# 7 Rental, Passive, and At-Risk

## Tab 7 Contents



### MACRS Recovery Periods for Property Used in Rental Activities

| *Type of Property* | *General Depreciation System (GDS)* | *Alternative Depreciation System (ADS)* |
|---|---|---|
| Computers and peripheral equipment | 5 years | 5 years |
| Office machinery—typewriters, calculators, copiers | 5 years | 6 years |
| Automobiles, light trucks | 5 years | 5 years |
| Appliances—stoves, refrigerators | 5 years | 9 years |
| Carpeting | 5 years | 9 years |
| Furniture used in rental property | 5 years | 9 years |
| Office furniture and equipment—desks, files | 7 years | 10 years |
| Roads, shrubbery, fences | 15 years | 20 years |
| Residential rental property—buildings and structural components. See *Cost Segregation,* page 9-16. | 27.5 years | 30 years |
| Any property that does not have a class life and that has not been designated by law as being in any other class | 7 years | 12 years |
| Additions and improvements. See *Repairs and Improvements,* page 9-11. | Same recovery period as underlying property, as if property was placed in service at same time as the addition or improvement. | |

See *Depreciation,* Tab 9.

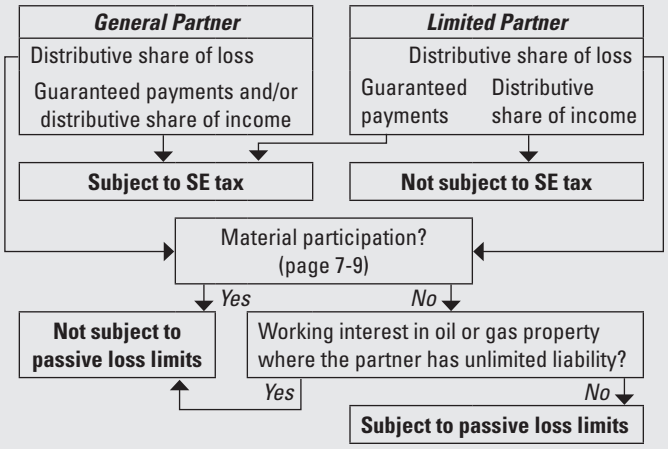
## New for 2024

- **Standard mileage rate.** The business standard mileage rate is 67.0¢ for 2024. See *Local transportation expenses,* page 7-4.

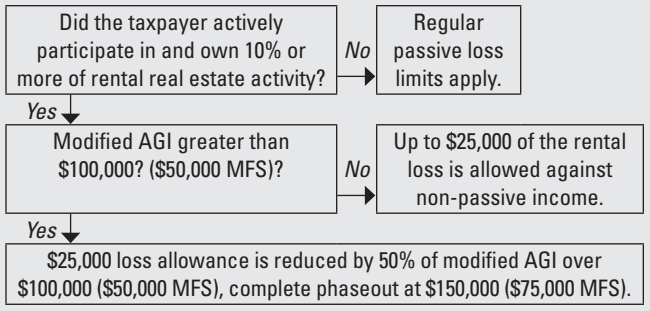
## Common Elections

- Qualified joint venture election, page 7-4.
- Election to increase basis for unused passive activity credits, page 7-8.
- Special election to combine rental activities—real estate professional, page 7-11.

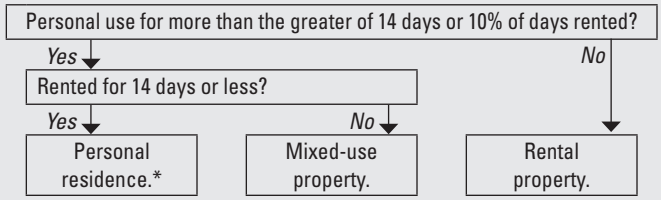
### Partnerships (See *Passive Activity Losses,* page 7-7)




### Special $25,000 Allowance for Rental Real Estate Chart (page 7-11)




### How to Classify Rental Property for Tax Treatment (page 7-5)




* Rental income not reported, expenses not allowed, report real estate taxes and qualified mortgage interest on Schedule A (Form 1040).

# Schedule E (Form 1040), Supplemental Income and Loss

## Cross References

- Schedule E (Form 1040), *Supplemental Income and Loss*
- IRS Pub. 527, *Residential Rental Property*
- IRS Pub. 925, *Passive Activity and At-Risk Rules*
- IRS Pub. 946, *How to Depreciate Property*

## Related Topics

- Interest Tracing Rules (Allocation of Interest), Tab 4
- Business Deductions, page 8-4
- Depreciation, Tab 9
- Depletion, page 9-17

## Schedule E (Form 1040), *Supplemental Income and Loss*

Use Schedule E (Form 1040) to report income or loss from rental real estate, royalties, partnerships, S corporations, estates, trusts, and residual interests in real estate mortgage investment conduits (REMICs).

**Rental of personal property.** Do not use Schedule E (Form 1040) to report income and expenses from the rental of personal property such as equipment or vehicles, unless the personal property is leased with real estate. If an individual is in the business of renting personal property, report income and expenses on Schedule C (Form 1040), *Profit or Loss From Business.* Renting personal property is a business if the primary purpose for renting the property is income or profit, and the taxpayer is involved in the rental activity with continuity and regularity.

If the rental of personal property is not a business, report income as Other Income on line 8l, Schedule 1 (Form 1040), and report expenses on line 24b, Schedule 1.

## Part I—Rental Real Estate and Royalties

Use Part I, Schedule E (Form 1040), to report the following.

- Income and expenses from rental real estate. Individuals who own a part interest in a rental real estate property report only their part of the income and expenses on Schedule E.
- Royalty income and expenses. Leave lines 1a and 2 of Part I blank for royalty property.

If the taxpayer has more than three rental real estate or royalty properties, attach as many Schedules E as necessary. However, fill in lines 23a through 26 on only one Schedule E.

See *Rental Real Estate,* page 7-3.

**Passive loss rules.** Rental activities are classified by statute as passive activities and are subject to passive loss limits. See *Limits on Rental Losses,* page 7-4.

**Fair rental days vs. personal use days.** If a rental unit is also used for personal purposes during the year, the taxpayer must report on Schedule E (Form 1040) the number of days the property was rented at fair rental value and the number of days of personal use. See *Mixed-Use Property—Vacation Homes (IRC §280A),* page 7-5, and *Personal use,* page 7-6.

**Working interest in oil or gas property.** A working interest in an oil or gas well held directly, or through an entity that does not limit liability, is not a passive activity even if the taxpayer did not materially participate. A working interest is one in which the owner pays all of the development and operating expenses to extract the oil or gas from the ground. Report income and expenses on Schedule C (Form 1040) and Schedule SE (Form 1040), *Self-Employment Tax.*

***Exception:*** Working interest income and expenses which are reported to a partner or S corporation shareholder on Schedule K-1, *Partner's* or *Shareholder's Share of Income, Deductions, Credits, Etc.,* should be reported on Part II, Schedule E, and on Schedule SE.

***Depletion.*** For more information on the depletion allowance for oil and gas properties, see *Depletion,* page 9-17.

**Royalties.** Royalty income from oil, gas, or mineral properties (not including operating interests), copyrights, and patents is reported on Part I, Schedule E. Use a separate column for each royalty property. Royalty income earned by a taxpayer who is in business as a self-employed writer, artist, inventor, etc., is reported on Schedule C (Form 1040), and is subject to self-employment tax. See *Royalties,* Tab 5.

## Part II—Partnerships and S Corporations

**Schedule K-1.** Information about partnership or S corporation income and deductions are passed through to partners on Schedule K-1 (Form 1065) or to shareholders on Schedule K-1 (Form 1120-S). Ordinary business income or loss is reported on Part II, Schedule E (Form 1040), which then flows through to line 5, Schedule 1 (Form 1040), *Additional Income and Adjustments to Income.* Instructions on how to report items from Schedule K-1 should be included with Schedule K-1. Do not attach Schedule K-1 to the 1040 tax return.

**Basis limitation.** Losses from partnerships and S corporations are limited to the partner's or shareholder's basis. See *Shareholder Basis,* Tab 19, and *Basis,* page 20-13.

