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IRS Grants Relief for late Real Estate Professional Election

By: Brett W. Neate, CPA, MT

As most individuals who invest in real estate know – or quickly learn when they file their income tax returns – they become subject to a complex set of rules known as the Passive Activity Loss (PAL) rules. In a nutshell, the rules state the following:

- Losses incurred in connection with a passive activity may only be deducted from income generated by that or other passive activities
- A passive activity is **any** business activity in which the taxpayer does not materially participate in management.
- Rental activities are automatically deemed to be passive activities, but
  - Real estate investors *may* be able to claim a limited amount of losses from those activities in which they *actively* participate. This is explained further, below.

Detailed definitions of "material participation" and "active participation" are, unfortunately, beyond the scope of this article, but are defined, in a limited way, below.

As discussed above, rental real estate losses incurred by an individual taxpayer are deemed to be from a passive activity and subject to the PAL rules. With few exceptions, the PAL rules disallow the deduction of passive losses that exceed passive income in any given tax year. While disallowed passive losses may be carried forward and deducted against passive income in future years, they do not provide any tax benefit to a taxpayer in the year the loss is incurred.

The most well-known exception to the PAL rules is the $25,000 exception for certain taxpayers actively involved in the ownership and management of rental real estate. This exception allows up to $25,000 of losses from rental real estate to be deducted against non-passive income. Unfortunately, this exception is often unavailable to taxpayers due to income level phase-outs.

Another exception to the PAL rules is provided to individuals who qualify as real estate professionals. Real estate professionals are allowed to treat losses generated by some or all of their rental real estate activities as nonpassive. Nonpassive losses are deductible against other types of income such as wages, interest, dividends, capital gains, self-employment income, and alimony, which can significantly reduce adjusted gross income (AGI) and, in turn, taxable income.

In order to be treated as a real estate professional an individual must be able to prove that:

1) More than 50% of their personal services during the tax year were performed in real estate businesses in which they materially participated, <u>and</u>

2) More than 750 hours of personal services were performed in real property businesses in which he or she materially participated.

Real estate businesses include any real estate development, construction, acquisition, conversion, rental, operation, management, leasing, or brokerage business.

Material participation occurs when the taxpayer's involvement in an activity is regular, continuous, and substantial. A taxpayer must meet one of seven IRS prescribed tests in order to be considered as materially participating in an activity. Among these tests is a 500 hour test which states that an individual is considered to materially participate in an activity if they participate in that activity for more than 500 hours over the course of a year.

Unfortunately, in determining material participation, each rental real estate property is treated as a separate activity, unless a special election is made to aggregate all properties into a *single* activity. Taxpayers who own or manage numerous properties may find that they cannot meet the material participation requirement for each property on an individual basis.

For example, Michael owns 30 properties and spends 30 hours per year managing **each** property. Michael does not spend any personal service hours on other activities. Since each property is treated as a separate activity none of them satisfies the material participation requirements under the 500 hour test.

However, if Michael elects to aggregate his 30 rentals and treats them as a single activity, he would have spent 900 hours in total on the aggregated group, thus satisfying the 500 hour test for material participation. Once material participation is established, Michael would now satisfy the 50% and 750-hour tests and could treat losses from his aggregated group as nonpassive.

Generally, the election to aggregate activities is made by including a statement in the original, timely filed income tax return for the year in which the election is to apply. Previously, if the election was not included with the originally filed return, a taxpayer would have to request relief through a private letter ruling (PLR) from the IRS, which can be quite cumbersome and costly. However, Revenue Procedure 2011-34 now allows real estate professionals to make a late election **without** requesting a PLR.

The late election benefits taxpayers who did not make a timely aggregation election in the past and did not otherwise satisfy the tests to be considered real estate professionals, yet, deducted rental losses on prior year income tax returns as if they had. These taxpayers may now decide whether or not making a late aggregation election is appropriate in their circumstances, to validate deductions taken on previously filed tax returns, as well as on future returns.

There are downsides which must be considered before making any aggregation election, be it timely or late. Some key questions that must be answered to determine if the aggregation election is advantageous include:

- Do they have suspended passive losses from prior periods?
- Do they have other sources of passive income or loss?
- Do their real estate interests normally generate net income rather than losses?
- Do they hold real estate interests in a limited partnership?
- How do they see their real estate interests changing in the future?

Another point to consider is that the election is irrevocable, unless there is a material change in the taxpayer's facts and circumstances. Therefore, each taxpayer's unique situation must be analyzed to determine whether or not making an aggregation election is in their best interest for past, present, and future tax years.

For answers to your questions about the aggregation election, please visit the Zinner & Co. LLP website, www.zinnerco.com, to contact one of our tax professionals. Your success is our business!