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Mr. A. Smith
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Dear Mr. Smith:

IRS Definitions for "Real Estate Investors"

The IRS does not view all real estate investors as created equal. If you are a real estate investor, there are four different types of real estate investor definitions that you will want to know. They are as follows and in this letter I discuss the benefits of the Real Estate Professional (#3).

1. Real Estate Investor
2. Real Estate Dealer
- 3. Real Estate Professional**
4. Real Estate Developer

Did you know that if in addition to your regular business (which has nothing to do with real estate), if you have a number of rental real estate properties that are throwing off losses, you may be able to claim those losses against your other income for tax purposes. As you may be aware, the passive activity loss (PAL) rules would normally make this impossible. Under those rules, losses from passive activities—that is, activities in which you do not “materially participate” (see below)—cannot be deducted against nonpassive activity income (such as salary, professional fees, income from a business in which you do materially participate, interest, or dividends); and credits from passive activities cannot be used to reduce taxes on nonpassive activity income. For purposes of the PAL rules, rental real estate activities are automatically treated as passive activities, even if the owner “materially participates” in their management, operations, etc. As a result, tax losses from rental realty can't be deducted against nonpassive income.

One important exception to this rule allows taxpayers to deduct up to \$25,000 of losses and credits from passive rental real estate activities against nonpassive income, if they “actively participate” in those activities. (Active participation requires a lesser degree of participation than “material participation”). This exception phases out for taxpayers with adjusted gross income over \$100,000.

There's another exception to the above rule that's even more potentially beneficial than the \$25,000 active participation rule I just mentioned. If you qualify as a “real estate professional,” your rental real estate interests are not automatically treated as passive activities. As a result, if you materially participate in the rental real estate activity, the activity will not be treated as passive, and you *will* be entitled to deduct losses from that activity against nonpassive income. In



addition, the amount of losses and credits allowed under the \$25,000 active participation rule is determined *after* any recharacterization of rental real estate activities as nonpassive under the rules discussed above. As a result, if you're a real estate professional, you can deduct against nonpassive income not only losses and credits from rental real estate that are nonpassive under the above rules, but up to \$25,000 of losses and credits from “active participation” rental real estate activities that remain passive after application of those rules.

How do you qualify as a real estate professional? First, you must materially participate (see below) in a real estate business. The business of renting and leasing realty is a real estate business. Second, more than 50% of the personal services you perform in all businesses during the year must be performed in real estate businesses in which you materially participate. Third, your personal services in material participation real property businesses during the year must amount to more than 750 hours. For these purposes, you can't count any work you perform in your capacity as an investor.

In determining whether you qualify as a real estate professional, each of your rental real estate interests is treated as a separate activity—that is, as a separate business—unless you make an election to treat all those interests as a single activity. Because of this rule, if you have multiple rental properties and you don't make the election, you must establish material participation for each property separately, and must satisfy the more-than-50% test *and* the 750-hours test for each property separately in order to qualify as a real estate professional with respect to that property—and qualifying for one property wouldn't mean you qualify for any other property. Thus, if you don't make the election, qualifying as a real estate professional for all your properties becomes more difficult (and may become impossible) as the number of properties increases. But if you do make the election, you only have to establish material participation, and satisfy the more-than-50% test and the 750-hours test, for the combined properties as a whole.

You don't have to work full-time in real estate to qualify as a real estate professional. Even if you have another occupation, you can qualify if you materially participate in a real estate business, and spend more time, and more than 750 hours, on that business. (But remember, in this case, if you have multiple properties, it may be difficult or impossible to qualify unless you make the “single interest” election mentioned above.)

These tests are applied annually. This means that you may qualify as a real estate professional in some years but not in other years. As a result, the same real estate activity may generate passive losses in some years and nonpassive losses in other years.

If you're a real estate professional, what more do you have to do to treat losses from rental real estate as nonpassive? If you qualify as a real estate professional, your rental real estate properties are not automatically treated as passive. This doesn't mean that they are automatically treated as nonpassive—it means that, if you materially participate (as explained below) in the operation of a rental real estate property, then it will be treated as nonpassive, and you may deduct losses from that property against other nonpassive income.

But if the real estate business that qualifies you as a real estate professional is the renting or leasing of real property, as discussed above, you will already have established that you materially participate in that business—because if you don't, you can't qualify as a real estate professional on the basis of that business (see above).



As I mentioned above, if you have multiple properties, you may not be able to qualify as a real estate professional unless you elect to treat *all* your rental real estate interests as a single activity. If you make the election, it applies both for purposes of qualifying you as a real estate professional, and for all other purposes of the PAL rules. And, generally speaking, the election is irrevocable. This means that you can't make the election in order to qualify as a real estate professional, and then revoke it with respect to a particular property later, when, for example, that property produces income, and you'd like to use that income to absorb losses from another non-real-estate-related passive activity. Making the election will also disqualify you from utilizing the \$25,000 active participation rule mentioned above, because that rule applies only with respect to losses from rental real estate activities that are passive, and the election will—presumably—work to make your rental real estate properties nonpassive. (If making the election is the right course for you, I can make sure that it is made in a timely and proper fashion.)

What's material participation in an activity? Material participation in an activity means involvement in the operations of the activity on a regular, continuous, and substantial basis. If a taxpayer passes one of the following seven tests, IRS accepts that as establishing material participation in an activity:

- participating in the activity for more than 500 hours in the tax year (the most frequently utilized test);
- participating in the activity if the taxpayer's participation is substantially all of the participation in that activity by any individuals (including non-owners);
- participating in the activity for more than 100 hours in the tax year, if nobody else (including nonowners) participated more;
- participating significantly in the activity, if participation in all “significant participation” activities for the tax year exceeds 500 hours (but this test isn't accepted for showing material participation in rental activities);
- having materially participated in the activity during any five of the ten tax years before the year at issue;
- with respect to personal service activities, having materially participated in the activity for any three years (not necessarily consecutive) before the year at issue;
- showing regular, continuous and substantial participation on the basis of all the relevant facts and circumstances, but only if more than 100 hours of participation during the tax year can be shown (and management services aren't taken into account for purposes of this test unless certain stringent requirements are satisfied).

The extent of an individual's material participation in an activity may be established by any reasonable means. But the most reliable means of showing material participation consists of contemporaneously kept appointment books, calendars, daily time reports, logs, or similar documents that provide a detailed account of what the taxpayer did with respect to an activity, when he or she did it, and how much time it took. Failure to substantiate material participation is one of the most common ways of losing the right to treat rental real estate activities as nonpassive.



Please call me to schedule an in-depth review to determine whether you can qualify as a real estate professional, and how you might use the above rules to your advantage—or to discuss any other aspect of your business.

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Very truly yours,
PIASCIK & ASSOCIATES, P.C.

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