**Separately stated items.** Most items of income and deductions flowing through on Schedules K-1 are combined and reported as one amount of ordinary income or loss. However, items that may be treated differently on returns of the recipients (such as charitable contributions or the Section 179 deduction) are reported as separately stated items, and are reported on various forms and schedules of Form 1040. For a listing of Schedule K-1 codes, see *Schedule K-1 Codes (Form 1120-S)—S Corporation,* Tab 19, and *Schedule K-1 Codes (Form 1065)—Partnership,* page 20-3.

**Unreimbursed partnership expenses.** Unreimbursed business expenses paid by a partner are deductible if the expenses were required to be paid under the partnership agreement. Enter such expenses on a separate line on line 28, column (i), Schedule E (Form 1040). See *Unreimbursed Partnership Expenses,* page 20-12.

**Self-employment tax.** For a partner, net earnings from self-employment are reported in box 14, Code A, Schedule K-1 (Form 1065). This amount is also reported on Schedule SE (Form 1040), *Self-Employment Tax.*

An S corporation shareholder's portion of net income is not subject to self-employment tax.

For more information about reporting income and deductions from partnerships and S corporations, see *S Corporation Example,* Tab 19, and *Partnership Example,* page 20-23.

**Pass-through entities—fiscal year.** Income, loss, or deductions passed through to partners, S corporation shareholders, and estate beneficiaries are reported by recipients in the year in which the entity's tax year ends.

**Example:** Elmer is a calendar year taxpayer. He has an interest in Bugs Partnership that has a fiscal year ending January 31. Elmer's distributive share of Bugs Partnership income will be $25,000 for the fiscal year ending January 31, 2025. During 2024, Elmer took partnership distributions totaling $25,000. Elmer will report the income and pay the tax on his 2025 income tax return even though most of the income was earned and distributions were taken in 2024.

## Part III—Estates and Trusts

Use Part III, Schedule E (Form 1040), to report income (even if not distributed) or loss from estates and trusts. The information to report should be provided by the fiduciary on Schedule K-1 (Form 1041). Do not attach Schedule K-1 to the tax return. See *Pass-through entities—fiscal year,* page 7-2.

If estimated taxes are credited to the taxpayer through a trust, write "ES payment claimed" and the amount on the dotted line next to line 37, Schedule E. Enter the amount as an estimated payment on line 26, Form 1040.

For more information about estates and trusts, see *Estates, Trusts, and Fiduciaries,* Tab 21. For a listing of Schedule K-1 codes, see *Estates and Trusts (Form 1041) K-1 Codes,* page 21-5.

## Missing or Erroneous Schedule K-1—Form 8082

If there will be inconsistent treatment between the way an item is reported by a pass-through entity on Schedule K-1 and the way the item is reported on the taxpayer's return, file Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR).* Also use Form 8082 to notify the IRS if a pass-through entity has not issued a Schedule K-1. Form 8082 is filed by partners, S corporation shareholders, beneficiaries of estates or trusts, owners of foreign trusts, or residual interest holders in a real estate mortgage investment conduit (REMIC).

# Rental Real Estate

## Cross References

- Schedule E (Form 1040), *Supplemental Income and Loss*
- IRS Pub. 527, *Residential Rental Property*
- IRC §199A, *Qualified business income*
- IRC §280A, *Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.*
- Rev. Proc. 2019-38

## Related Topics

- Sales of Business Property (Form 4797), page 6-16
- Business Deductions, page 8-4
- Depreciation, Tab 9

## Qualified Business Income Deduction (QBID)—IRC §199A

For tax years 2018 through 2025, eligible taxpayers may be entitled to a deduction of up to 20% of qualified business income (QBI), subject to certain limitations. In general, income from rental real property held for investment purposes is not eligible for the QBID. However, an investor may be eligible for the QBID if the rental activity is operated as a real estate business. Additionally, the rental or licensing of tangible or intangible property to a related trade or business qualifies if both businesses are commonly controlled. See *Qualified Business Income Deduction (QBID)—IRC §199A,* page 8-15.

**Rental real estate safe harbor.** A safe harbor is available for a rental real estate enterprise to be treated as a trade or business solely for purposes of the QBID. (Rev. Proc. 2019-38)

To qualify, the rental enterprise must satisfy all the following requirements for the tax year.

- Maintenance of separate books and records for each rental enterprise to reflect income and expenses,
- For rental real estate enterprises that have been in existence less than four years, 250 or more hours of rental services are performed per year. For other rental real estate enterprises, 250 or more hours of rental services are performed in at least three of the past five consecutive tax years that ends with the current tax year,
- Maintenance of contemporaneous records for hours of all rental services performed, including description of services, dates performed, and who performed the services, and
- Attach a statement, as specified in Rev. Proc. 2019-38, to a timely filed original tax return for each tax year in which the taxpayer relies on the safe harbor.

If an enterprise fails to satisfy these requirements, it may still be treated as a trade or business for purposes of IRC section 199A if the enterprise otherwise meets the definition of a trade or business.

**Safe Harbor Rental Services**

| *Rental Services* | *Not Considered Rental Services* |
|---|---|
| • Advertising to rent property.<br>• Collecting rent.<br>• Daily operation, maintenance, and repair of property.<br>• Management of property.<br>• Negotiating/executing leases.<br>• Purchase of materials.<br>• Supervision of employees and contractors.<br>• Verifying prospective tenant information. | • Arranging property financing.<br>• Financial management activities.<br>• Hours spent travelling to/from rental properties.<br>• Investment management activities.<br>• Planning or constructing capital improvements.<br>• Procuring rental property.<br>• Reviewing financial statements.<br>• Reviewing reports on operations. |

***Excluded rental real estate arrangements.*** The safe harbor does not apply to the following rental real estate arrangements.

- Real estate used by the taxpayer as a personal residence for any part of the year.
- Real estate rented or leased under a triple net lease which requires tenant to pay property taxes, insurance, and maintenance.
- Real estate rented to a trade or business conducted by the taxpayer (including a partnership or S corporation) which is commonly controlled.
- Entire rental real estate enterprise if any portion is treated as a specified service trade or business (SSTB).

***Multiple properties.*** A taxpayer may treat each rental property as a separate rental real estate enterprise, or may treat similar properties as a single rental real estate enterprise. For this purpose, similar properties must be either all residential or all commercial.

## Rental Income

Rental income includes any payment received for the use or occupancy of property. In addition to normal rent payments, the following items are reported as rental income.

**Types of Rental Income**

| *Income* | *Description* |
|---|---|
| Advance rent | Any amount received prior to the period that the payment covers. |
| Payment for cancelling a lease | Any amount paid by a tenant to cancel a lease. |
| Expenses paid by tenant* | Any amount paid by a tenant on behalf of the property owner to cover maintenance or improvement expenses. |
| Property or services** | The FMV of property or services received in lieu of rent. |
| *All of these types of rent are reported as income in the year received.* | |

*continued on next page*

*Types of Rental Income continued*

* *Example:* The tenant pays the cost to repair a furnace and subsequently deducts the amount from rent. The cost of the repair is treated by the property owner as rental income and the same amount is deducted as a rental expense for repairs and maintenance.

** *Example:* The tenant paints the property instead of paying two months rent. The amount of rent the tenant would have paid is included as rental income and the same amount is deducted as a rental expense for painting. If the services are provided at an agreed-upon price, that price is considered the FMV unless there is evidence to the contrary.

**Security deposits.** A security deposit is not included in rental income when received if the property owner plans to return it to the tenant at the end of the lease. Any amount kept during the year because the tenant did not live up to the terms of the lease, is included as rental income. If an amount called a security deposit is to be used as a final payment of rent, it is advance rent and is included as income in the year received.

***Note:*** Individual states have laws requiring payment of interest by property owners who hold security deposits of tenants. Check state laws for more information.

## Qualified Joint Venture Election

A married couple who jointly own and operate a rental real estate business can elect to be treated as a qualified joint venture and not as a partnership for federal tax purposes. A joint venture is qualified if:

- The only members of the joint venture are a married couple who file a joint return,
- Both spouses materially participate (See *Material Participation,* page 7-9), and
- Both spouses elect not to be treated as a partnership.

