

Designating Yourself a ‘Real Estate Professional’ and Claiming Real Estate Losses Against Ordinary Income

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Welcome to the world of real estate, where savvy individuals who have earned the right to call themselves *real estate investors* have more options for taking advantage of tax-saving opportunities.

For those involved in the real estate industry, “materially participating” in the management of your properties or investments and being classified as a “real estate professional” can translate to substantial tax savings, leaving you with more cash to build your real estate investment portfolio.



In this SWC singlette, we explore the distinct tax advantages that come with material participation and being recognized as a real estate professional, delving into how these designations can increase deductions, minimize tax liability, and ultimately enhance your financial portfolio of real estate investments.

Whether you’re a seasoned investor or a newcomer eager to optimize your tax planning, understanding and harnessing the potential of these classifications can accelerate your progress toward meeting your real estate investment goals and your overall financial goals.

Claiming Real Estate Losses Against Ordinary Income

As real estate investors know, rental real estate is ordinarily a “passive” activity. Generally, when you’re preparing your tax return, you can deduct passive losses only from *passive income* – income from sources such as stocks, mutual funds, royalties, and rental properties. You’re generally not allowed to deduct passive losses against *ordinary income* – income from sources such as salary and interest.

If all your income is passive, or if your passive gains exceed your passive losses, this restriction doesn’t impact your tax obligation. However, if your passive losses exceed your passive gains, and you have ordinary income, being able to claim passive losses against ordinary income can reduce your tax obligation.

There are two important exceptions that allow you to claim passive losses against ordinary income:

- If you pass the “material participation” test, you may be able to deduct up to \$25,000 of rental real estate losses against ordinary income – even if you don’t qualify as a real estate professional.
- If you do qualify as a “real estate professional,” you can elect not to treat income from the rental activities in which you “materially participate” as passive. This allows you to deduct your full loss from those activities, not just your first \$25,000. In addition, you can claim the deduction regardless of your overall adjusted gross income (AGI).

Proving “Material Participation”

So how exactly do you go about proving material participation in real estate activities for tax planning purposes? Material participation means you are actively and genuinely involved in a real estate activity, such as managing a rental property. That’s as opposed to just investing money and letting someone else do all the work. For those opting for the former, the United States Internal Revenue Service (IRS) has created a test.

According to the IRS, you can demonstrate material participation the following ways:

500-Hour Test: To meet this test, you need to have spent at least 500 hours during the year for which you’re filing actively working on real estate activities. This may include tasks like managing property, making real estate-related decisions, and doing maintenance work.

Substantially All Test: This test requires that your participation in the real estate activity constitutes substantially all the work done in that activity throughout the year. While there’s no specific percentage defined for “substantially all,” it often means you must be significantly involved and not just a passive investor. For example:

- You provide “substantially all” management services
- You participate for more than 100 hours during the tax year, and your participation is not less than that of any other individual (including non-owners) for the year

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- You “significantly participate” and your aggregate participation in all “significant participation” activities exceeds 500 hours
- You materially participated for any five (5) tax years (consecutive or not) during the 10 tax years that precede the current year
- Your activity is a *personal service* activity, and you materially participated for any three (3) tax years (consecutive or not) preceding the current year
- •Based on all of the facts and circumstances, you participate on a regular, continuous, and substantial basis

Warning – Property Managers: If a property has a separate manager, passing the material participation test as a real estate professional is nearly impossible. You would fail the test of providing substantially all the management services and would most likely not have enough activity to meet the 500-hour material participation requirement.

Identifying Yourself as a “Real Estate Professional”

Here’s the good news. If you meet the “material participation” test in one or more activities, you’ll qualify as a “real estate professional” – if you meet two further tests:

1. You spend at least 750 hours per year in “real property trades or businesses” in which you materially participate. (*More about this below.*)
2. You spend more than half of your working time on real estate activities in which you materially participate.

Qualifying trades or businesses include property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Services you perform as an employee are not treated as performed in real property trades or businesses unless you own five percent (5%) or more of the employer entity. Hours that you’re “on call” or “willing to work” do not count towards this 750-hour requirement.

Laying Claim to Real Estate Tax Breaks

Below are a few tips to help you take advantage of these potential tax breaks. However, keep in mind that specific rules and requirements can be complex and may change over time. As a result, we recommend consulting with a trusted tax planning professional who can provide guidance tailored to your individual circumstances.

- **Record Keeping:** Keep a good business diary or appointment book to verify your hours of service. While U.S. Treasury Department regulations do not prescribe specific recordkeeping requirements, they don’t allow a post-event “ballpark guesstimate.”
- **Passive Income Generators:** If your income is too high to claim the rental real estate loss allowance and you don’t qualify as a real estate professional,

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you may be able to acquire passive income generators (generally limited partnerships) for tax-free income to be “soaked up” by real estate losses. If you’re self-employed, you might restructure part of your business to generate passive income that can be soaked up as well. Ask your tax planning professional about this before making many related moves!

- **Lumping Real Estate Activities:** Consider lumping all your real estate activities into a single activity. Material participation is defined separately for each activity, but you can elect to treat all of your real estate activities as a single activity. This makes sense if no single activity meets the 750-hour test to qualify for “real estate professional” status, or if you don’t meet the material participation test in an activity generating losses that would be disallowed if you chose not to aggregate your activities.
- **Form 1040, Schedule E, Part V:** Make the election by filing a statement with your original return for any taxable year in which you qualify by completing the “Reconciliation for Real Estate Professionals” on Form 1040, Schedule E, Part V, to identify yourself as a real estate professional. The election is binding for the year made and all future years (even if you no longer would qualify to make the election) You can revoke it only if there is a “material change” in your facts and circumstances.

If you’re struggling to decide whether making the Reconciliation for Real Estate Professionals election is in your best interests, or if you’re having trouble figuring out how to maximize your tax savings as a real estate investor or real estate professional, we can help. [Contact us](#) to schedule a consultation.

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