

Dear Client:

You recently asked whether and how you can deduct a loss from residential rental property you own and are renting out.

The problem with rental activities is that they generally fall into the category of "passive" activities. Thus, rental losses you incur can only be deducted currently against passive income.

However, if you "actively participate" in the residential rental activity, you may be able to deduct a loss of up to \$25,000 against ordinary (nonpassive) income such as your wages or investment income. You actively participate in the rental activity if you make key management decisions such as whom to rent to, the rental terms, approving capital expenditures, etc. You also can show active participation if you arrange for others to provide services. Active participation does not require regular, continuous, substantial involvement with the property. But in order to satisfy the active participation test, you (together with your spouse) must own at least 10% of the rental property. Ownership as a limited partner does not count.

If you meet the above tests, you can claim up to \$25,000 in losses against nonpassive income (\$12,500 if you're married, file separately, and live apart from your spouse for the entire year—but if you're married, file separately and *don't* live apart from your spouse for the entire year, you're not eligible for this break at all). If your adjusted gross income (AGI) is above \$100,000, the \$25,000 allowance amount is reduced by one-half the excess over \$100,000. (If you're married, file separately and are eligible for the break, the \$12,500 allowance amount is reduced by one-half the excess over \$50,000.) Under this rule, if AGI is \$150,000 or more (\$75,000 or more for eligible married taxpayers who file separately), the allowance is reduced to zero. (For these purposes, AGI is modified to some extent, e.g., you ignore taxable Social Security income and the Individual Retirement Account (IRA) deduction.)

Example. Tina, who's single, has adjusted gross income of \$120,000. Thus, one-half of the \$20,000 excess ($\$120,000 - \$100,000$) equals \$10,000. Tina's maximum loss allowance is reduced from \$25,000 to \$15,000.

Losses which are not allowed because of the amount limitations do not simply disappear. They are carried forward and can be deducted against nonpassive income in future years if you continue to actively participate in the rental real estate activity which originally generated the losses. But if you cease to actively participate, the carried-forward losses are treated as passive activity losses which may only be used to offset passive activity income or your gain when you dispose of your ownership interest in the activity.

If you have any questions or would like to discuss this topic further, please call.

Very truly yours,

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