Generally, rental real estate income or loss is passive, even if the material participation rules are satisfied, and filing as a qualified joint venture will not alter the character of passive income or loss.

***Note:*** The election is not available for joint ownership of property that is not a trade or business or for a business owned and operated by spouses through an LLC.

**Making the election.** To make the election, check the "QJV" box on line 2 of Part I, Schedule E (Form 1040), for each property that is part of the qualified joint venture. Divide all items of income, gain, loss, deduction, and credit attributable to the rental real estate business between the taxpayer and spouse, and report as separate rental properties. Once made, the election cannot be revoked without IRS permission.

## Payments Requiring Forms 1099

For information on when a taxpayer may be required to file Forms 1099, see *Form 1099-NEC, Nonemployee Compensation,* page 23-7, and *Form 1099-MISC, Miscellaneous Information,* page 23-8.

## Rental Expenses

The same general rules apply to rental expenses that apply to business expenses. For information about specific expense items, see *Business Deductions,* page 8-4.

**Start-up costs.** Costs paid or incurred before a rental real estate activity begins are start-up costs. For more information about start-up costs for rental real estate activities, see *Start-Up/Organizational Costs,* page 8-22.

**Depreciation.** Depreciation deductions begin when property is ready and available for rent.

***Note:*** If the property is converted from personal use, the basis used for depreciation is the lesser of FMV or original cost. See *Property converted from personal use,* page 9-3.

**Vacant property.** Expenses are deductible beginning at the time the property is available for rent regardless of when rental income is actually received.

**Insurance premiums paid in advance.** Insurance premiums paid more than 12 months in advance are deducted in the year to which the policy applies. Premiums paid for 12 months or less are deductible in the year paid.

**Local transportation expenses.** Local transportation expenses incurred to collect rental income or to manage, conserve, or maintain rental property are deductible. The taxpayer may deduct either actual expenses or the business standard mileage rate for an auto (67¢ per mile for 2024). For more information about auto expenses, see *Automobiles and Listed Property,* Tab 10.

**Commuting.** IRS regulations for investment expenses specifically mention a commuter's expenses as nondeductible, which means the same commuting rules that apply to business expenses also apply to passive rental activities. [Reg. §1.212-1(f)]

See *Commuting,* page 10-2.

**Travel expenses.** Expenses for traveling away from home, such as transportation and lodging, are deductible if the primary purpose of the trip is to manage, collect rental income, conserve, or maintain the rental property. For more information about travel expenses, see *Travel and Lodging,* page 8-10.

**Prepaid interest.** Do not deduct prepaid interest when paid. Instead, deduct prepaid interest in the period to which it applies. Points or loan origination fees paid for rental property are deducted over the life of the loan.

***Business interest expense limitation.*** For 2024, a limitation applies on the deduction for business interest for taxpayers with average annual gross receipts in excess of $30 million. Interest paid as part of a rental real estate activity is not subject to the limitation on business interest unless the rental real estate activity is a trade or business. For more information, see *Business Interest Expense Limitation,* page 20-9.

## Limits on Rental Losses

Limits to rental losses must be considered in the following order.

- At-risk limits. See *At-Risk Rules,* page 7-12.
- Passive activity loss limits. See *Passive Activity Losses,* page 7-7, and *Special $25,000 Allowance for Rental Real Estate,* page 7-11.
- Excess business loss limits.

**Excess business loss limitation.** A loss from a trade or business of a noncorporate taxpayer may be limited, including a loss from rental real estate activities operated as a trade or business. The limits for 2024 are losses over $305,000 ($610,000 MFJ). See *Excess Business Loss Limitation,* Tab 5.

## Personal Use of Rental Property—Roommates and Boarders

If a portion of property is rented out, and a portion is used for personal purposes, any reasonable method of allocating expenses between personal and rental use is allowed. For example, dividing the cost of utilities by the number of people living in the home, or dividing expenses based on square footage of use, are reasonable methods.

**Example**: Phil owns and lives in a personal residence that has 1,800 square feet of floor space. Phil takes in a boarder and rents out a room for the entire year that is 12 × 15 feet, or 180 square feet. Phil can allocate 10% of the home's expenses to the rental. The total utility bills for the year are $2,700. Phil can deduct $270 ($2,700 × 10%) from rental income on Schedule E (Form 1040).

**Phone expense.** The cost of the first phone line into a home that is used for both personal and rental purposes is not deductible.

**Direct rental expenses.** A full deduction is allowed for expenses that belong only to the rental part of the property. Examples of fully-deductible rental expenses include painting a room that is rented out, additional liability insurance attributable to the rental, and the cost of a second phone line that is strictly for the tenant.

# Mixed-Use Property—Vacation Homes (IRC §280A)

## Cross References

- Schedule E (Form 1040), *Supplemental Income and Loss*
- IRS Pub. 527, *Residential Rental Property*
- IRC §280A, *Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.*
- Gig Economy Tax Center, www.irs.gov/businesses/gig-economy-tax-center

## Related Topics

- Business Deductions, page 8-4
- Depreciation, Tab 9

## Gig (Sharing) Economy

Taxpayers who use an online platform such as Airbnb to rent out a spare bedroom or house are involved in what is sometimes referred to as the gig, or sharing economy. Rules for reporting income and deductions from these activities follow established rules, including filing requirements, business expenses, and depreciation. Issues that may affect individuals who participate in the gig economy include:

- Schedule E (Form 1040), *Supplemental Income and Loss,* page 7-2.
- Roommates and Boarders, page 7-4.
- Personal Use of Rental Property, next column.
- Methods of allocating expenses for mixed-use property, page 7-6.
- Passive Activity Losses, page 7-7.
- Not rental under passive loss rules, page 7-10.
- Business Deductions, page 8-4.
- Depreciation, Tab 9.

**Example:** Sally used an online app to rent a room in her house 73 days during 2024, or 20% of the year. The room is 12 × 15 feet (180 square feet). The entire house has 1,800 square feet of living space. Sally can deduct 10% of any expense that must be divided between rental use and personal use, divided again by the percentage of time the room was available for rent during the year.

Sally's heating bill for the entire house was $1,200 for the year. Sally can deduct $24 as a rental expense ($1,200 × 10% × 20%). The balance of $1,176 is a personal expense and is not deductible.

If substantial services are provided, income is reported on Schedule C (Form 1040) and is subject to SE tax.

**Providing substantial services.** If a taxpayer provides substantial services that are primarily for the tenant's convenience, such as regular cleaning, changing linen, or housekeeping service, the rental income and expenses are generally reported on Schedule C (Form 1040), and subject to self-employment taxes. Substantial services do not include furnishing of heating and lighting, cleaning of public areas, trash collection.

See *Not rental under passive loss rules,* page 7-10.

## Allocating Income and Expenses

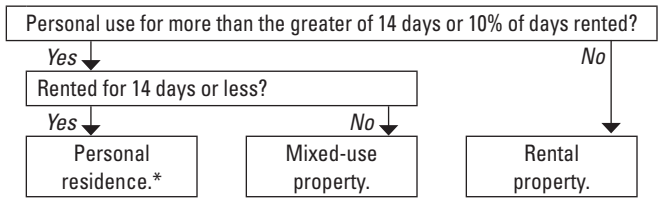
When a dwelling unit is used for both personal purposes and rented out during the year, treatment of income and expenses depends on the amount of personal use.

**Dwelling unit defined.** A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property if the property contains basic living accommodations, including sleeping space, toilet, and cooking facilities. A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment.

**Rented 14 days or less.** If a dwelling unit used for personal purposes is rented out for 14 days or less, rental income is not reported and expenses are not allowed. See *How to Classify Rental Property for Tax Treatment,* below.

**Example:** Roland lives in Phoenix. In 2024 he rented out his house for the weekend of the Super Bowl. It was the only rental use during the year and the remaining use was personal. Because the rental was for less than 14 days, Roland does not need to report the income on his 2024 tax return and he is not allowed to claim any rental expenses.

### How to Classify Rental Property for Tax Treatment




* Rental income not reported, expenses not allowed, report real estate taxes and qualified mortgage interest on Schedule A (Form 1040).

