Chapter 6: Rental Activities

Corrections were made to this material through January of 2012. No subsequent modifications were made.

Taxpayers become involved in rental activities in a variety of ways. They may purchase a rental property as an investment or they may purchase a vacation home and rent it for a portion of the year. They may live in a college community and rent a room in their home to a student or they may turn their residence into a bed and breakfast. Other taxpayers may invest in commercial property or multiresidence apartment buildings. Some may even purchase machinery and equipment and rent it to others. Regardless of the activity, the proper reporting of rental profits and losses involves more than entering amounts on the appropriate schedule or form.

PASSIVE ACTIVITIES

Prior to 1986, a taxpayer could generally deduct losses in full from rental activities and trades or businesses regardless of the taxpayer's level of participation. This gave rise to significant numbers of tax shelters that allowed taxpayers to deduct noneconomic losses against wages and investment income. The Tax Reform Act of 1986 added IRC §469, which limits the taxpayer's ability to deduct losses from businesses in which they do not materially participate and from rental activities.

The passive activity loss rules are applied at the individual level and extend beyond tax shelters to virtually every business or rental activity, whether reported on Schedule C, *Profit or Loss From Business (Sole Proprietorship);* Schedule F, *Profit or Loss From Farming;* or Schedule E, *Supplemental Income and Loss.* The rules also apply to flow-through income and losses from partnerships, S corporations, and trusts.

The passive loss limitations apply in full to personal service corporations. IRC §469 also applies to closely-held C corporations but has limited applications. The passive loss limitations related to these entities are not covered in this chapter.

The general rule, with exceptions, is that losses generated by passive activities can only be used to offset income generated by passive activities.

TYPES OF ACTIVITIES

There are two kinds of passive activities.[1]

- Rentals, including equipment leasing and rental real estate
- Businesses in which the taxpayer does **not materially participate** (includes activities on Schedules C or F and from partnerships, S corporations, and LLCs)

> **Note.** The LLC files as a partnership, corporation, or a disregarded entity. If the LLC is a disregarded entity, the activity is reported on an individual's Form 1040, Schedule C.[2] For the sake of simplicity in this text, when the term "partnership" is used, multimember LLCs taxed as partnerships are included. When "sole proprietorship" is used, single-member LLCs are included.

WHAT IS PASSIVE?

Income and losses from the following activities are generally **passive** in nature.[3]

1. Rental real estate (except rentals in which a real estate professional materially participates)[4]
2. Equipment leasing
3. Sole proprietorship or farm in which the taxpayer does not materially participate (i.e., does not regularly work)
4. Limited partnership interest, with some exceptions[5]
5. Partnership, S and C corporations, and LLC business in which the taxpayer does not materially participate

Income and losses from the following are generally **nonpassive** in nature.

1. Salaries, wages, and Form 1099-MISC commissions
2. Guaranteed payments
3. Portfolio income (interest, dividends, royalties, gains on stocks and bonds)
4. Sale of undeveloped land or other investment property
5. Royalties
6. Sole proprietorship or farm in which the taxpayer regularly works (i.e., materially participates)
7. Partnership, S corporation, or LLC business in which the taxpayer materially participates

Activity Rules

The term "activity" under IRC §469 does not necessarily mean a single business or separate entity owned by the taxpayer. A grouping decision generally should have been made in 1994 when the regulations were finalized or at the time the activity was acquired, whichever is later. Grouping allows a taxpayer to treat several businesses as one single activity if they form an appropriate economic unit. Alternatively, there can be two or more distinct activities within a single entity. **For example, there can be a rental activity and a business activity within the same tax return.**

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1. IRC §469(c).
2. See Treas. Reg. §301.7701-3(a).
3. See IRC §469(c)(2). There are exceptions in Temp. Treas. Reg. §1.469-1T(e)(3) discussed later in the text.
4. IRC §469(c)(7).
5. Temp. Treas. Reg. §1.469-5T(e).

Because material participation[6] is determined for each activity, the way the taxpayer's business and rental operations are combined or divided into "activities" is very important.

Businesses forming an appropriate economic unit may be grouped into one single activity based on the following criteria.[7]

1. Similarities/differences in types of activities
2. Extent of common control
3. Extent of common ownership
4. Geographic location of the activities
5. Interdependence between activities

Exceptions. The general rule in IRC §469 provides that passive losses can offset only passive income. There are, however, exceptions such as the following.

1. On an **entire disposition** to an unrelated party in a fully taxable transaction, both current and suspended passive losses may be deducted against wages, portfolio income, and other nonpassive income.[8]
2. Rental real estate losses up to $25,000 may be deducted by an individual whose modified adjusted gross income (MAGI) does not exceed $100,000. To qualify for this offset, the taxpayer must **actively participate,** own at least 10% of the property, and not be a limited partner. The $25,000 exception is phased out at the rate of 50 cents per dollar of MAGI over $100,000. Therefore, when MAGI exceeds $150,000, the offset is completely phased out.

