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**Real Estate Professional Tax Update**

# Agenda



- Passive Activity Reporting
- Real Estate Professional
- IRS Audit Update
- Tax Relief Act of 2010

# Passive Activity Reporting

- Why matter?
  - Losses from passive activities can only offset income from passive activities
  - Suspended losses carried forward
- What is a passive activity?
  - Ordinary trade or business with no material participation
  - Rental of equipment or real estate

# Passive Activity Reporting

- Exceptions to passive activity rules
  - Active rental real estate losses up to \$25,000
  - Disposition of a passive activity
  - Materially participating real estate professional
  - Securities traders
  - Working interests in oil and gas

# Passive Activity Reporting

- Active rental real estate
  - Maximum allowable loss of \$25,000
  - Phase out begins @ \$100,000 of modified AGI (fully phased out at \$150,000 or more)
  - Not available to limited partners and owners with < 10% ownership in entity

# Passive Activity Reporting

- Material participation tests (7):
  - More than 500 hours
  - “Substantially all” of the work
  - More than 100 hours and no one does more
  - “Significant participation activity”
    - All trade or business activities between 100 and 500 hours and in total together exceed 500 hours
  - Materially participated in any 5 of last 10 preceding years

# Passive Activity Reporting

- Material participation tests (7) (continued)
  - Materially participated in a “personal service activity” in any 3 prior years
    - Fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor
  - Facts and circumstances

# Passive Activity Reporting

- Limited partners are always passive unless:
  - More than 500 hours
  - Material participation in any 5 of last 10 years
  - Material participation in any 3 prior years for personal service activities
- What about LLC members?



# Passive Activity Reporting

- Grouping activities
  - Revenue Procedure 2010-13
    - Mandatory written statement in 2011 and future tax returns
    - Covers any changes to groupings or new activities acquired after 12/31/2010
    - No reporting prior to 2011

# Passive Activity Reporting

- Grouping activities (continued)
  - Appropriate “economic unit”
    - Similarities in business types
    - Common control and ownership
    - Geographic location
    - Interdependencies between activities
  - Rental activities generally cannot be grouped with trade or business activities

# Passive Activity Reporting

- Why group?
  - Material participation is determined at the activity level
  - Active participation is determined at the activity level
  - Suspended losses become allowable upon complete disposition of an entire activity in a taxable transaction

# Real Estate Professional

- Why be one?
  - Current deduction for otherwise passive losses from rental real estate activities

# Real Estate Professional

- Who is one?
  - Someone who
    - Spends more than 50% of their personal service time in real property trades or businesses in which they materially participate, **and**
    - Performs more than 750 hours of service in real property trades or businesses in which they materially participate

# Real Estate Professional

- Real property trades or businesses include real property
  - Development or redevelopment
  - Construction or reconstruction
  - Acquisition
  - Conversion
  - Rental
  - Operation

# Real Estate Professional

- Real property trades or businesses include real property (continued)
  - Management
  - Leasing
  - Brokerage (including real estate agents)

# Real Estate Professional

- Real property trades or businesses **do not** include
  - Professionals such as attorneys, accountants, bankers, investment advisors, mortgage brokers, etc. specializing in real estate
  - Interior decorator
  - Anyone peripherally involved in real property trades or businesses



# Real Estate Professional

- Other special rules
  - More than 50% and more than 750 hours tests applied individually to each spouse
    - If one spouse qualifies, so does the other
    - Do get to count toward material participation test hours of spouse in same trade or business
  - 5% or less owners of an otherwise qualifying business cannot count time toward the more than 50% and more than 750 hours tests

# Real Estate Professional

- I'm a real estate professional, so I get to deduct my rental losses, right?

# Real Estate Professional

- **Wrong** ... one more test
  - Can only deduct such losses if materially participate in **each** rental activity
  - Material participation for rentals generally consists of only 3 tests
    - More than 500 hours
    - Substantially all of the work
    - More than 100 hours, and no one else did more

# Real Estate Professional

- Exception to material participation in each rental activity requirement
  - File a written election to treat all real estate rentals as one single activity (“aggregation election”)
    - Once filed, election is binding on all future years
    - Keep copy of return with election in permanent records

Did you materially participate in that activity this year?

Did you participate more than 500 hours in day to day operations this year?

yes →

no ↓

Did you do substantially all the work in the activity this year?

yes →

no ↓

Did you participate more than 100 hours and more than anyone else during this year?

yes →

no ↓

Have you materially participated in this activity in any five of the last ten years?

yes →

no ↓

Is this a personal service activity, did you materially participate for any three years before this year?

yes →

no ↓

Were there other facts and circumstances which indicate material participation during year?

yes →

no ↓

You were a material participant for this year!

