

Materially Participating Real Estate Professional – Are You Sure?

For years, owners of rental real estate could have their cake and eat it too. They could collect cash from their rental properties and use their tax rental real estate losses to offset their other income. Depreciation deductions often cause rental property to have tax losses despite generating positive cash flow.

In 1986 Congress dramatically minimized this tax advantage by enacting the Passive Activity Loss rules under Internal Revenue Code §469. Under §469, a taxpayer can only deduct losses from passive activities to the extent of net income from other passive activities in a given tax year. Rental real estate activities are defined as passive by §469, and are therefore subject to these limitations. However, §469 does provide an exception for taxpayers primarily engaged in real property businesses. A taxpayer that qualifies as a Materially Participating Real Estate Professional (MPREP) can treat net tax losses from rental real estate as non-passive, and therefore are not subject to the passive loss limitations.

In order for a taxpayer to qualify they must meet the following requirements:

- 1 More than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
- 2 Such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

There are several tests to determine whether a taxpayer materially participates, but the most common measure is that the taxpayer spends at least 500 hours in the activity. A real estate owner will rarely spend 500 hours a year on a single rental property. So how is it possible to meet these requirements? The taxpayer can make an election to aggregate all rental real estate activities. For example, if the election is made, a taxpayer that has 10 rental properties, in each of which taxpayer spends 80 hours a year, is considered to have spent 800 hours in the rental real estate activity. As long as the taxpayer does not spend more than 799 hours in other trade or business activities, the rental real estate losses can be treated as non-passive. The election must be made in the first year the taxpayer wishes to aggregate.

The IRS has recently focused their attention on taxpayers claiming MPREP status, and will certainly request supporting documentation upon examination, including a copy of the election made to aggregate rental activities. No guidance from the IRS exists as to what documentation should be maintained to support time spent on the rental real estate activities. However, if the taxpayer can provide contemporaneous records such as timesheets and/or calendars that document their activities, it can be the difference in whether the IRS will challenge the position.

It should also be noted that certain states, such as California, do not provide for the MPREP exception for allowing losses from rental real estate. Before taking losses as a MPREP in a state, you should determine whether it allows for it.

It is our experience that unwary taxpayers often deduct rental real estate losses without following the appropriate steps to support their position. They run the risk of losing significant deductions if the IRS comes calling. Anyone taking these losses should confirm with their tax advisor that they have not overlooked any of these crucial details.