> **Note.** If the taxpayer is married filing separately (MFS) and living apart from their spouse at all times during the tax year, up to $12,500 in rental real estate losses may be deducted if MAGI does not exceed $50,000.[9] No deduction is allowed for MFS taxpayers who lived together during the year.

A **real estate professional** may be able to deduct all current rental real estate losses regardless of their MAGI.[10] This exception is discussed later in the chapter.

Disallowed passive losses can be carried forward indefinitely[11] until there is passive income or an entire disposition in a fully taxable transaction. Disallowed losses die with the taxpayer. Net gain on the sale of a passive activity is generally passive income, which can be offset by unrelated passive losses.

Participation Rules. There are two distinct types of participation.

1. Material participation
2. Active participation

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6. IRC §469(h)(1).
7. Treas. Reg. §1.469-4(c).
8. IRC §469(g).
9. IRC §469(i).
10. IRC §469(c)(7) and Treas. Reg. §1.469-9.
11. IRC §469(b).

Material participation generally applies to **business** activities. IRC §469(h)(1) provides that losses are nonpassive (i.e., deductible in full) for taxpayers who work on a regular, continuous, and substantial basis in the business operations. To meet the material participation requirement, the taxpayer **must meet at least one of the seven** following requirements for the taxable year.[12]

1. The taxpayer participates in the activity for more than 500 hours during the year.
2. The taxpayer's participation constitutes substantially all of the participation of all individuals.

Example 1. Max owns a lawnmower repair service and works at this business. He has a helper, but the helper only works a few hours per year. Max performs substantially all of the business's work.

3. The taxpayer participates more than 100 hours in the activity and not less than any other individual's participation.

Example 2. Larry and Gary run an escort service. They both work at the business. Larry works 200 hours annually and Gary works 150 hours annually. While both hourly totals are above 100, Larry qualifies as a material participant, but Gary does not because his hours are lower than Larry's.

4. The activity is a significant participation activity, and the taxpayer participates more than a total of 500 hours in all significant participation activities.

Example 3. Stu owns three business activities. He works a combined total of 600 hours and all three activities are considered significant participation activities. Stu qualifies as materially participating in the three activities.

5. The taxpayer materially participated in the activity for any five years during the immediate 10 years.
6. The activity is a personal service activity with the taxpayer materially participating for any three preceding years.
7. Based on the facts and circumstances, the taxpayer participates on a regular, continuous, and substantial basis.

Active participation[13] relates only to **rental real estate** activities and is a less stringent standard than material participation. Taxpayers who make management decisions generally can deduct up to $25,000 in losses against nonpassive income, subject to the $150,000 MAGI limitation.

Neither the material participation standard nor the active participation standard generally applies to long-term equipment rentals. Equipment leasing losses are generally passive regardless of the level of participation.[14] Thus, equipment leasing losses are generally not deductible unless the taxpayer has passive income from other sources.

The spouse's personal services are not counted when determining whether the material participation rules are met. However, the spouse's participation is included when determining material participation.

ACTIVITY GROUPING

On January 6, 2010, the IRS issued **Rev. Proc. 2010-13,**[15] which sets forth the rules for reporting how passive activities are grouped. **These rules are effective for all tax years beginning on or after January 25, 2010. For calendar-year taxpayers, the rules are effective beginning in 2011.** They do not apply to real estate professionals.[16] Special disclosure rules apply to partnerships and S corporations.

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12. Temp. Treas. Reg. §1.469-5T(a).
13. IRC §469(i)(6).
14. IRC §§469(c)(2) and (4).
15. Rev. Proc. 2010-13, 2010-4 IRB 329.
16. See Treas. Reg. §1.469-9.

Form 8582

Passive losses and income are most commonly found on Schedule E. The computational form used to limit these losses is Form 8582, *Passive Activity Loss Limitations*, with line 16 being the sum of passive losses allowed for the current year.[17] Following is a brief description of Form 8582 for 2002 and later years.

Part I separates all passive activities into three categories.

1. Rental real estate activities in which the taxpayer **actively participates** are entered on line 1. These rentals qualify for the $25,000 special allowance, subject to the MAGI limitation, which is computed on line 7.
2. The commercial revitalization deduction from rental real estate activities is entered on line 2. Taxpayers are entitled to the commercial revitalization deduction regardless of the level of their income and whether or not they actively participate, up to the $25,000 offset which remains after deducting any other rental losses.

> **Note.** Only 40 communities nationwide qualified as designated renewal communities on December 31, 2001. No property placed in service after December 31, 2009 qualifies for the deduction.[18]

3. All other passive activities, including rental real estate **without active participation** and equipment rentals, are entered on line 3. Losses entered on line 3 are not deductible unless the taxpayer has passive income.

