive). **OR**
7. The taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis during the year.

Under **IRC 469(c)(7)(A)(ii)** a taxpayer may make a one-time election to group all rental activities as a single activity to apply the passive activity loss limitation rules. One or more rentals may be treated as a single activity if the activities constitute an “appropriate economic unit.”



Note that the different material participation tests apply to different real estate activities, and there are special rules for closely held corporations. If you wish to maximize your tax deductions, first consult the tax team at Moskowitz, LLP.



■ Why You Need Skilled and Aggressive Tax Audit Representation.

When it comes to real estate loss deductions, IRS auditors tend to cast an exceptionally wide net. If you are a real estate investor whose deductions have been disallowed and/or you are being audited, you need a highly skilled and aggressive tax attorney on your side. The highly experienced tax lawyers at Moskowitz, LLP have represented thousands of clients before the IRS and state taxing agencies.

MOSKOWITZ LLP is a tax law and accounting firm that has dedicated over 30 years to representing individuals and businesses with civil and criminal tax problems, cleaning up accounting and tax messes, and providing estate planning & tax and accounting advisory services.

■ We make it easy and affordable for you to set yourself up for lower taxes and for success.

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