



# HOW TO MAKE RENTAL LOSS DEDUCTIBLE: ACTIVE PARTICIPATION VS. MATERIAL PARTICIPATION

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It is helpful for taxpayers with rental properties to know the rules and regulations about deductible rental losses.

Understanding the difference between active participation and material participation is crucial as these two terms play a big role in determining the deductibility of rental losses.

In general, rental activity is considered a passive activity that creates passive income or passive losses.

There are two types of passive activities:

1. **Trade or business activities**, in which taxpayers do not materially participate during the year.
2. **Rental activities**, including rental real estate activities, are passive activities even if taxpayers materially participate unless they qualify as a real estate professional.

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Typically, passive rental losses are only deductible against passive activity income. However, there are two exceptions which the IRS provides to the [Passive Activity Loss Rules](#):

1. The \$25,000 deduction for actively participating in rental real estate.
2. The real estate professional exemption.

## RENTAL REAL ESTATE WITH ACTIVE PARTICIPATION

If the taxpayer or spouse **actively participated** in a passive rental real activity, the taxpayer may be eligible to deduct up to \$25,000 from the rental losses against nonpassive income. Examples of nonpassive income are salaries, wages, 1099 commission income, guaranteed payments, interest and dividends, and royalties derived from the ordinary course of business. This special allowance is an exception to the general rule of disallowing losses more than income from passive activities.

### EXAMPLE

Maria is single and has \$50,000 in wages, \$2,000 of passive income from a limited partnership, and \$3,500 of passive loss from a rental real estate activity in which she actively participated. \$2,000 of Maria's \$3,500 loss offsets her passive income. The remaining \$1,500 loss can be deducted from her \$50,000 wages.

To actively participate in rental real estate activities, taxpayers must:

- Own 10% or more of the rental property.
- Make management decisions in a significant and bona fide sense. Management decisions that count as active participation include approving new tenants, deciding on rental terms, approving expenditures, and other similar decisions. Taxpayers have a significant involvement in the management of the rental property and cannot just leave it to a property manager.

The \$25,000 special allowance will be reduced by 50% of the amount by which the modified adjusted gross income (MAGI) for the taxable year exceeds \$100,000, and completely phased out if the MAGI is above \$150,000.







## RENTAL REAL ESTATE WITH MATERIAL PARTICIPATION

A real estate professional who materially participates in the business can offset ordinary income against passive real estate losses. The following requirements must be met to qualify as a real estate professional:

- During the tax year, more than half of the personal services performed in all trades or businesses were performed in real property trades or businesses in which a taxpayer materially participated. This does not include personal services performed as an employee in real property trades or businesses unless you were a 5% owner of your employer.
- During the tax year, performed more than 750 hours of services in real property trades or businesses in which a taxpayer materially participated.

A taxpayer must materially participate in a real property trade or business for the personal services provided by the taxpayer in that real property trade or business to count towards meeting the qualifying taxpayer requirements as mentioned above (more than 50% of time and more than 750 hours test).

IRS Publication 925 listed the material participation tests. The taxpayer materially participated in a trade or business for a tax year if any of the following tests are satisfied:

1. The taxpayer participated in the activity for more than 500 hours during the year.
2. The taxpayer's participation was substantially all the participation in the activity of all individuals for the tax year, including the participation of individuals who are not owners of interests in the activity.
3. The taxpayer participated in the activity for more than 100 hours during the taxable year and participated at least as much as any other individual (including individuals who are not owners of interest in the activity) for the year.
4. The activity is a significant participation activity, and the taxpayer participated in all significant participation activities for more than 500 hours. A significant participation activity is any trade or business activity in which you participated for more than 100 hours during the year and in which you didn't materially participate under any of the material participation tests, other than this test.
5. The taxpayer materially participated in the activity for any five (whether or not consecutive) of the ten immediately preceding tax years.
6. The activity is a personal service activity and the taxpayer materially participated in the activity for any three (whether or not consecutive) preceding tax years. An activity is a personal service activity if it involves the performance of personal services in the fields of health (including veterinary services), 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.
7. Based on all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year.



Qualifying as a real estate professional has many benefits, including the following listed below:

- Rental loss deduction is unlimited.
- All the losses from real estate can be treated as active losses which means they can be offset against ordinary income.
- Taxable income gets lower by deducting qualifying expenses and losses from their overall taxable income.
- Can waive the 3.8% net investment income tax if the rental activity rises to a trade or a business and material participation takes place in the business.
- Maintaining accurate records and documentation should be common practice for a real estate professional to substantiate their qualification.

If you are engaged in rental activity, you can find guidelines for determining material participation, the rules for determining who is a real estate professional and what is active participation in [Publication 925, Passive Activity and At-Risk Rules](#).

KROST is here to assist you if you need any help with your rental activity. [Contact our team of real estate professionals](#) with any questions or concerns. However, remember, a two-step authentication and strong password should still be key elements when setting up or updating accounts. Essentially, a client portal adds another layer of protection.

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## **About the Author**



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Elvira Frencillo is a Tax Director at KROST. She has 30 years of accounting, financial, and taxation experience in both public and private industries. She has been in public accounting for over 15 years. Her areas of focus include tax planning, tax compliance, financial reporting for individuals and their closely held businesses, partnerships, corporations, and trusts. [» Full Bio](#)