Form **8582**
Department of the Treasury
Internal Revenue Service (99)

Passive Activity Loss Limitations

▶ See separate instructions.
▶ Attach to Form 1040 or Form 1041.

OMB No. 1545-1008
2011
Attachment Sequence No. **88**

Name(s) shown on return | **Identifying number**

Part I **2011 Passive Activity Loss**
Caution: *Complete Worksheets 1, 2, and 3 before completing Part I.*

Rental Real Estate Activities With Active Participation (For the definition of active participation, see **Special Allowance for Rental Real Estate Activities** in the instructions.)					
1a	Activities with net income (enter the amount from Worksheet 1, column (a))	1a			
b	Activities with net loss (enter the amount from Worksheet 1, column (b))	1b	( )		
c	Prior years unallowed losses (enter the amount from Worksheet 1, column (c))	1c	( )		
d	Combine lines 1a, 1b, and 1c			1d	
Commercial Revitalization Deductions From Rental Real Estate Activities					
2a	Commercial revitalization deductions from Worksheet 2, column (a)	2a	( )		
b	Prior year unallowed commercial revitalization deductions from Worksheet 2, column (b)	2b	( )		
c	Add lines 2a and 2b			2c	( )
All Other Passive Activities					
3a	Activities with net income (enter the amount from Worksheet 3, column (a))	3a			
b	Activities with net loss (enter the amount from Worksheet 3, column (b))	3b	( )		
c	Prior years unallowed losses (enter the amount from Worksheet 3, column (c))	3c	( )		
d	Combine lines 3a, 3b, and 3c			3d	
4	Combine lines 1d, 2c, and 3d. If the result is net income or zero, all losses are allowed, including any prior year unallowed losses entered on line 1c, 2b, or 3c. **Do not** complete Form 8582. Report the losses on the forms and schedules normally used			4	

If line 4 is a loss and:
- Line 1d is a loss, go to Part II.
- Line 2c is a loss (and line 1d is zero or more), skip Part II and go to Part III.
- Line 3d is a loss (and lines 1d and 2c are zero or more), skip Parts II and III and go to line 15.

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17. Generally, Form 8582 should be attached to the return. See the instructions for Form 8582 for exceptions. IRS Pub. 925, *Passive Activity and At-Risk Rules,* also provides helpful information.

18. The Community Renewal Tax Relief Act of 2000, 2000-3 CB 239, 241, provides details of designated renewal communities.

Part II is the calculation for allowable losses from rental real estate with active participation entered on line 1.

Part II or Part III. Instead, go to line 15.

Part II Special Allowance for Rental Real Estate Activities With Active Participation

Note: *Enter all numbers in Part II as positive amounts. See instructions for an example.*

5	Enter the **smaller** of the loss on line 1d or the loss on line 4			5	
6	Enter $150,000. If married filing separately, see instructions	6			
7	Enter modified adjusted gross income, but not less than zero (see instructions)	7			
	Note: *If line 7 is greater than or equal to line 6, skip lines 8 and 9, enter -0- on line 10. Otherwise, go to line 8.*				
8	Subtract line 7 from line 6	8			
9	Multiply line 8 by 50% (.5). **Do not** enter more than $25,000. If married filing separately, see instructions			9	
10	Enter the **smaller** of line 5 or line 9			10	
	If line 2c is a loss, go to Part III. Otherwise, go to line 15.				

Part IV calculates the total allowable passive activity losses for the entire return. Line 16 allows losses up to total passive income, plus up to $25,000 for the commercial revitalization deduction and any allowable rental real estate losses.

If line 2c is a loss, go to Part III. Otherwise, go to line 15.

Part III Special Allowance for Commercial Revitalization Deductions From Rental Real Estate Activities

Note: *Enter all numbers in Part III as positive amounts. See the example for Part II in the instructions.*

11	Enter $25,000 reduced by the amount, if any, on line 10. If married filing separately, see instructions	11	
12	Enter the loss from line 4	12	
13	Reduce line 12 by the amount on line 10	13	
14	Enter the **smallest** of line 2c (treated as a positive amount), line 11, or line 13	14	
Part IV	**Total Losses Allowed**		
15	Add the income, if any, on lines 1a and 3a and enter the total	15	
16	**Total losses allowed from all passive activities for 2011.** Add lines 10, 14, and 15. See instructions to find out how to report the losses on your tax return	16	

For Paperwork Reduction Act Notice, see instructions. Cat. No. 63704F Form **8582** (2011)

LEASED LAND

Income from leased land (ground rents) is nonpassive and should **not** be entered on Form 8582, line 1a. Temp. Treas. Reg. §1.469-2T(f)(3) recharacterizes income as nonpassive if it is from leased property when less than 30% of the unadjusted basis is depreciable. Examples include the following.

