

## FYI

Rental real estate activities are considered to be "passive" activities even if the owner "actively" participates in the activity. Generally losses from passive activities can only be applied against "passive income". You cannot use a passive loss to offset W-2 income or interest and dividends. As accountants love acronyms, the rule is that you need a PIG (positive income generator) to offset a PAL (passive activity loss).

There is a special exception to the rule for rental real estate activities in which you "actively" participate — i.e. you own more than 10% of the property and are substantially involved in its management. Up to \$25,000 in rental real estate losses can be used to offset other income, such as wages and interest and dividends.

This special \$25,000 allowance is "phased-out" as your "modified" Adjusted Gross Income (AGI) goes from \$100,000 to \$150,000. To calculate "modified" AGI you start with "regular" AGI, subtract any taxable Social Security or Railroad Retirement benefits, and add back —

- net passive losses (including rental losses),
- excluded US Savings Bond interest used for higher education expenses,
- excluded employer adoption assistance payments,
- the deduction for contributions to IRAs and other qualified retirement plans,
- the deduction for ½ of self-employment tax,
- the deduction for student loan interest,
- the deduction for qualified tuition and fees, and
- the deduction for "Section 199" domestic production expenses.

Taxpayers who are considered to be a qualified "real estate professional" do not have to treat their rental real estate activities as passive activities and can deduct all rental losses in full.

Internal Revenue Code Section 469(c)(7)(B) defines a real estate professional as a taxpayer who (1) spends more than 750 hours and (2) performs more than one-half of his or her personal services during the tax year in real property trades or businesses in which he or she materially participates.

A real estate professional is generally considered to be a real estate agent or broker, a landlord, a professional property manager, a developer or in the construction business.

Under Internal Revenue Code Section 469(c)(7)(D)(ii) time worked as a real estate professional does not count unless taxpayer owns 5 percent or more of the activity. According to the IRS, "If, for example, the taxpayer works full-time for a construction company, but does not own any of the company, he is not a real estate professional";

It is important to properly document time spent in rental activities if you're claiming to be a real estate professional. Taxpayers ideally should keep contemporaneous daily time reports, logs, or similar documents. If the taxpayer uses appointment books, calendars, or narrative summaries to identify services performed over a period of time

that estimate time spent on real estate property trades or businesses the time estimated must be reasonable.

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This issue arose when a client whose return was extended (waiting for a Form K-1) informed me that for 2007 he was a general partner, one of three, in a partnership that owned and managed rental real estate. The partnership generated a substantial net loss. My client's "modified" AGI was well over \$150,000 for 2007, so none of the real estate loss was deductible on the 2007 return. The 2007 loss will be "suspended" until a year when his MAGI is less than \$150,000 or until he terminates his interest in the partnership.

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My client told me that his partner's accountant said that they qualified as real estate professionals and were therefore exempt from the \$150,000 income threshold.

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One partner worked for a hedge fund that invested in commercial real estate. Another partner monitored the risks of an insurance company's investments in securities backed by residential and commercial mortgages. The third, my client, worked with mortgages for a bank.

If they did not each own more than 5% of the hedge fund, insurance company or bank, which they obviously did not, then the time they spent working in these positions does not count toward qualifying for real estate professional status. It is as if they were bus drivers. The only time that counts toward the one-half of all work is time spent working on real estate investments in which they have a material ownership. The time involved in running the real estate partnership would count - but because the partners are all employees each would have to spend over 2000 hours per year on this activity.

A Real Estate Professional is one who is self-employed in the real estate field managing properties that he/she has a substantial ownership interest in. If in 2008 the three partners do not have "day jobs" and spent their entire time (at least 750 hours each) actively managing the real estate properties held by the partnership then they could each be a real estate professional. Working as an employee in an industry that is somewhat tied to real estate investment and management does not cut it unless you have a 5% or more ownership in the firm for which you work.

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Courtesy of THE WANDERING TAXPRO