TAX IMPLICATIONS OF RENTAL REAL ESTATE ACTIVITIES

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Certain online sites such as Airbnb and VRBO (Vacation Rental By Owner) have made it easier and more appealing for homeowners to rent out their property, which has led to a nation-wide increase in short-term rentals over the last few years. According to AirDNA.co, New York City has more than 34,000 active Airbnb listings. While renting out a house, apartment, condominium unit or even one's vacation property can be a great investment opportunity, property owners and real estate investors should be aware of potential tax implications when reporting the associated rental income and expenses on their tax returns.

Rental Real Estate – Passive Activity

Losses from rental real estate activities are subject to limitations and different rules depending on the activity classification and the involvement of the property owner. Internal Revenue Code (IRC) Section 469(c)(1) defines "passive activity" as any activity which involves the conduct of any trade or business and in which the taxpayer does not "materially participate." Subject to certain exceptions, the term "passive activity" includes any rental activity (IRC Section 469(c)(2)). Generally, rental activities are considered passive activities when the owner of the property receives income for the use of tangible property (real or personal), rather than for services.

Losses from rental activities that are considered passive activities can only be used to offset income from other passive activities, and any excess net loss (amount by which the passive activity deductions exceed the passive activity gross income) is carried forward to the next year. Passive rental losses are carried forward indefinitely until there is enough rental income (or other passive income) to deduct the losses against or until the property is disposed of in a fully taxable transaction with an unrelated third party. A taxpayer that has carryover passive rental losses or expects to have net passive rental losses that will carry over into future years should consider investing in other passive activities that generate passive income as a tax planning strategy. Taxpayers can use the passive income generated from other investments to offset the passive rental losses, which would otherwise be carried forward indefinitely if not utilized to offset income in the current year.

Rental Real Estate – Active Participation

An exception to the general rule of limiting rental losses to the extent of other passive income occurs when the taxpayer is considered to be "actively participating" in normally passive rental real estate activity. In this case, the taxpayer can deduct up to $25,000 of loss from the rental activity against non-passive income (i.e. wages, pension income, self-employment income, etc.) in any taxable year the taxpayer is actively participating in the rental real estate activity. Taxpayers filing Married Filing Separate (MFS) on their personal returns are not eligible for the $25,000 special allowance; there is a $12,500 loss deduction available if the taxpayer files MFS and lives apart from their spouse, and no deduction is allowed if taxpayer files MFS and lives with his/her

spouse. The $25,000 deduction is phased out if the taxpayer's Modified Adjusted Gross Income (MAGI) is between $100,000 and $150,000 (the MFS phase out is between $50,000 and $75,000). If MAGI is $150,000 ($75,000 if MFS) or more, no deductions in excess of the passive activity income are allowed.

IRC Section 469 does not explicitly define what constitutes active participation. However, there have been a number of cases in which tax courts have elaborated on it. In Madler v. Commissioner the Internal Revenue Service had disallowed the claimed losses attributable to the petitioner's condominium unit, on the basis that the taxpayer had failed to show evidence that the taxpayer was actively participating in the rental activity.

In this instance the tax court defined active participation as a rental activity in which a taxpayer participates by making "management decisions" or arranging for others to provide services. Management decisions that may count as active participation include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions. In Madler v. Commissioner, the petitioner paid a fee under a contract to the property manager, who handled most of the decisions described above such as approving tenants and repairs. Since it was the property manager making management decisions, the petitioner was not eligible to deduct rental losses in excess of rental income, and was not deemed to be actively participating in rental real estate activity.

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Although there is not an explicit definition of “active participation, IRC Section 469(i)(6) does require that an individual own at least 10% (by value) of all interests in any rental real estate activity in order to be treated as actively participating in the rental real estate.

Rental Activity - Part Rental Property/Part Personal Property

Taxpayers that use rental property for both rental and personal purposes should be aware that, if the rental unit is considered a residence, rental expenses will have to be divided between the rental and personal portion (with only the rental portion deductible against rental income). A rental unit is a residence if the taxpayer used it for personal purposes more than the greater of 1) 14 days, or 2) 10% of the total days it is rented out to others at a fair rental price. If the taxpayer used the property as a residence and rented it out for less than 15 days during the year, its primary function is not considered to be as a rental, and the taxpayer is not required to report the rental income nor is the taxpayer allowed to deduct rental related expenses from this activity.

Rental Real Estate – Real Estate Professional

Another exception to the general rule of limiting rental losses to the extent of other passive income occurs for taxpayers, who are “real estate professionals.” To qualify as a real estate professional, more than half of the work the individual performs in trades or businesses during the taxable year must be in real property trades or businesses in which the individual materially participated and the individual must work more than 750 hours during the year in these trades or businesses.

Real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

A taxpayer is deemed to have materially participated in a trade or business if any of the following is satisfied:

1. The taxpayer participated in the activity for more than 500 hours during the year;
2. The taxpayer’s participation in the activity was substantially all the of the participation in the activity of all individuals;
3. The individual participated in the activity for more than 100 hours during the year and participated at least as much as any other individual for the year;
4. The activity is a significant participation activity and the sum of the individual’s participation in all significant participation activities during the year exceeds 500 hours;
5. The individual materially participated in the activity in any 5 of the previous 10 years;
6. The activity is a personal service activity in which the taxpayer materially participated in any 3 prior years; or
7. Based on all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year.

As highlighted by the above rules, a real estate professional is someone who is very involved in the real estate area. It is not someone who rents out one or two properties during the year. However, many people who are involved in the development of properties in conjunction with other real estate activities often overlook the benefit of being a real estate professional.
If a person is a “real estate professional,” losses from the applicable real property trades or businesses (including those rental activities that qualify) are non-passive and can offset any type of income such as wages, interest income, dividend income, etc.

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Losses from rental real estate activities are generally considered passive losses and can only offset passive income. A person who actively participates in a rental real estate activity may be able to deduct up to $25,000 against non-passive income. A person who qualifies as a real estate professional may be able to deduct all their rental losses against non-passive income. There are difficult rules to navigate to determine how to properly account for rental income and expenses. Please consult your Mazars USA LLP tax adviser for more tax planning opportunities and questions.

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