- Fields leased to a farmer
- Mobile home parks
- Land leased for billboards
- Lots leased to sell Christmas trees
- Land leased for cell towers
- Campgrounds

The character of an activity is not changed. Even though **income** is recharacterized as nonpassive, the **activity** remains a passive activity and any losses generated are generally passive.[19]

19. Temp. Treas. Reg. §1.469-2T(f)(1).

RENTAL LOSSES

Rentals generally are passive activities and are subject to the passive loss disallowance rules.[20] A loss from a passive activity is not currently deductible unless one of the following applies.

- Passive income exists. (Losses are allowed to the extent of passive income.)
- The taxpayer actively participates in a rental real estate activity and qualifies for the $25,000 special allowance.
- There is a qualifying disposition under IRC §469(g).
- The taxpayer meets the requirements of IRC §469(c)(7) for real estate professionals.

POTENTIAL ISSUES

There are a number of areas that could create a potential error when reporting a rental loss. They include the following.

- Six exceptions exist to the definition of "rental."[21] Certain activities normally thought of as rentals are specifically treated as nonrental businesses under this section.
- The $25,000 rental real estate special allowance under IRC §469(i)(8) allows individuals to offset losses from rental real estate activities without necessarily having passive income.
- A real estate professional is permitted to treat a rental activity like any other business (i.e., the taxpayer must materially participate to treat it as nonpassive).
- Equipment rentals normally are passive activities regardless of whether the taxpayer materially participates. Because equipment leases do not involve rental real estate, they are not eligible for the $25,000 special allowance under IRC §469(i).
- Short-term vacation rentals are often treated as businesses, subject to the material participation standard.

Exception to Rental Definition

Under Temp. Treas. Reg. §1.469-1T(e)(3)(ii), six types of activities normally defined as rentals are treated as nonrental activities (i.e., as businesses) in most cases. As a result, the active participation standard and the $25,000 allowance do not apply. If the activity falls outside the rental definition, it is passive or nonpassive based on whether the taxpayer materially participates. Following are the six exceptions.

1. The average period of customer use is seven days or less. Examples include condo rentals; short-term rentals of hotel/motel rooms; and businesses that rent videos, tuxedos, cars, tools, etc.
2. The average period of customer use is 30 days or less and significant personal services are provided with the rental.
3. Extraordinary personal services are provided with the rental. Examples include the use by patients of a hospital's boarding facilities and the use by students of a boarding school's dormitories.
4. The rental is incidental to a nonrental activity.
5. The taxpayer customarily makes the rental property available during defined business hours for nonexclusive use by various customers. Examples include golf courses, health clubs, and spas.
6. The taxpayer provides the property for use in a nonrental activity of their own partnership, S corporation, or joint venture. The key word here is **provides,** not rents.[22]

20. IRC §469(c)(2).

21. Temp. Treas. Reg. §1.469-1T(e)(3)(ii).

22. Temp. Treas. Reg. §1.469-1T(e)(3)(vii)

$25,000 Special Allowance

A taxpayer may deduct up to $25,000 in rental real estate losses as long as the taxpayer **actively participates** and MAGI does not exceed $100,000. However, the amount allowed for married taxpayers filing separately is zero (if they lived together during the year) or a maximum of $12,500 (if they did not live together).

The following conditions must be met in order to deduct the $25,000 special allowance.

- The activity must consist of rental real estate (not an equipment lease).
- The taxpayer must have "actively participated" in the rental.
- The MAGI must not exceed $100,000 in order to obtain the full $25,000 benefit.

An exception to the $25,000 limitation exists for the commercial revitalization deduction.

Active Participation

As long as a taxpayer participates in management decisions in a bona fide sense, they **actively participate** in the rental real estate activity. There is no specific hour requirement. However, the taxpayer must be exercising independent judgment and not simply ratifying decisions made by a manager.

Several categories of taxpayers do not meet the standard of active participation and therefore do not qualify for the $25,000 special allowance.

- A limited partner in an activity[23]
- A taxpayer who has less than 10% ownership[24]
- A trust or corporation (The $25,000 special allowance is available only to natural persons.)

> **Note.** An exception to the trust exclusion exists for a grantor trust owned by a natural person because it is not deemed a separate entity.

- A taxpayer whose rental activity consists of a net lease (Under a net lease, the tenant pays most of the expenses.)

Passive loss limitations for rental real estate generally apply to the following.

- Leased residential property
- Leased vacation homes, if the average rental period is greater than seven days
- Leased condos, if the average rental period is greater than seven days
- Leased commercial buildings
- Leased land
- Mini-warehouses
- Self-storage units

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23. IRC §469(i)(6)(C).
24. IRC §469(l)(6)(A).

Modified Adjusted Gross Income

The full $25,000 special allowance is available for taxpayers whose MAGI does not exceed $100,000. For every dollar that a taxpayer's MAGI exceeds $100,000, the allowance is reduced by 50 cents. Once MAGI exceeds $150,000, the special allowance is no longer available.