### Personal Use of Rental Property

| | *Mixed-Use Property* | *Rental Property* |
|---|---|---|
| ***Personal Use*** | More than the greater of 14 days or 10% of the days the unit was rented at fair rental value. | Not more than the greater of 14 days or 10% of the days the unit was rented at fair rental value. |
| ***Rental Income*** | Report on Schedule E. | Report on Schedule E. |
| ***Real Estate Tax Expense*** | Allocate between rental portion (Schedule E) and personal (Schedule A). | Allocate between rental portion (Schedule E) and personal (Schedule A). |
| ***Mortgage Interest Expense*** | Allocate between rental portion (Schedule E) and personal (Schedule A). | Allocate between rental portion (Schedule E) and personal (nondeductible). |
| ***Direct Expenses*** | Deduct on Schedule E subject to passive activity loss rules. | Deduct on Schedule E, subject to passive activity loss rules. |
| ***Indirect Expenses*** | Deduct rental portion on Schedule E, limited to rental income. Personal portion is nondeductible. | Deduct rental portion on Schedule E, subject to passive activity loss rules. Personal portion is nondeductible. |
| ***Losses*** | A loss cannot be reported on the tax return. Expenses limited by this provision are carried over to future years. See *Exceptions,* below. | Losses from rental activities are subject to passive activity loss limits. See *Passive Activity Losses,* page 7-7. |

***Exceptions:*** Certain expenses are allowed in full for mixed-use property.

- Rental portion of deductible home mortgage interest, real estate taxes, and casualty and theft losses (only if taxpayer itemizes deductions), and
- Direct rental expenses such as rental agency fees, advertising, office supplies, and other expenses related only to the rental activity.

***Note:*** For taxpayers claiming the standard deduction, the rental portion of deductible home mortgage interest, real estate taxes, and casualty and theft losses are limited to rental income.

If expenses that are allowed in full create a loss on mixed-use property, report the loss on Schedule E (Form 1040).

**Example:** Jeff owns a second home that he uses personally and rents out. Days of rental and personal use place the home in the category of mixed-use property. Jeff itemizes deductions.

| | |
|---|---|
| Rental income | $6,000 |
| Allocated mortgage interest | ( 4,500) |
| Allocated real estate taxes | ( 2,700) |
| Allowable loss | ($1,200) |
| Other rental expenses | $3,200 |

Because qualified mortgage interest and taxes are allowed in full for mixed-use property, Jeff will show a $1,200 loss on Schedule E (Form 1040). Additional expenses of $3,200 carryover to the following year.

**Personal use.** Use of a dwelling by the taxpayer, family member, or any person who has an interest in the property is considered personal use for purposes of allocating expenses. An exception exists if a family member uses the dwelling as his or her main home and fair rental value is paid. Days spent working substantially full time on repairs or maintenance do not count as personal days.

***Less than fair rental value.*** Use of a dwelling by any individual who pays less than fair rental value is considered personal use by the owner. Therefore, no expenses attributable to that period of rental are deductible. All rental income must nevertheless be reported as income. [IRC §280A(d)(2)]

**Court Case:** Married taxpayers purchased a home and rented it to the wife's mother. An appraisal of comparable properties in the area indicated average market rents of $800 to $1,100 per month. The taxpayers testified that they charged the mother $600 per month for rent. Because the property was not leased at a fair rental value, the period of time the mother lived in the home was attributable to personal use and the taxpayers were not entitled to claim any expenses for the property on Schedule E (Form 1040). (*Langley,* T.C. Memo. 2013-22)

**Court Case:** In a similar case to *Langley,* above, though the taxpayer failed to prove receipt of fair rental value, the court held that rent that was 20% less than the appraised value was considered fair rental value because the tenants, parents of the taxpayer, were expected to take unusually good care of the property, and the taxpayers were able to avoid incurring management fees. (*Bindseil,* T.C. Memo. 1983-411)

**Methods of allocating expenses for mixed-use property.** Expenses are allocated between personal and rental based on the number of days during the year the unit is rented out. IRS publications state that the allocation is computed by dividing the number of days the property is rented out by the total number of days the unit is occupied. However, a different method has been allowed by the courts. See *Court Case,* next column.

**IRS Method for Allocating Expenses**

$$\frac{\text{Days Rented}}{\text{Days Rented + Personal Use Days}} = \text{Rental Percentage}$$

**Ordering rules.** Deductions for mixed-use rental property are taken in the following order.

1) Amounts allowable as deductions without regard to the rental use, such as mortgage interest and real estate taxes.
2) Rental expenses that do not result in an adjustment to basis of the property, such as the rental portion of utilities and maintenance expense.
3) Expenses that result in a basis adjustment, such as depreciation.

**Example:** J.R. owned residential rental property that he also used for personal purposes. In 2024, he rented out the property for 310 days and received $12,000 in rental income. During the year, he used the property personally for 34 days. The cost of maintaining the property was $11,000 for operating expenses and $4,000 for depreciation for a total of $15,000. J.R. allocated expenses on the dwelling as follows:

310 (days rented) ÷ 344 (days occupied) = 90.12% rental use
$15,000 × 90.12% = $13,518 expenses allocated to rental

Since J.R. used the property for more than the greater of 14 days, or 10% of the days the dwelling was rented at fair rental value, the dwelling is considered mixed-use property. Expenses attributable to the dwelling are limited to the amount of rent received, which was $12,000. Disallowed expenses of $1,518 are carried over to 2025. Because of ordering rules, the disallowed expenses are attributed to depreciation.

**Court Case:** The taxpayers allocated mortgage interest and taxes based on the number of days in the year. They allocated other operating expenses, including depreciation, using the number of days occupied according to the IRS-prescribed method. This method applied a smaller percentage to mortgage interest and property taxes against the rental, which allowed a higher amount of other operating expenses to be applied against the income limit. Interest and taxes not deducted against the rental were allowed as itemized deductions.

The court allowed the method because interest and taxes accrue evenly throughout the year, but other operating expenses are more closely connected with actual days of occupancy. (*Bolton,* 9th Cir., December 2, 1982)

***Bolton decision facts:***

- Mixed-use property.
- Personal use 30 days, rented out 91 days = 121 days occupied.
- Gross rents $2,700.
- Interest and property taxes $3,475.
- Operating expenses $2,693.

| *Bolton Method* | | *IRS Method* | |
|---|---|---|---|
| Rental income limit | $2,700 | Rental income limit | $2,700 |
| Interest and taxes<br>91 ÷ 365 = 25% × $3,475 | ($ 869) | Interest and taxes<br>91 ÷ 121 = 75% × $3,475 | ($2,606) |
| Operating expenses<br>91 ÷ 121 = 75% × $2,693 | ($2,020) | Operating expenses<br>91 ÷ 121 = 75% × $2,693 | ($2,020) |
| Unallowed deduction | ($ 189) | Unallowed deduction | ($1,926) |

**Author's Comment:** Interest and taxes disallowed on mixed-use rental property may qualify as itemized deductions on Schedule A (Form 1040). With higher standard deduction amounts and limits on itemized deductions, using the Bolton method to compute rental expenses may not provide a tax benefit in as many situations as in previous years. This increases the importance of comparing expenses using both methods to determine the greatest tax benefit.

## Interest on Rental—Second Home

If the home is mixed-use property, mortgage interest is allocated between the rental portion (Schedule E) and personal (Schedule A). If the home is rental property, mortgage interest is allocated between the rental portion (Schedule E) and personal (nondeductible) [Reg. §1.163-10T-(p)(3)(iii)]. See *Personal Use of Rental Property* chart, page 7-5, and *Passive Activity Losses,* page 7-7.

For more information, see *Home Mortgage Interest,* Tab 4, and *Interest Tracing Rules (Allocation of Interest),* Tab 4.

## Sale of Rental Property

For MACRS nonresidential real property and residential rental property that has been depreciated using the straight-line method, gain attributable to depreciation is unrecaptured section 1250 gain subject to a maximum tax rate of 25%. Any remaining gain is subject to regular capital gain rates.

