Season 1 – Episode 10 - Navigating Real Estate Taxation: Passive Activity, Active and Material Participation, and Beyond

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Welcome to Tax Blueprints, a Rohr CPAs podcast. I'm Daniel Rohr, the managing shareholder of Rohr and Associates, a premier CPA firm based in California. I'm a CPA, personal financial specialist and enrolled agent. I have extensive experience advising individuals and business owners with tax minimization and personal financial planning strategies. On each episode of Tax Blueprints, I delve into the intricacies of tax laws, explain the subtleties of business tax planning, and guide individuals towards a path of financial stability. Whether you're a business owner navigating the murky waters of taxation or an individual planning for a worry-free retirement, Tax Blueprints will provide you with the tools and knowledge you need. I hope you enjoy this episode.

If you've ever considered owning real estate, you've probably heard the terms passive activity, active participation or material participation. These phrases might sound foreign and perhaps even intimidating. And today I'm going to try and demystify these terms and deep dive into the world of passive activity, rentals and real estate taxation rules. So let's start by defining a passive activity. According to the Internal Revenue Code, Section 469, passive activities are those trade or business activities in which you do not materially participate. And rental real estate activities are generally considered passive activities. Even if you materially participate in them, they are considered something called a per se passive, meaning they're automatically passive. Now, there are exceptions that we will be diving into today as an overview. The determination that an activity is passive matters when the activity generates tax losses. These losses fall under what is called the passive activity loss rules.

A law under Section 469 was introduced under the Tax Reform Act of 1986. And the rules were designed to curb tax shelters that allowed investors to deduct losses from passive activities such as rental real estate, from non-passive income like your wages or investment earnings, like interest or dividends or capital gains, or from earnings from a business. What this means is losses from past activities can only be used to offset income from other passive activities. So, for example, if you earn 50,000 in wages plus 10,000 in passive income from a rental property A and have 15,000 in passive losses from rental property B, you can offset the 10,000 income from property A with part of your losses from property B, and you'd have 5000 in. Losses left over that would be carried over to a future year. And that 5000 overall loss. It can't reduce the amount of tax you pay on your $50,000 wage.

Now, as many things are in taxation, there are exceptions to these rules. And one of the exceptions is the active participation rule. So you're considered to actively participate in a rental real estate activity if you own more than 10% of the activity and you are involved in a meaningful management decisions regarding the property. These decisions can be as simple as approving tenants deciding on rental terms or approving repairs and maintenance. It doesn't mean that you need to go and mow the lawn or fix the plumbing yourself. You can hire a property manager and still meet the active Participation standards. So as long as you're making the important decisions, that's pretty rare for an owner of a real estate property to not qualify as meeting the Active Participation standard. And meeting this standard opens up the ability to deduct rental real estate losses. Depending on your total income, you may be able to deduct up to 25,000 of your rental losses against non-passive income like the wages.

Now that said, the Special Activity Active Participation Allowance begins to phase out if your modified adjusted gross income exceeds 100,000, and it disappears entirely when your modified adjusted gross income reaches $150,000. So, for example, let's say you have a rental property that generated a loss of $30,000 this year and you have a job that pays $95,000 annually. Because your modified adjusted gross income is below 100,000 and you actively participate in your rental activity, you could deduct 25,000 of your rental loss against your wage income, which will significantly lower your tax bill. The remaining 5000 loss would then be carried forward to future years. If your job paid you 150,000, though, the entire 30,000 would be carried over to a future year, and the carried over loss can be used against future passive income. So if the property turns a profit in a future year, or if your income drops below the special allowance threshold, or you can utilize it if you end up selling the property.

Now, if you want to deduct more than the 25,000 allowance, or you don't want to be subject to that 150,000 income max threshold, you'll need to materially participate in your rental activities as well as meet an exception to the per se passive rental real estate determination. So first, material participation requires

that you spend more time and effort on your rental activities. And the IRS has seven tests for material participation, but the most common one is working on the rental activity for more than 500 hours during the year. And if you're married, you can combine the total time spent by each spouse to see if you eclipse the 500 hours test. Now, there are a number of exceptions to having to treat the rental as per se passive, but we will cover the two most common exceptions in this podcast. One being a real estate professional.

And the second is having an average period of customer use that is less than or equal to seven days, which is typically an Airbnb. So let's first discuss how to be classified as a real estate professional. There are two criteria that must be met. First, more than half of the personal services you perform in all trades or businesses during the tax year must be performed in real property trades or businesses in which you materially participate. And second, you must perform more than 750 hours of services during the tax year in real property trades or businesses in which you maturely participate. Now, real property trader business includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental operation, management, leasing, or a brokerage trader business. So pretty much anything that has to do with real estate. It's also important to note that each spouse's material participation is considered separately.

This means that if you're married, you can't combine your hours with your spouses to reach the 750 hours requirement. So I want to make this clear. To be considered a real estate professional for tax purposes does not mean that you necessarily are a real estate agent or broker. You don't need to go out and start selling homes to take advantage of this. Two common examples of real estate professionals qualifying for this treatment are contractors and stay at home spouses. So let's go into an example to see how a stay at home spouse can qualify for this. So John and sue are married. John is an attorney who makes 400,000 a year income, and John and sue own eight rental properties. Sue's only work is to manage the rental properties, and she spends 100 hours a year on each rental, of which 100 hours spent on any one rental is one of the material participation tests.

So in total, sue spends 800 hours on real property trades or businesses. If the rentals combined lose 80,000 a year, the 80,000 can offset the attorney income, substantially reducing their taxes. To be clear, the only way our example works is if Sue combines the 100 hours of time spent for each rental to reach the 750 hours requirement. And the way that she does this is by making a grouping election to group together multiple rentals. And the grouping election allows her to treat all of her rental activities as one activity, which totals up her hours spent, allowing her to be considered a real estate professional. It's important to note that once you choose to group your rental activities, you must continue to treat them as a single activity in future tax years, unless there's a significant change in your circumstances. Let's quickly change gears a bit and discuss the Airbnb, where customer use is less than or equal to seven days.

As I previously stated, this is an exception to the per se passive treatment, meaning it's not automatically considered passive. So if you materially participate in the Airbnb, you can claim the losses against your other income and the loss is not limited. An important note the grouping election does not apply to your Airbnb property, so you will need to look at the time spent solely on this property to determine if you maturely participate. All right, well, we've covered a lot of ground today, and I hope that you found this information to be useful. As always, please consult with a tax professional regarding your own specific situation.
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