> **Example 4.** Jack and Jill's MAGI is $110,000. Their $25,000 special allowance is reduced by $5,000 ($110,000 − $100,000) × 50%) to a $20,000 ($25,000 − $5,000) maximum allowance.

MAGI is determined by computing AGI without taking into account any of the following.

- Passive loss or passive income
- Rental losses (whether or not allowed by IRC §469(c)(7))
- Deductible contributions to IRAs and pension plans
- Taxable social security and tier 1 railroad retirement benefits
- Domestic production activities deduction
- Deduction for one-half of self-employment (SE) tax[25]
- Exclusion for adoption expenses under IRC §137
- Student loan interest
- Exclusion for interest income from U.S. savings bonds (used to pay higher education tuition and fees)
- Tuition and fees deduction
- Any overall loss from a publicly-traded partnership (PTP)

Dispositions. If there is an **overall loss** after considering current and suspended losses against the gain on a disposition, the loss is **nonpassive.**[26] Thus, it enters into the MAGI computation and reduces income. Stated differently, both the income and the losses enter into the MAGI computation.

If there is an **overall gain** after considering current and suspended losses against the gain on a disposition, neither the gain nor the losses should be considered in computing MAGI. This is because the net gain constitutes passive income under Temp. Treas. Reg. §1.469-2T(c)(2).

25. IRC §469(i)(3)(E).

26. IRC §469(g).

Exceptions. The following are exceptions to the usual MAGI calculation.

- The deduction equivalent of the rehabilitation credit[27] is phased out beginning at MAGI of $200,000. Even a limited partner may take the rehabilitation credit. There is no participation requirement for the low-income housing credits (LIHC),[28] rehabilitation credits, or for the commercial revitalization deduction.[29]
- There is no phaseout range for the LIHC. **Any** taxpayer can claim the LIHC, including a limited partner.[30] Furthermore, for both the rehabilitation credit and LIHC, even a limited partner may use the $25,000 offset. Both of these credits affect Form 8582-CR, *Passive Activity Credit Limitations,* rather than Form 8582.
- A **real estate professional** who materially participates in **each** rental activity (including low-income housing (LIH) and rehabilitation activities) may deduct all current losses without limitation. However, even if the taxpayer is a real estate professional, many LIH and rehabilitation interests are owned via a **limited partner interest;** thus, losses from these activities generally are subject to the same passive loss rules. Rental losses that are allowed by virtue of the real estate professional rules increase MAGI. The increase in MAGI may limit the amount of the $25,000 offset available.[31]
- There are special rules for married taxpayers who file separately.[32]
- There is no phaseout for the commercial revitalization deduction.[33]

Exception for Real Estate Professional

Beginning in 1994, a real estate professional can treat rental real estate activities as **nonpassive** if the taxpayer **materially participates** in the rental activities.[34] The material participation requirement applies separately to **each** rental activity (unless the taxpayer made a timely election to group all rentals as a single activity). These rules apply to individual taxpayers and closely-held C corporations.

To qualify as a real estate professional and deduct losses without limitation, the taxpayer must:

1. Spend more than 50% of their time in real estate activities,
2. Spend more than 750 hours in real estate activities, and
3. Materially participate in **each** rental activity.[35]

For married couples, each spouse's time is taken into account separately for the first two tests. Therefore, at least one spouse must satisfy both the personal service and 750-hour requirements. Services performed as an employee do not count unless the employee is at least a 5% owner. For the third test, both spouses' time can be combined but only time applied to rental real estate activities (and not to real property trades or businesses) is counted.

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27. IRC §47.
28. IRC §42.
29. IRC §469(i)(6)(B).
30. IRC §469(i)(3)(D).
31. IRC §469(i)(3)(E)(iv).
32. IRC §469(i)(5).
33. IRC §469(i)(3)(C).
34. IRC §469(c)(7).
35. Treas. Reg. §1.469-9(e)(1).

To qualify as a real estate professional, an individual must spend the majority of their time in real property businesses, including the following.

1. Development or redevelopment
2. Construction or reconstruction
3. Acquisition or conversion
4. Rental
5. Management or operation
6. Leasing
7. Brokerage

Grouping. A real estate professional may file a **written election** to group all rental real estate activities together.[36] If the election is not made, each rental is treated as a separate activity. The taxpayer may file the election in any year, and it will bind future years from that point.[37] In order to make a valid election, Treas. Reg. §1.469-9(g) requires a taxpayer to file a written statement and attach it to an original return.

Caution. This election cannot be made on an amended return or during an audit.

Note. See the discussion of "Suspended Losses" in the "Sale of Rental Real Estate" section of this chapter for a possible disadvantage of making the grouping election.

Material Participation for Real Estate Professionals. If the taxpayer **materially participates** in an activity, net income or loss from that activity is nonpassive. If the taxpayer does not materially participate despite being a real estate professional, the rental is passive and losses (or income) are reported on Form 8582.