For more information about the sale of rental property, see *Depreciation Recapture—Sale of Business or Investment Property,* page 6-17.

**Sale of principal residence with prior rental use.** Space that was once used for rental purposes may be considered a principal residence at the time of sale and not affect the gain/loss calculations, unless depreciation was allowed, if certain conditions are met. See *Exclusion of Gain,* page 6-23.

The part of any gain equal to depreciation allowed or allowable after May 6, 1997, cannot be excluded. See *Business Use or Rental of Home—Application of Exclusion Rules,* page 6-25.

# Farm Rentals

## Cross References

- Schedule E (Form 1040), *Supplemental Income and Loss*
- Schedule F (Form 1040), *Profit or Loss From Farming*
- Form 4835, *Farm Rental Income and Expenses*
- IRS Pub. 225, *Farmer's Tax Guide*

## Related Topics

- Schedule F—Profit or Loss From Farming, Tab 5
- Business Deductions, page 8-4

## Farm Rentals

**Form 4835, *Farm Rental Income and Expenses.*** Use Form 4835 if rental income is based on shares of crops or livestock produced by the tenant. Income or loss computed on Form 4835 is then entered on line 40, Schedule E (Form 1040). Use Form 4835 only if the activity is subject to passive activity loss limitations. Do not use Form 4835 if the landowner materially participates in the production or management of production of the farm products on the land.

***Note:*** The definition of "material participation" for purposes of treatment of farm rental income is different from the general material participation rules for passive activities. See *Material participation by farm landowner,* below.

**Schedule E (Form 1040), *Supplemental Income and Loss.*** Landowners use Schedule E (Form 1040) to report cash rent received for pasture or farmland if the amount is based on a flat charge.

**Material participation by farm landowner.** If the farm landowner materially participates in the activities associated with the rental, the income is reported on Schedule F (Form 1040) and is subject to self-employment tax. A farm landowner materially participates if an arrangement with the tenant exists for the landowner's participation, and the landowner meets one of the following tests.

- The landowner does at least three of the following:
  - Pays, using cash or credit, at least half the direct costs of producing the crop or livestock,
  - Furnishes at least half the tools, equipment, and livestock used in the production activities,
  - Advises or consults with the tenant, or
  - Inspects the production activities periodically.
- The landowner regularly and frequently makes, or takes an important part in making, management decisions substantially contributing to or affecting the success of the enterprise.
- The landowner works 100 hours or more over a period of five weeks or more in activities connected with agricultural production.
- The landowner performs activities that, considered in their totality, show material and significant involvement in the production of farm commodities.

**Farm losses.** Farm losses may be limited under the hobby loss rules, the passive activity rules, and the at-risk basis limitation rules. See *Hobby Loss Rules,* Tab 5, *Passive Activity Losses,* below, and *At-Risk Rules,* page 7-12.

# Passive Activity Losses

## Cross References

- Form 8582, *Passive Activity Loss Limitations*
- Form 8810, *Corporate Passive Activity Loss and Credit Limitations*
- IRS Pub. 925, *Passive Activity and At-Risk Rules*
- IRC §469, *Passive activity losses and credits limited*

## Related Topics

- Hobby Loss Rules, Tab 5
- Self-Employment Tax, Tab 5
- S Corporations, Tab 19
- Partnerships and LLCs, Tab 20

## At-Risk Limitations

If the taxpayer is not at risk for actual financial loss for any amounts invested in a passive activity, at-risk loss limitations are applied before the passive activity loss limitations. See *At-Risk Rules,* page 7-12.

**Income and Deduction Categories**

| *Portfolio Income* | *Nonpassive Activities* | *Passive Activities* |
|---|---|---|
| • Interest, dividends, annuities, or royalties not derived from the taxpayer's trade or business. | • Income and deductions from a trade or business in which the taxpayer materially participates.[1]<br>• Compensation for personal services.[1] | • Trade or business activities with no material participation.[2]<br>• Rental activities even with material participation.[3] |

[1] See *Partners, LLC Members, Corporation Shareholders,* page 7-10.
[2] See *Material Participation,* page 7-9.
[3] See *Real Estate Professionals,* page 7-10.

## Passive Activity Loss Limits

A taxpayer cannot deduct losses from passive activities in excess of income from passive activities in any given tax year. Losses that are not allowed under these rules are allocated among the taxpayer's passive activities and carried over to future years.

**Taxpayers subject to passive activity rules.** Passive activity rules apply to individuals, estates, trusts (other than grantor trusts), personal service corporations, and closely-held corporations. Although the rules do not apply directly to grantor trusts, partnerships, and S corporations, they do apply to the owners of those entities.

**Disposition of a passive activity.** Suspended losses are allowed as a deduction in the year the activity is fully disposed of in a taxable transaction. If the sale of a passive activity results in a gain that exceeds that activity's current and suspended losses, the excess gain is passive income which will allow the deduction of losses from other passive activities. The activity must be passive in the year of sale. For information about allocating and reporting passive losses, see *Form 8582, Passive Activity Loss Limitations,* page 7-11.

Allowable passive loss carryovers are reported on the same form or schedule that contains passive activity expenses.

***Gifts.*** If a taxpayer gives away an interest in a passive activity, related unused passive activity losses cannot be deducted. Instead, increase the basis of the transferred interest by the amount of these losses.

***Death.*** If a passive activity interest transfers because the owner dies, unused passive activity losses are allowed as a deduction on the decedent's final tax return to the extent the losses exceed the beneficiary's stepped-up basis in the passive activity.

**Planning Tip:** Beware using an IRC section 1031 like-kind exchange with a passive property that has accumulated passive activity losses. Since a like-kind exchange is not taxable, no passive gain would be generated to offset the accumulated losses. The losses remain suspended until other passive income could offset them. Under certain circumstances, it may be better to structure the transaction so that it does not qualify as a like-kind exchange and thus allow suspended passive losses to offset gain generated by the sale. See *Like-Kind Exchanges (Form 8824),* page 6-19.

***Installment sales.*** If a taxpayer sells an entire interest in a passive activity through an installment sale, the current-year loss allowed under passive activity rules is computed by multiplying the overall loss (not including losses allowed in prior years) by a fraction. The numerator is the gain recognized in the current year, and the denominator is the total gain from the sale minus all gains recognized in prior years. See *Installment Sales (Form 6252),* page 6-17.

**Example:** Justin has a total gain of $10,000 from the sale of an entire interest in a passive activity. His suspended losses are $12,000. Under a 5-year installment method, he reports $2,000 of gain each year, including the year of sale. For the first year, passive losses of $2,400 are allowed ($12,000 × $2,000 ÷ $10,000 = $2,400). For the second year, passive losses of $3,000 are allowed ($12,000 × $2,000 ÷ $8,000 = $3,000).

***Former passive activities.*** A former passive activity is an activity that was a passive activity in a previous year but is not a passive activity in the current year. A prior year unallowed loss may be deducted up to the amount of the taxpayer's current year net income from the activity. Any remaining prior year loss is treated like any other passive loss.

***Partnerships and S corporations.*** If a taxpayer disposes of his or her entire interest in a partnership, the passive activity losses from the partnership that have not been allowed are generally allowed in full. They will also be allowed if the partnership (other than a PTP) disposes of all the property used in that passive activity.

If the entire interest is not disposed, the gain or loss allocated to a passive activity is treated as passive activity income or deduction in the year of disposition.

These rules also apply to the disposition of stock in an S corporation.