You were not a material participant for this year

# Did you qualify as a Real Estate Professional this year?

Did you materially participate in a trade or business in which you own more than 5% this year?

no →

yes ↓

Did you spend more than half of your professional time this year performing services for real property trades or businesses?

no →

yes ↓

Did you spend more than 750 hours this year performing services for real property trades or businesses?

no →

yes ↓

You do not qualify as a Real Estate Professional

You qualify as a Real Estate Professional this year!  
**But wait, there's more!**  
Do you have a Grouping election in place? If not, are you planning to make one this year?

yes →

Treat all RP rental activities as one activity and ask yourself: did I materially participate in this activity?  
(refer to the first three qualifications on the material flowchart)

Your activity is treated as nonpassive

yes ↙

yes ↗

For each RP rental activity, ask yourself: did I materially participate in this activity?  
(refer to the first three qualifications on the material flowchart)

no →

Your activity is treated as passive

no ↙

# IRS Audit Update



- Targeting passive activities in general, and real estate professionals in particular
  - Really a rental real estate activity?
    - Hotels, motels, vacation condos, beach cottages, property held for investment, property under construction or renovation
- Many new inexperienced auditors
- Specially designed audit programs

# IRS Audit Update



- Typical document requests include
  - Copy of grouping election, if made
  - Copies of property management agreements and other relevant contracts for each rental
  - Copies of year end property management statements/reports
  - Log of time spent by activity, or any other supporting documentation of time spent



# IRS Audit Update



- Audit strategies to consider
  - Appropriate passive activity groupings?
  - Real estate professional qualifications met?
  - Material participation for each rental activity?
    - If grouping election made, test all rental activities
    - If grouping election not made, test each separate rental activity
  - Did independent contractors do more than you?

# IRS Audit Update



- Audit strategies (continued)
  - Will all time spent qualify?
    - Investor time such as reading monthly reports, analyses, etc. (unless involved in day-to-day operations)
    - Be careful if you have a property manager or management company
    - Work not customarily done by owner
    - Employee time or for trades or businesses
    - Time spent on acquisitions or dispositions
    - Travel time

# Tax Relief Act of 2010

- Signed by President Obama on 12/17/2010
- Followed up the Small Business Jobs Act of 2010 enacted on 9/27/2010
- Extended many of the Bush tax cuts for 2 more years, included typical “tax extenders”, and added some very surprising gift and estate tax provisions

# Tax Relief Act of 2010

- Income tax rates
  - Extended reduced tax rates through 2012
    - 35% - maximum federal
    - 15% - qualified dividends
    - 15% - capital gains
    - 25% - depreciation recapture
  - Absent future legislation, rates return to Clinton years effective in 2013

# Tax Relief Act of 2010

- Bonus depreciation
  - 100% bonus depreciation for assets placed in service from 9/9/2010 – 12/31/2011
  - 50% bonus depreciation for assets placed in service from 1/1/2010 – 9/8/2010 & 2012
  - Applies only to “new” property
  - Oregon **not** connected (i.e., no bonus)

# Tax Relief Act of 2010

- Section 179 expensing
  - Up to \$500,000 for assets placed in service in 2010 or 2011 (\$2 million phase out level)
  - Up to \$250,000 of the \$500,000 can be for “qualified real property”
  - Applies to both “new” and “used” property
  - Oregon **not** connected
    - \$134,000 maximum for 2010
    - \$25,000 maximum for 2011 forward

# Tax Relief Act of 2010

- 15 year MACRS recovery period
  - Extended shorter depreciable life for 2010 & 2011 for:
    - Qualified leasehold improvements
    - Qualified restaurant property
    - Qualified retail improvements
  - Oregon **not** connected

# Tax Relief Act of 2010

- Other provisions
  - Personal exemption and itemized deduction phase-out rules for higher income taxpayers extended through 2012
  - AMT “patch” added for 2010 and 2011 (inflation indexed exemption amount)
  - 2% Social Security payroll tax cut for 2011
    - Applies both to wage earners and self-employed
    - Maximum benefit is \$2,136 per taxpayer



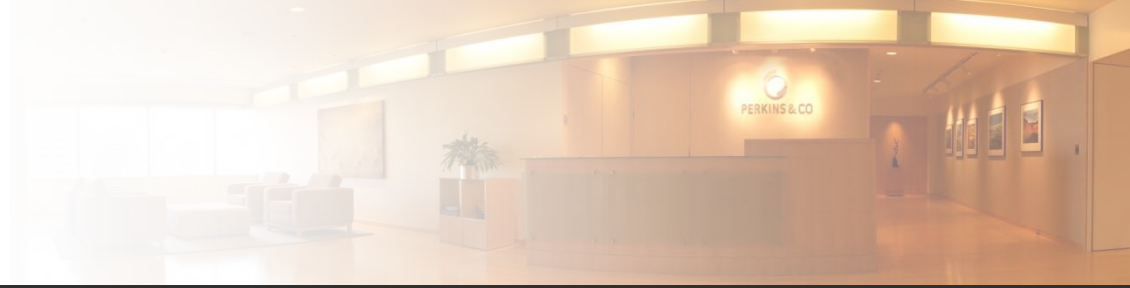
# Tax Relief Act of 2010

- Other provisions (continued)
  - Retroactively enacted for 2010 and extended through 2011 the following:
    - Research credit
    - New markets tax credit
    - Expensing of environmental remediation costs
    - Cash grant in lieu of claiming credit for ITC
    - Credits for energy efficient appliances and energy efficiency existing home improvements

# Tax Relief Act of 2010

- Other provisions (continued)
  - Retroactively enacted for 2010 & extended through 2011 the following:
    - Itemized deduction for sales taxes
    - Tax-free distributions from IRAs to charity (maximum of \$100,000 for taxpayers age 70 ½ or older)
    - Acquisition of qualified small business stock eligible for 100% exclusion
    - Deduction for mortgage insurance premiums as qualified residence interest expense

# Conclusion



- Pay attention to your activities
- Document your time
- Visit our website