The seven tests for material participation are listed earlier in this chapter. A taxpayer who does most of the work in a rental activity meets the second test (i.e., the taxpayer's participation constitutes substantially all of the participation of all individuals). However, if there is **onsite management,** it may be difficult for the taxpayer to materially participate for the following reasons.

1. Rental activities, by nature, normally do not require significant day-to-day involvement (i.e., they are not time intensive).
2. For many taxpayers using any kind of outside management, the only material participation test available is the 500-hour test. In many situations, the other tests do not apply.
3. In many circumstances, an individual rental activity does not require 500 hours of participation, nor does the taxpayer have sufficient time available to spend 500 hours on **each** individual rental real estate activity.
4. Treas. Reg. §1.469-9(g) requires a taxpayer to file a written statement in advance of the first taxable year to which a grouping election applies.

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36. IRC §469(c)(7)(A).

37. Treas. Reg. §1.469-9(g).

The real estate professional rules affect only the current deductibility of Schedule E rental real estate losses. IRC §469(c)(7) has no impact on the individual's Schedule C. Some practitioners argue that by claiming the benefits of this Code section, the taxpayer must treat the sale of their rental properties as ordinary income subject to social security taxes. Other practitioners voice the concern that use of this Code section results in dealer status for the taxpayer. Neither of these concerns is valid. There is no connection between §469(c)(7) and these other provisions in the Code or Regulations.

Example 5. Helen operates a busy real estate practice as a sales associate with Zip Realty. Helen earns in excess of $220,000 in commission income per year, with an average net profit on Schedule C of $155,000. Helen is a full-time realtor, and this is her only trade or business. She easily meets the 750-hour annual requirement for real estate professionals.

Helen also owns a 9-unit apartment building. In 2010, her Schedule E reflects a rental loss of $13,967. She uses an area property management company to manage the building. Because her AGI is over $150,000, she cannot deduct the loss unless she qualifies under the real estate professional rules.

Helen spent 30 hours during the year reviewing management reports and meeting with her property manager. She had no other involvement either in the current year or prior years.

Question 5A. Is the $13,967 Schedule E rental loss currently deductible by Helen under the real estate professional rule?

Answer 5A. No. Helen's involvement in the management of the rental activity does not meet any of the **seven** material participation standards.

Question 5B. Would the answer in Question 5A be the same if Helen managed the building herself?

Answer 5B. Maybe. Helen should carefully document the time she spends managing the building to see whether she can meet one of the seven tests.

In addition to the material participation requirement, there is another requirement that is often overlooked. Unless an election is made to the contrary, **each rental real estate interest of the taxpayer is required to be treated as a separate activity.**[38]

Example 6. Assume the same facts as **Example 5,** except Helen owns **seven rental properties.** The rental properties reflect a total 2010 Schedule E loss of $32,819.

Question 6A. Can Helen claim this total loss on her 2010 return?

Answer 6A. No. While Helen is probably closer to meeting one of the material participation tests, the Code and Regulations make it clear that the material participation tests must be met for "**each** interest of the taxpayer in a rental real estate activity." Since Helen has seven interests in rental real estate, she must materially participate in **each** property in order to qualify for the 2010 deduction of the loss attributable to that property.

The word **each** in the Code is the key to the confusion regarding the deductibility of rental property losses.

Question 6B. Is there anything Helen can do to make losses from her seven rental properties deductible in 2010 and future years?

Answer 6B. Yes. Helen can make an election on her 2010 return under IRC §469(c)(7)(ii) to treat **all** interests in rental real estate as **one activity.**

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38. IRC §469(c)(7)(A)(ii).

Making the Election. An election to treat all interests in rental real estate as one activity falls under IRC §469(c)(7)(ii). The Regulations provide guidance on the process for making the election.

> ***Election to Treat All Interests in Rental Real Estate as a Single Rental Real Estate Activity:***
>
> ***In general.*** *A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. This election is binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer under paragraph (c) of this section, even if there are intervening years in which the taxpayer is not a qualifying taxpayer. The election may be made in any year in which the taxpayer is a qualifying taxpayer, and the failure to make the election in one year does not preclude the taxpayer from making the election in a subsequent year.*
>
> ***Filing a statement to make or revoke the election.*** *A qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's original income tax return for the taxable year. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to section 469(c)(7)(A). A taxpayer may make this election for any taxable year in which section 469(c)(7) is applicable.*[39]

Following is a typical election statement.

Election to Group Activities Pursuant to Treas. Reg §1.469-4(c)

The taxpayer hereby elects to group the following activities together so that the grouped activities are treated as a single activity for the current tax year and all years thereafter. The following activities are to be grouped together and treated as one activity.

1. Apartment building located at 413 Elm St., Clinton, IL
2. Duplex located at 1302 Church St., Clinton, IL

Question A. What should be done about the prior year's returns if losses were claimed and the practitioner realizes the client does not qualify for the loss deductions because the election was not previously made?