***Publicly Traded Partnerships (PTPs).*** A PTP is a partnership whose interests are traded on a securities market or other secondary market. Passive activity losses from a PTP can be used only to offset income or gain from passive activities of the same PTP. Likewise, the limit on passive activity credits applies separately to the credits from each PTP. In addition, the special allowance for rental real estate activities, does not apply to passive losses from PTPs. For information on reporting income, gains and losses from PTPs see the instructions for Form 8582, *Passive Activity Loss Limitations.*

## Activities That Are Not Passive Activities

Certain activities are specifically identified in the IRC and Regulations as not passive activities. These activities include:

- Trade or business activities in which the taxpayer materially participated during the year.
- A working interest in an oil or gas well held directly or through an entity that does not limit the taxpayer's liability (such as a general partner interest in a partnership). In this case, it does not matter if the taxpayer materially participated in the activity. If the partner's interest was converted from a general partner interest to a limited partner interest during the year, income and deductions must be allocated. [Reg. §1.469-1T(e)(4)(ii)]
- Rental of a dwelling unit that was also used for personal purposes during the year for more than the greater of 14 days or 10% of the number of days during the year that the home was rented at a fair rental value (mixed-use property). Income from mixed-use property cannot be offset by passive losses. A loss from mixed-use property is limited to its income.
- An activity of trading personal property for the account of those who own interests in the activity. [Reg. §1.469-1T(e)(6)]
- Rental real estate activities in which the taxpayer materially participated as a real estate professional. See *Real Estate Professionals,* page 7-10.

## Passive Activity Credits

Passive activity credits can reduce tax only from the tax on net passive income. Credits that are more than the tax on income from passive activities are carried forward.

**Election to increase basis.** Unallowed passive activity credits, unlike unallowed passive activity losses, cannot be claimed when the passive activity is disposed of. However, the taxpayer can elect to increase the basis of the credit property by the amount of the original basis reductions for the credit, to the extent that the credit was not allowed.

To elect the basis increase, complete Part VI, Form 8582-CR, *Passive Activity Credit Limitations.*

Form 8582-CR is used by individuals, estates, and trusts with any of the following credits from passive activities.

- Qualified plug-in electric and electric vehicle credit.
- General business credits.

See *General Business Credit,* page 31-3.

## Self-Rental Rule

If a taxpayer rents property to an activity in which the taxpayer materially participates, any net rental income for the year is treated as nonpassive income, while any loss is treated as passive. The effect of this rule is to not allow self-rental income to offset passive losses. See *Rental of home office to employer,* Tab 5.

**Taxpayer defined.** Under the self-rental rule, a taxpayer may be an individual, estate, trust, S corporation, partnership, LLC, closely held C corporation, or a personal service corporation (PSC). (*Larry and Dora Williams,* 5th Cir. February 2, 2016)

**Court Case:** Married taxpayers purchased an office building for use by the husband's wholly-owned medical corporation. The taxpayers reported rental income received from the corporation on their Schedule E (Form 1040). The rental income was treated as passive and taken into account in calculating passive losses. The IRS recharacterized the rental income as nonpassive under the self-rental rules. The Tax Court agreed with the IRS and held that because the husband materially participated in the business activity and the property was rented for such use, the self-rental rule applies. The rental income was nonpassive and could not be offset against accumulated and unused passive losses. (*Samarasinghe,* T.C. Memo. 2012-23)

## Self-Charged Interest

Certain self-charged interest or deductions may be treated as passive activity gross income or passive activity deductions if the loan proceeds are used in a passive activity.

Generally, self-charged interest income and deductions result from loans between a taxpayer and a partnership or S corporation in which he or she had a direct or indirect ownership interest.

This includes both loans made to the partnership or S corporation and loans the partnership or S corporation made to the taxpayer. It also includes loans from one partnership or S corporation to another partnership or S corporation if each owner in the borrowing entity has the same proportional ownership interest in the lending entity.

**Exception.** The self-charged interest rules do not apply to an interest in a partnership or S corporation if the entity made an election under Regulation section 1.469-7(g) to avoid the application of these rules. (Reg. §1.469-7)

## Material Participation

Material participation is defined as the taxpayer being involved in the activity on a basis that is regular, continuous, and substantial. [IRC §469(h)(1)]

The taxpayer will be considered to materially participate in an activity if [Reg. §1.469-5T(a)]:

1) The individual participated in the activity for more than 500 hours during the year,
2) The individual's participation in the activity constitutes substantially all of the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity,
3) The individual participated in the activity for more than 100 hours during the tax year, and the individual's participation was at least as much as any other individual for the year,
4) The activity is a significant participation activity for the year (more than 100 hours participation per activity with aggregate of 500 hours),
5) The individual materially participated in the activity for any five (whether or not consecutive) of the 10 immediately preceding tax years,
6) The activity is a personal service activity and the individual materially participated in the activity for any three (whether or not consecutive) preceding tax years (see *Personal service activity,* below), or
7) Based on all the facts and circumstances, the individual participated in the activity on a regular, continuous, and substantial basis during the year. This test is not met if the individual participated in the activity for 100 hours or less during the year. Managing the activity does not count for this purpose if any person other than the individual received compensation for managing the activity, or any other individual spent more hours during the year managing the activity.

**Personal service activity.** For purposes of material participation rules, a personal service activity includes the performance of services in the fields of health (including veterinary services), law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business where capital is not a material income-producing factor.

**Participation as an investor.** Work performed in the capacity as an investor does not count as participation under these rules unless the taxpayer is directly involved in the day-to-day management or operations of the activity. Work done as an investor includes reviewing financial statements or other reports, preparing summaries or analyses for personal use, and monitoring the finances or operations of the activity in a nonmanagerial capacity.

**Spouse's participation.** A spouse's participation in an activity is included with the taxpayer's participation for purposes of material participation rules. This applies even if the taxpayer and spouse do not file a joint return for the year.

## Grouping Activities

For purposes of classification of activities under passive loss rules, a taxpayer is allowed to keep each activity separate or to group activities into appropriate economic units. [Reg. §1.469-4(c)]

**Disclosure requirement.** Taxpayers must report certain changes to groupings that occur during the tax year. Failure to report these changes to the IRS will result in the activities being treated as separate activities for purposes of the passive activity loss and credit limitation rules. A statement must be filed with the original income tax return for the tax year in which the taxpayer:

- Originally groups two or more activities into a new grouping,
- Adds a new activity to an existing grouping, or
- Regroups activities.

The statement must provide the name, address, and EIN, if applicable, for the activities being grouped. In addition, the statement must contain a declaration that the grouped activities make up an appropriate economic unit for the measurement of gain or loss under passive activity rules. If activities are being regrouped, the statement must also contain an explanation of the material change in the facts and circumstances that made the original grouping clearly inappropriate. (Rev. Proc. 2010-13)

**Regrouping by the IRS.** If any of the activities resulting from the grouping is not an appropriate economic unit, and one of the primary purposes of the grouping (or failure to regroup) is to avoid the passive activity rules, the IRS may regroup the activities.

**Grouping Activities—Advantages and Disadvantages**

| | *Grouping Activities* | *Keeping Activities Separated* |
|---|---|---|
| ***Material Participation*** | Grouping activities can make material participation requirements easier to meet. | Material participation requirements must be met separately for each activity. |
| ***Sale of Activity*** | Sale of one activity in a group is not considered a full disposition of the larger activity. Therefore, suspended passive losses will not be allowed on the sale. | Sale of a separate activity is considered a full disposition of the activity. Therefore, any suspended losses are deductible at the time of sale. |
| ***$25,000 Special Loss Allowance*** | Grouping activities can help the taxpayer meet the 10% ownership test for the special loss allowance for active participation in rental real estate. | If activities are separated, the 10% ownership test for purposes of the special loss allowance must be met for each separate activity. |

See *Special $25,000 Allowance for Rental Real Estate,* page 7-11.

**Court Case:** The taxpayer operated three separate rental properties but did not choose to group the rental activities. Each property generated a loss, and the losses totaled $43,129. Because the activities were not grouped, the IRS determined material participation was not met for each rental property. The court upheld the determination of the IRS and found the rental activities to be passive activities subject to passive activity loss limits. (*Bugarin,* T.C. Summary 2013-61)

**Appropriate economic units.** Whether a grouping is an appropriate economic unit depends on facts and circumstances. Factors to consider are:

- The similarities and differences in the types of trades or businesses.
- The extent of common control.
- The extent of common ownership.
- The geographical location.

*continued on next page*

- The interdependencies between or among activities, which may include the extent to which the activities:
  - Buy or sell goods between or among themselves,
  - Involve products or services that are generally provided together,
  - Have the same customers,
  - Have the same employees, or
  - Use a single set of books and records for the activities.

