Qualifying Real Estate Professional and Joint Tax Returns

Under current tax regulations, rental activities are automatically classified as passive activities, and unless a taxpayer has passive income from other sources, rental losses may not be immediately deductible. On its face, this passive treatment creates quite an issue for taxpayers that are actively in the business of renting property.

Rental properties often require significant capital investments and so the after-tax return on this investment is a critical measurement tool. To address this, the code provides certain exceptions for individuals that are considered “Qualifying Real Estate Professionals”. A taxpayer that qualifies under these exceptions has an opportunity to exclude rental activities from the passive activity requirements of IRC section 469. The focus of this article is to discuss those exceptions and their application to jointly filed income tax returns.

Qualifications for a Real Estate Professional

1. More than one-half of the personal services performed in trades or business by the taxpayer during the taxable year must be related to real property trades in which the taxpayer materially participates.

Real property trades are not limited to those individuals that rent real property. In fact developers, property managers and others in the industry have the opportunity to qualify. It is important to note, however, that individuals that provide services to those engaged in real property trades (accountants and attorneys for example) would not likely qualify because their trade is not a “real property activity” instead it is the service they are providing.

Additionally, “Material Participation” can be a sticky subject. IRC §469(h) defines a taxpayer as materially participating only when the taxpayer is involved in the operation of the activity on a basis which is regular, continuous and substantial. The tax regulations do little more to define “regular, continuous and substantial”. The interpretation of these words has been litigated heavily in tax court and with varying decisions.

For purposes of considering a taxpayer’s participation, it is important to identify who else is involved in operating the rental activity and what other business activities the taxpayer engages himself in during the year. The results of tax court decisions have indicated that taxpayers who employ property managers will have a difficult time defending that they in fact participate regularly, continuously and substantially in the rental activity. Further, taxpayers that have other non-real estate businesses or employment will also have a difficult time defending their position.

2. The taxpayer must perform more than 750 hours of services during the tax year in real properties trades or businesses.

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An important consideration for this exception is to discern that the tax regulation’s intention is to apply the criteria above to each activity separately. Often times, a taxpayer would have difficulty meeting the 750 hour requirement at any one rental property. Fortunately, there is an option for taxpayers to group their rental activities together, which may make the difference in passing this test. A taxpayer exercises this option by filing an election under §469(c)(7)(A). The election should be filed in the first year that the real estate professional status is claimed and in years where any additional properties are added to the group.

Tax court rulings have shown that the taxpayer’s maintenance of contemporaneous time logs and other records are imperative to their ability to prove they have met this test. In a recent tax case (Shaw Case No. 09-18648-FJB, U.S. Bankruptcy Court, Dist. Of Massachusetts), the taxpayer was denied status as a Qualified Real Estate Professional because her time logs were not exact. In this case, the judge determined that the taxpayer’s estimate of hours was not sufficient proof to uphold the taxpayer’s position. Real estate professionals should approach this time keeping requirement diligently to solidify their tax position. Documentation can be analogous to a time sheet, memorializing the day, time and specific activities that are performed by the taxpayer. This is especially critical for taxpayers that maintain more than one business activity throughout the year.

A taxpayer that qualifies as a real estate professional may have the opportunity to use tax losses from rental real estate. Without this exception, these real estate losses would generally otherwise be limited to $25,000 per year (subject to phase out and active participation requirements).

**Real Estate Professionals Filing Joint Returns**

Further complicating the issue is determining how taxpayers filing a joint return treat rental property that is jointly owned or owned by the non-real estate professional spouse.

Treasury Regulation §1.469-9(c)(4) explains that only one spouse needs to qualify as a real estate professional to treat rental losses in the manner described earlier. Note that although only one spouse must qualify, the same spouse must independently pass both the more than one half of personal services test and the greater than 750 hours test. The tax opportunities presented with the inclusion of a non-real estate professional spouse and a qualifying spouse can be profound. Income or losses that would have otherwise been subject to the passive activity rules may now be exempt. For example, assume in 2013 a husband and wife file a joint tax return.

The husband is a real estate professional, but the wife is not. The wife is an attorney and receives a W-2 reporting wage income of $200,000 each year. The husband’s rental real estate activities, while cash flow positive, report cumulative losses of $150,000 as a result of depreciation and debt service. On their 2013 tax return, the wife’s wages will be directly reduced by the husband’s real estate losses, leaving the couple with approximately $50,000 of taxable income before considering itemized deductions and personal exemptions.
Understanding the application of these exceptions and the documentation requirements is critical for individuals actively engaged in rental real estate activities. Real estate professionals need to carefully navigate these exceptions and maintain proper documentation to support their position. Ongoing dialogue with a tax professional is highly recommended as the industry has seen a significant increase in the audits of taxpayers claiming real estate losses.

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With a background of more than 30 years in both public and private accounting, Rick has developed the necessary knowledge and technical skill to help clients achieve their goals. Over the years, he has advised several entities to undergo cost segregation studies, which resulted in reduced income tax burden and increased cash flow. In addition, Rick has worked closely with contractors to help them obtain bonding for construction jobs and match them with bonding agents.

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