Answer A. An amended return should be filed.

Question B. If the practitioner was not aware of the real estate professional rule in earlier years and the client has passive loss carryovers to the current year, will the election to aggregate all interests in real estate activities in the current year allow the current year's deduction of the passive loss carryovers?

Answer B. No. The losses remain as passive loss carryovers, although they may be deducted under the $25,000 rental real estate exception if the taxpayer qualifies.[40]

39. Treas. Reg. §1.469-9(g).
40. Treas. Reg. §1.469-9(j).

RECENT COURT DECISIONS

Lack of Proof for Time Spent on Real Estate Activities

- ***Alma Perez v. Comm'r,*** **TC Memo 2010-232 (Oct. 25, 2010).** The taxpayer qualifies as a real estate professional because of her activities as a self-employed real estate loan agent. However, she could not deduct the losses on her three rental properties. She admitted she did not materially participate in the properties.

- ***James F. and Lynn Moss v. Comm'r,*** **135 TC No. 18 (Sep. 20, 2010).** The taxpayers owned rental properties that generated losses. While the taxpayers admit they did not meet the 750-hour test to qualify as real estate professionals, they contend that Mr. Moss was "on call" for work on rental properties during the time he was not at his full-time job and those hours should count against the 750-hour requirement. The court did not agree with the taxpayer.

Lack of Proof and/or Failure to Elect to Aggregate Interests

- ***Anjum Shiekh v. Comm'r,*** **TC Memo 2010-126 (Jun. 10, 2010).** Mr. Shiekh met the requirements of a real estate professional. However, he failed to meet the 750-hour material participation test. He also failed to make the election to group his rental activities. Consequently, he could not net the income from one property against the loss from another.

- ***Donald W. Trask v. Comm'r,*** **TC Memo 2010-78 (Apr. 15, 2010).** Mr. Trask met the 750-hour material participation test to be a qualified real estate professional. However, he could not deduct his losses because he failed to make the grouping election. The court did not accept the document he gave the IRS representative at trial as a valid election. The election should have been made on an original return.

Equipment Rentals

As a general rule, equipment rentals are defined as passive activities under IRC §469(c)(2). Income and losses should be entered on Form 8582, line 3 (All Other Passive Activities). Equipment rental activities are passive regardless of whether the taxpayer materially participates.[41] Material participation is generally irrelevant if the activity is an equipment rental activity. Unless a taxpayer meets one of the six exceptions[42] to the rental definition (listed earlier), neither the active participation standard nor the material participation standard apply. As a result, **the $25,000 special allowance for rental real estate activities cannot be used for equipment rentals.**

41. IRC §§469(c)(2) and (4).

42. Temp. Treas. Reg. §1.469-1T(e)(3)(ii).

VACATION RENTALS

In order to determine the tax consequence of a vacation cottage, condo, time-share, hotel, motel, or bed and breakfast, a multiple step analysis is required.

Step 1. Is the average rental period seven days or less? Is the average period of customer use 30 days or less with significant personal services provided? If the answer to either question is yes, the activity is treated as a **business** in which the taxpayer must **materially participate.**[43]

Step 2. Did the taxpayer spend more than the greater of 14 days at the property or 10% of the days rented at a fair rental value? If so, the rental deductions are limited to the amount of rental income.[44]

Step 3. If taxpayer does not meet either the **Step 1** test or **Step 2** test, does the taxpayer **actively participate** in the activity and have an MAGI that does not exceed $100,000? If so, the activity is a passive rental activity subject to the $25,000 special allowance. If the taxpayer does not qualify for the $25,000 special allowance, the loss is suspended.

Step 4. To meet the material participation test of **Step 1,** the taxpayer must meet one of the following six tests.

1. Does the taxpayer and/or spouse work more than 500 hours a year on activities related to the rental?
2. Does the taxpayer perform substantially all of the work?
3. Does the taxpayer work at least 100 hours and not less than any other individual?
4. Does the taxpayer have several passive businesses with losses in which they participate 100–500 hours, and does the total participation in the activities exceed 500 hours?
5. Did the taxpayer materially participate for 5 out of the last 10 years?
6. Do facts and circumstances indicate that the taxpayer materially participates?

If any one of these six tests are met, the vacation property rental loss is 100% deductible on Schedule C. If none of the six tests are met, the taxpayer does not qualify for the $25,000 special allowance and the vacation property rental loss is a suspended loss limited to passive income.

PERSONAL USE LIMITATIONS

If the taxpayer or family members use a vacation property for the **greater of 14 days or 10% of the property's rental time,** the personal-use limitations of IRC §280A apply and IRC §469 are no longer applicable. IRC §280A severely limits losses.

