Abstract: Rental real estate activities are subject to passive loss rules that often limit a taxpayer's ability to deduct losses. Certain exceptions, such as qualifying as a real estate professional, can allow more favorable treatment. This article explains how passive activity loss rules function, why real estate professional status is beneficial, and options for taxpayers who don't meet the criteria.

Unlock bigger deductions on rental real estate

Many rental property owners are surprised to learn that federal tax law often restricts their ability to deduct losses, treating most rental activities as passive unless specific requirements are met. But if you can qualify for the real estate professional exception, you may be able to turn otherwise suspended losses into immediate tax savings.

The real estate professional advantage

For federal tax purposes, rental real estate losses are usually treated as passive, meaning they can be deducted only against passive income, such as profits from other rental properties. If you don't have enough passive income, your unused losses are suspended and carried forward. Those suspended losses can be deducted later, once you have sufficient passive income or when you sell the property that generated them.

However, there's a big exception for real estate professionals. If you qualify, a rental real estate loss potentially can be classified as a nonpassive loss.

To be eligible for the real estate professional exception:

- You must spend more than 750 hours during the year delivering personal services in real estate activities in which you materially participate, and
- Those hours must be more than half the time you spend delivering personal services (in other words, working) during the year.

The next step to being able to claim a nonpassive loss is determining if you have one or more rental properties in which you materially participate. Generally, you need to pass one of the following to meet the material participation test for a rental real estate activity:

1. Spend more than 500 hours on the activity during the year.
2. Spend more than 100 hours on the activity during the year and make sure no other individual spends more time than you.
3. Make sure the time you spend on the activity during the year constitutes substantially all the time spent by all individuals.

There are other ways to meet the material participation test, but these three are typically the easiest. Note, also, that participation by your spouse is included for material participation purposes, although it's not included for the real estate professional test.

If you qualify as a real estate professional and meet the material participation test for a property, losses from the property are treated as nonpassive losses that you can generally deduct in the current year.

Make the most of your tax benefits

With proper documentation and knowledge of available exceptions, you can better position yourself to reduce your tax liability. Professional guidance can assist. Contact us today.

SIDEBAR: Don’t meet the requirements?

If you don’t meet the real estate professional rules, you may still deduct certain rental losses currently through limited exceptions:

Small landlord exception. If you own at least 10% of the property and actively participate, you may be able to treat up to $25,000 of losses as nonpassive. (Properties owned via limited partnerships don’t qualify.) This exception begins to phase out when adjusted gross income (AGI) exceeds $100,000. It’s eliminated when AGI reaches $150,000.

Seven-day rental rule. If the average rental period is seven days or less, the activity is treated as a business, not real estate. Passing a material participation test makes losses nonpassive.

30-day rental with services. If the average rental period is 30 days or less and significant personal services are provided, the activity is also considered to be a business. Losses may be treated as nonpassive if a material participation test is met.