**Example:** Emily owns a bakery and a movie theater at a shopping mall in Baltimore and a bakery and movie theater in Philadelphia. Any of the following may be considered appropriate economic units.
- One activity.
- A movie theater activity and a bakery activity.
- A Baltimore activity and a Philadelphia activity.
- Four separate activities.

**Rental activities.** Rental activities cannot be grouped with trade or business activities unless the activities form an appropriate economic unit and one of the following provisions applies.
- The rental activity is insubstantial in relation to the trade or business activity.
- The trade or business activity is insubstantial in relation to the rental activity.
- Each owner of the trade or business activity has the same ownership interest in the rental activity, in which case the part of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity. [Reg. §1.469-4(d)(1)]

## Partners, LLC Members, Corporation Shareholders

**Limited partners.** A limited partner is presumed not to have materially participated in an activity. Therefore, a partner's share of income or loss that is distributed in his or her capacity as a limited partner is generally treated as passive income or loss. To avoid passive income or loss treatment, the partner can use tests (1), (5), or (6) listed under *Material Participation,* page 7-9.

**LLP or LLC member.** Under proposed regulations, a member of an LLP or LLC is not automatically classified as a limited partner for purposes of passive activity losses. (REG-109369-10)

Additionally, the Tax Court has held that an LLP or LLC member that participates in management is treated as a general partner rather than a limited partner. (*Garnett,* 132 T.C. No. 19)

**Distributive share of income.** No portion of a partner's distributive share of partnership income, or a shareholder's pro-rata share of income from an S corporation, shall be treated as compensation for personal services under passive activity rules. The treatment of the distributive share of income or loss flowing through on Schedule K-1 is determined under regular material participation rules. [Reg. §1.469-2T(c)(4)(i)(F)]

**Corporations.** A closely held corporation or a personal service corporation is treated as materially participating in an activity only if one or more shareholders holding more than 50% by value of the outstanding stock of the corporation materially participate in the activity.

## Rental Activities

Rental activities are automatically classified as passive activities even if the taxpayer materially participates in the activity.

***Exception:*** See *Real Estate Professionals,* next column.

For taxpayers who actively participate in real estate activities, see *Special $25,000 Allowance for Rental Real Estate,* page 7-11.

For information about rental income, expenses, and how to report, see *Rental Real Estate,* page 7-3.

**Self-employment tax—real estate dealers.** Generally, income from rental real estate is not subject to self-employment (SE) tax. [Reg. §1.1402(a)-4]

***Exception:*** An individual who is a real estate dealer is subject to SE tax. A real estate dealer is an individual who is engaged in the business of selling real estate to customers. On the other hand, an individual who merely holds real estate for investment or speculation and receives rental income is not considered a real estate dealer. When a real estate dealer holds real estate for investment or speculation, in addition to real estate held for sale to customers, only the rental income from the real estate held for sale to customers is subject to SE tax.

**Example:** Arthur builds homes and sells them to customers. He is a real estate dealer. His home construction and sale activity is subject to self-employment tax. He has trouble selling some of his inventory and allows a potential buyer to rent one of his new homes with an option to buy since he cannot find a buyer to purchase the home. Even though it is now a rental activity, it is still subject to SE tax, because the real estate is held for sale to customers.

**Not rental under passive loss rules.** An activity is not considered a rental activity if any of the following provisions apply. [Reg. §1.469-1T(e)(3)]
- The average period of customer use of the property is seven days or less, such as auto or boat rental, or Airbnb.
- The average period of customer use is 30 days or less, and the taxpayer provides significant personal services with the rentals, such as hotels. Significant personal services include only services performed by individuals.
- Customer use of the property is incidental to performance of personal services. For example, the rental of a hospital room is incidental to the receipt of personal services provided by hospital staff.
- The rental is incidental to a non-rental activity. For example, rental is incidental to investment if the main purpose of holding the property is to realize a gain from its appreciation, and the gross rental income is less than 2% of the smaller of the property's unadjusted basis or FMV. For more examples, see Regulation section 1.469-1T(e)(3)(viii).
- The property is made available for nonexclusive use by customers during defined business hours, such as a golf course.
- The taxpayer provides the property for use in a non-rental activity as the owner of an interest in a partnership, S corporation, or joint venture.

***Note:*** Although the above activities are not considered rental and therefore not passive activities by default, the activities will nevertheless be classified as passive activities unless the taxpayer meets material participation requirements. See *Material Participation,* page 7-9.

## Real Estate Professionals

Rental activities of real estate professionals are not automatically treated as passive activities. However, a rental activity will be considered passive if the real estate professional does not materially participate in it. (*Charles and Delores Gragg,* 9th Cir., August 4, 2016)

**Qualifications.** The taxpayer qualifies as a real estate professional if both the following requirements are met.
- More than half the personal services the taxpayer performed in all trades or businesses during the tax year were performed in real property trades or businesses in which the taxpayer materially participated, and
- The taxpayer performed more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participated.

Personal services performed as an employee do not count unless the taxpayer was a 5% or greater owner of the employer.

Real property trades or businesses include development, construction, acquisition, conversion, rental, operation or management, or brokerage of real property.

**Special election to combine rental activities.** For real estate professionals only, each of the taxpayer's rental activities are treated as separate activities unless the taxpayer elects to treat all interests in rental real estate as a single activity. Failure to make the election can trigger passive loss limits for real estate professionals that do not materially participate in each activity.

To make the election, the taxpayer must file a statement with the original income tax return declaring that he or she is a qualified taxpayer for the taxable year and is making the election to treat all interest in rental real estate as a single rental real estate activity pursuant to IRC section 469(c)(7)(A). The election is binding for the taxable year it is made and for all future years whether or not the taxpayer continues to be a qualifying taxpayer. A taxpayer may revoke the election only in the taxable year in which a material change in facts and circumstances occurs. [Reg. §1.469-9(g)(3)]

A taxpayer may qualify for late election relief. (Rev. Proc. 2011-34)

***Note:*** This special election is for real estate professionals only and is not the same as grouping activities.

**Example:** Leo is a real estate agent who spends more than 750 hours and more than 50% of his time selling real estate. He also owns several rental properties. As a real estate professional, in order for Leo to treat his rental properties as nonpassive activities, he would either have to pass the material participation rules for each separate rental property or elect to combine all rentals into one activity and meet the material participation rules as a group. See *Material Participation,* page 7-9.

**Court Case:** For over 20 years, the taxpayer had been buying, selling, renting, and managing real estate properties. For the years at issue, the taxpayer aggregated all rental income and expenses as a single activity on Schedule E (Form 1040), but did not attach an election to treat all rental properties as a single activity. The Tax Court rejected the taxpayer's "deemed election" argument, stating that a taxpayer must clearly notify the Commissioner of the intent to make the election. Without treating the rental properties as one activity, the taxpayer was not able to meet material participation requirements. Net losses were treated as passive losses, and the amounts in excess of the special $25,000 allowance for rental real estate were not allowed under passive loss rules. (*May,* T.C. Summary 2005-146)

## Form 8582, *Passive Activity Loss Limitations*

Form 8582 is filed by individuals, estates, and trusts that have passive activity deductions, including prior year unallowed losses. Any losses that are not allowed in the current year are allocated among the taxpayer's various passive activities and carried over to the next year. Form 8582 is not filed for any year that a taxpayer has an overall loss on disposition of an entire interest in a passive activity or former passive activity.

Form 8582 is not required if the taxpayer's only loss from passive activities is fully deductible under the special $25,000 loss allowance for rental real estate with active participation. See *Special $25,000 Allowance for Rental Real Estate,* next column.

## Form 8810, *Corporate Passive Activity Loss and Credit Limitations*

Form 8810 must be filed by personal service corporations and closely held corporations that have losses or credits from passive activities, including prior year unallowed losses and credits. See Form 8810 instructions for details.

