

Generally, any rental activity is treated as a passive activity even if the taxpayer materially participates in that activity. ( ¶ 413,501 et seq.) However, if the taxpayer meets the requirements for the real estate professional exception to the passive activity loss rules, any rental real estate activity in which he materially participates is treated like a nonrental activity and losses from that activity are not limited by the passive activity rules. Thus, a taxpayer (qualifying for the exception) may use any losses or credits generated by that activity to offset the taxpayer's active or portfolio income. ( ¶ 413,801 et seq.)

Here's a checklist to use to ensure that your clients take advantage of the real estate professional exception to the passive activity loss rules:

*(1) Are more than one half of the personal services performed in trades or businesses by the taxpayer during the tax year performed in real property trades or businesses (see (2) below) in which the taxpayer materially participates (see (3) below)? ( ¶ 413,808 )*

The taxpayer must satisfy this requirement in addition to the more-than-750 hours requirement described at (4) below.

*(2) Does the taxpayer perform personal services in a real property trade or business?*

A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. ( ¶ 413,815 )

*(3) Does the taxpayer materially participate in the real property trades or businesses (see (2) above) in which he performs personal services?*

A taxpayer materially participates ( ¶ 413,002 et seq.) in a trade or business if he satisfies one of the following tests:

... participating in the activity for more than 500 hours, see ¶ 413,005 .

... the taxpayer's participation is substantially all of the participation in the activity of all individuals for the tax year, including the participation of individuals who didn't own any interest in the activity, see ¶ 413,006 .

... the taxpayer participated in the activity for more than 100 hours during the tax year, and the taxpayer participated as much as any other individual (including other individuals who did not own any interest in the activity) for the year, see ¶ 413,007 .

... the activity is a significant participation activity, and the taxpayer participated in all significant participation activities for more than 500 hours, see ¶ 413,008 .

... the taxpayer materially participated in the activity for any five (whether or not consecutive) of the ten preceding tax years, see ¶ 413,009 .

... the activity is a personal service activity in which the taxpayer materially participated for any three (whether or not consecutive) preceding tax years, see ¶ 413,010 .

... based on all of the facts and circumstances, the taxpayer materially participated in the activity on a regular, continuous, and substantial basis, see ¶ 413,012 .

*(4) Does the taxpayer perform more than 750 hours of services during the tax year in real property trades or businesses (see (2) above) in which the taxpayer materially participates (see (3) above)? ( ¶ 413,808 )*

The taxpayer must satisfy this requirement in addition to the more-than-half test described at (1) above.

*(5) If the taxpayer performs services as an employee, is he a 5% owner of the employer?*

If so, personal services performed as an employee are treated as performed in real property trades or businesses for purposes of the more-than-half test (see (1) above) and the more-than-750-hours test (see (4) above). ( ¶ 413,810 ) To be a 5% owner, the employee must:

... own (or be considered to own) more than 5% of the employer's outstanding stock or more than 5% of his employer's voting stock.

... own more than 5% of the capital and profits of his employer.

If the taxpayer isn't a 5% owner, personal services performed as an employee can't be treated as performed in real property trades or businesses for purposes of satisfying the more-than-half test and the more-than-750-hours test.

*(6) Were the taxpayer's personal services performed in connection with a trade or business?*

If so, those personal services are taken into account for purposes of determining whether the more-than-half test (see (1) above) and the more-than-750-hours test (see (4) above) are met. ( ¶ 413,809 )

*(7) Was the work performed by the taxpayer performed in his capacity as an investor?*

If so, personal services would *not* include any work performed by an individual in the individual's capacity as an investor for purposes of the more-than-half test (see (1) above) and the more-than-750-hours test (see (4) above). ( ¶ 413,809 )

*(8) If the taxpayers are married and file a joint return, can either spouse separately satisfy the more-than-half test and the more-than-750-hours test?*

One of the spouses must separately satisfy both requirements without regard to the services performed by the other spouse. However, in determining material participation, the participation of one spouse is treated as participation by the other spouse. ( ¶ 413,002 )

*(9) If the taxpayer is a closely-held C corporation ( ¶ 411,505 ), are more than 50% of the corporation's gross receipts for the tax year derived from real property trades or businesses (see (2) above) in which the corporation materially participates (see (3) above)?*

If so, a closely-held C corporation may qualify for the real estate professional exception. ( ¶ 413,812 )

*(10) Is the taxpayer's rental real estate activity grouped with any other activity of the taxpayer?*

A taxpayer meeting the more-than-half requirement (see (1) above) and the more-than-750 hours test (see (4) above) cannot group a rental real estate activity with any other activity. Thus, only the participation of the taxpayer with respect to the rental real estate activity could be used to satisfy the taxpayer's material participation requirement (see (3) above). ( ¶ 413,807 )

*(11) Does the taxpayer hold the rental real estate interest through a passthrough entity?*

An interest of a qualifying taxpayer (i.e., a taxpayer who meets the more-than-half test (see (1) above) and the more-than-750-hours test (see (4) above)) in rental real estate

held by a partnership or S corporation (passthrough entity) is treated as a single interest in rental real estate if the passthrough entity grouped its rental real estate as one rental activity ( § 412,008 ). On the other hand, if the passthrough entity groups its rental real estate into separate rental activities, each rental real estate activity is treated as a separate interest in rental real estate. However, the taxpayer can elect to aggregate (see (13) below) his rental real estate interests. ( § 413,806 )

*(12) Does the taxpayer hold the interest in the rental real estate activity through a limited partnership?*

The determination of whether a taxpayer materially participates with respect to any interest in a limited partnership as a limited partner is not affected by the real estate professional exception. A limited partner can't satisfy the material participation test by aggregating his limited partnership interest with other rental real estate interests in which, on an aggregate basis, the taxpayer might satisfy one of the material participation tests. If a taxpayer makes an election to treat all interests in rental real estate as a single real estate activity (see (13) below) and at least one of the taxpayer's interests is a limited partnership interest, the combined rental real estate activity is treated as a limited partnership interest for purposes of determining material participation. Thus, the taxpayer has to establish material participation under the rules discussed at § 413,022 et seq. for determining a limited partner's material participation. ( § 413,610 )

*(13) Can the taxpayer satisfy the more-than-half test (see (1) above) and the more-than-750-hours test (see (4) above) if he elects to treat all interests in rental real estate as one activity? ( § 413,803 )*

Electing to treat all of a real estate professional's rental real estate activities as a single activity makes it easier to meet the material participation requirement by allowing the taxpayer to aggregate his participation in all of those activities.

It may not be advisable for a real estate professional to make the election to aggregate all rental real estate interests if he has positive net income from real estate activities and passive losses from activities other than real estate activities. In that case, the taxpayer would prefer for the real estate activity to be a passive activity so that he could currently deduct the losses from the other activities against the passive income from the real estate activities. If the taxpayer made the election to aggregate all real estate interests, the passive losses (from the non-real estate activities) would be suspended and would not be deductible until the taxpayer disposed of the entire activity.

For procedures that apply to the making of the election, see § 413,804 .

*(14) Has the return preparer entered the individual taxpayer's (i.e., the real estate professional's) net income (or loss) reported anywhere on the Form 1040 from all rental real estate activities in which he materially participated under the passive activity loss rules on line 42 of Schedule E (Form 1040)?*



**RIA observation:** A closely-held C corporation qualifying for the real estate professional exception is not required to enter the amount of its net income (or loss) from all rental real estate activities in which it materially participates on the Form 1120.

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