# Special $25,000 Allowance for Rental Real Estate

## Cross References

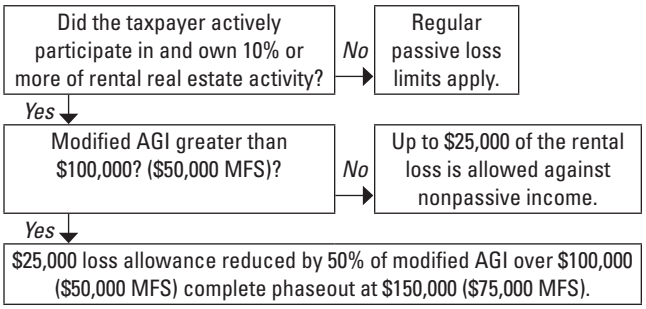
- Form 8582, *Passive Activity Loss Limitations*
- IRS Pub. 925, *Passive Activity and At-Risk Rules*
- IRC §469, *Passive activity losses and credits limited*

## Related Topics

- Hobby Loss Rules, Tab 5
- Low-Income Housing Credit (Form 8586), page 31-15

If the taxpayer or spouse actively participated in a passive rental real estate activity, a loss deduction of up to $25,000 is allowed against nonpassive income if certain requirements are met.

**Rental Real Estate Loss for Individuals**




**Mixed-use property.** Mixed-use property is not eligible for the special allowance. (*Van Malssen and Kiley,* T.C. Memo. 2014-236)

**Limits based on filing status—MFS.** If a taxpayer is married, files a separate return, and lived apart from the spouse for the entire tax year, the special allowance cannot be more than $12,500. If the taxpayer is married, filing a separate return, and lived with the spouse at any time during the year, the special allowance is not allowed.

**AGI phaseout.** The special allowance is reduced by 50% of the amount of modified AGI that is more than $100,000 ($50,000 MFS). If modified AGI is $150,000 or more ($75,000 MFS), the allowance is completely phased out. Modified AGI for this purpose is AGI computed without the following items.

- Passive activity income or loss included on Form 8582, *Passive Activity Loss Limitations,*
- Rental real estate losses allowed for real estate professionals. See *Real Estate Professionals,* page 7-10,
- Taxable Social Security or Tier 1 railroad retirement benefits,
- Deductible contributions to a traditional IRA and IRC section 501(c)(18) pension plans,
- The student loan interest deduction,
- The deduction for one-half of self-employment tax,
- The exclusion from income of interest from series EE and I U.S. savings bonds used to pay higher education expenses,
- Any excluded amounts under an employer's adoption assistance program,
- Any overall loss from a publicly traded partnership, and
- Foreign-derived intangible income and global intangible low-taxed income.

***Exceptions to the phaseout rules.*** For rehabilitation investment credits from rental real estate activities the phaseout starts when modified AGI exceeds $200,000 ($100,000 MFS). There is no phaseout of the special $25,000 allowance for low-income housing credits or for the commercial revitalization deduction.

**Example:** Pete is single and is not a real estate professional. During 2024, Pete had $120,000 in salary and a $31,000 loss from rental real estate activities in which he actively participated. His modified AGI is $120,000. For 2024, Pete may deduct only $15,000 of his passive loss. The remaining $16,000 will carryover to 2025. The deduction and carryover are computed as follows:

| | |
|---|---|
| Modified AGI | $120,000 |
| Minus beginning phaseout amount | (100,000) |
| Amount subject to phaseout | $ 20,000 |
| × 50% = reduction in allowance | $ 10,000 |

$25,000 allowance minus $10,000 reduction = $15,000 loss allowed.

**Active participation.** Active participation is not the same as material participation. Active participation standards are met if the taxpayer (or the taxpayer's spouse) participates in management of the rental property in a significant and bona fide sense. For example, management decisions such as approving new tenants, deciding on rental terms, approving expenditures, and similar decisions meet active participation standards.

***10% ownership test.*** Only individuals can actively participate in rental real estate activities, and the taxpayer (and/or spouse) must hold at least 10% by value of all interests in the activity throughout the year. A limited partner is not treated as an active participant in a partnership rental real estate activity.

***Exception:*** A decedent's estate is treated as actively participating for its tax years ending less than two years after the decedent's death if the decedent would have satisfied the active participation rules in the year the decedent died.

# At-Risk Rules

## Cross References

- Form 6198, *At-Risk Limitations*
- IRS Pub. 925, *Passive Activity and At-Risk Rules*
- IRC §465, *Deductions limited to amount at risk*

## Related Topics

- Shareholder Basis, Tab 19
- Basis, page 20-13

## At-Risk Limits

Losses are allowed only up to the amount of a taxpayer's risk of financial loss from a trade, business, or activity for the production of income. At-risk limits apply to individuals (including partners and S corporation shareholders), estates, trusts, and certain closely held C corporations.

**Closely held C corporation.** A C corporation is a closely held corporation under at-risk rules if, at any time during the last half of the tax year, more than 50% in value of its outstanding stock is owned directly or indirectly by or for five or fewer individuals.

**At-risk loss carryovers.** A loss that is not allowed under at-risk rules is treated as a deduction for the activity in the next tax year.

## At-Risk Basis

**Amount at risk.** Amounts considered at risk are:

1) The amount of money or the adjusted basis of property contributed by the taxpayer to the activity, plus
2) Amounts borrowed with respect to the activity.

***Note:*** A taxpayer's at-risk basis may be different from the basis for computing gain or loss from sale of an asset, or for loss limitations related to an S corporation or partnership.

***Amounts borrowed.*** To be considered at risk for an amount borrowed, the taxpayer must be personally liable for repayment or have pledged property as security for the loan. The amount at risk for property pledged as security is limited to the net FMV of the taxpayer's interest in the property. Only property that is not used in the activity qualifies as pledged property under these rules.

Even if the taxpayer is personally liable for a loan, or secures a loan with property not used in the activity, the at-risk basis is not increased if the amount is borrowed from a person who has an interest in the activity, or from someone related to a person who has an interest in the activity. Related parties under at-risk rules are described in IRC section 267(b) and IRC section 707(b)(1).

**Amounts not at risk.** Amounts not at risk include:

- Nonrecourse loans used to finance the activity or used by the taxpayer to acquire an interest in the activity. ***Exception:*** See *Qualified nonrecourse financing—real property,* below.
- Cash, property, or borrowed amounts used in the activity that are protected against loss by a guarantee, stop-loss agreement, or other similar arrangement.
- Amounts borrowed for use in the activity from a person who has an interest in the activity other than as a creditor or who is a related party. A person shall be considered as having an interest in the activity only if the person has either a capital interest or a profits interest. ***Note:*** An interest in a corporation as a shareholder is not an interest in any activity of the corporation under these rules. [Reg. §1.465-8(a)(2)]

**Qualified nonrecourse financing—real property.** Qualified nonrecourse financing is financing for which no one is personally liable for repayment and is:

- Borrowed in connection with holding real property,
- Secured by real property used in the activity,
- Not convertible debt, and
- Loaned or guaranteed by any federal, state, or local government or from a qualified source (such as a bank or savings and loan association). A qualified source does not include related parties, the seller of the property, or a person who receives a fee as a result of the taxpayer's investment in the property.

**Partner's share of qualified nonrecourse financing.** A partner's share of qualified nonrecourse financing is determined on the basis of the partner's share of partnership liabilities incurred in connection with the financing. The partner's share of qualified nonrecourse financing should be listed on item K1, Schedule K-1 (Form 1065).

**Adjustments to At-Risk Basis**

| *Increases* | *Decreases* |
|---|---|
| • Additional cash or property contributed to the activity.<br>• Assumption of additional qualified liabilities.<br>• Distributive share of taxable or nontaxable income from pass-through entities. | • Distributions of cash or property to the taxpayer.<br>• Relief from liabilities, including conversion of a recourse debt to a nonrecourse debt.<br>• Distributive share of losses flowing through from a pass-through entity. |

**Recapture rule—at-risk basis less than zero.** If a taxpayer's at-risk amount in any activity at the end of the tax year is less than zero, recapture of previously allowed losses may apply. The recapture amount is the lesser of the:

- Negative at-risk amount (recaptured as positive income), or
- Total amount of losses deducted in previous tax years minus any amounts previously recaptured as income.

## Form 6198, *At-Risk Limitations*

Form 6198 is filed by individuals, estates, trusts, and certain closely held C corporations if the taxpayer has losses from an activity, and any amounts invested are not at risk.

*~ End ~*