Example 7. Frank and Sandy own a condo in Orlando, Florida. They use the property for their 4-week winter vacation in March each year. The remainder of the time they allow the condo association to rent it on a monthly basis. Frank and Sandy receive the rental income minus a 25% handling fee the condo association charges for managing the rental and preparing the condo for the next tenant.

In 2010, the association rented the condo for a total of 250 days. The rental income net of the condo fee was $25,000 ($33,333 gross rental income − $8,333 gross rental expense).

Because Frank and Sandy used the property for **over 14 days, the 10% rule** determines whether their Schedule E deductions are limited.

250 rental days × 10% = 25 days

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43. Temp. Treas. Reg. $1.469-1T(a).

44. IRC §§280A(c)(5) and (d)(1).

Frank and Sandy used the property for personal purposes 27 days. Consequently, their Schedule E deductions are limited.

The following illustrates the allocations to Schedule E and Schedule A:

Rental portion	250 days ÷ 365 days = 68.49%
Residential portion [a]	115 days ÷ 365 days = 31.51%

[a] Any day that the property is available for rent but not actually rented is not a day of rental use.

Item	Total	Rental Portion	Residential Portion
Rental income	$33,333	$33,333	$ 0
Expenses			
Utilities	4,000	2,740	1,260
Condo fees	2,000	1,370	630
Rental fee	8,333	8,333	0
Real estate tax	5,000	3,424	1,576
Mortgage interest	18,000	12,328	5,672
Depreciation	9,000	6,164	2,836
Total expenses	$46,333	$34,359	$11,974
Net rental	($13,000)	($ 1,026)	($11,974)

The $1,026 rental loss is not deductible. This loss can be carried forward to future years. Only the mortgage interest and real estate taxes are allowable itemized deductions on Schedule A. Therefore, the total itemized deduction produced by the vacation home is $7,248 ($1,576 real estate tax + $5,672 mortgage interest).

Example 8. Use the same facts as **Example 7,** except the condo association guarantees Frank and Sandy $25,000 of rental income each year. The condo association collects more than $25,000 in rent and it retains the excess. Frank and Sandy can deduct their rental expenses against the rental income because the condo association rented the property for all but the 27 days the property was used by the owners.[45]

A personal-use day is considered to be the 24-hour period for which a normal rental is calculated. Therefore, if the owner occupies the property on Friday and Saturday night, it is considered two days even if they arrive at noon on Friday and leave at noon on Sunday.[46] **Personal-use days do not include owner "work days" on the condo.**

Use by Family Members

Use by a family member is considered personal use, even if they pay a fair rental value for the vacation property. Family members include spouses, brothers, sisters, ancestors, lineal descendants, and spouses of lineal descendants.[47] If the family member **pays a fair rental value** and uses the property **as their principal residence,** the time rented is not counted as personal use.[48]

45. *M. Razavi v. Comm'r,* 74 F.3d 125 (6th Cir. 1996).

46. *Dorrance D. and Helen A. Bolton v. Comm'r,* 694 F.2d 556 (9th Cir. 1982); *Edith G. McKinney v. Comm'r,* 732 F.2d 414 (10th Cir. 1983).

47. IRC §267(c)(4).

48. IRC §280A(e)(1).

Example 9. Rich owns a vacation condo in Colorado. He allows his son to use the condo for 14 days in 2011 and charges him no rent. The 14 days represent personal-use days by Rich in 2011. Even if Rich was paid fair rental value for the 14 days, those days would still represent personal-use days by Rich because the condo was not used as the son's principal residence.

Reciprocal Arrangements

Any rental under a **reciprocal arrangement,** whether or not a fair rental is charged, is considered personal use.

Example 10. Terri and Randy own a vacation home in Canada that they typically rent for $700 per week. They agree to trade a week's usage of their Canada property with their friends Curtis and Ruth, who own a property in St. Thomas. The St. Thomas property rents for $2,000 per week, so Terri and Randy pay Curtis and Ruth $1,300. This is considered a week's personal use by both couples.

Donation of Use of Vacation Property

A taxpayer may donate the right to use their vacation property to a charity fund-raising auction. Even if the right to use the property is sold at or above the fair rental value, the use by the successful bidder is considered personal use. **A charitable deduction is not available to the property owner because the gift of a right to use property is not a deductible contribution.**

DEDUCTION LIMITATIONS FOR REAL ESTATE NOT RENTED FOR PROFIT

Rental activities must be operated with a profit motive for any losses generated to be deductible. If a property is used partly to generate income and partly for personal purposes, the amount of deductible expenses may be limited.

The instructions for Schedule E, *Supplemental Income and Loss*, identify the following people whose use is considered **personal use by the taxpayer.**

- The taxpayer, if the property is occupied for personal purposes
- Any other person that owns part of the unit and uses the property for personal purposes, unless rented to that person under a "shared equity" financing agreement
- Anyone in the taxpayer's family, unless the unit is rented at a **fair rental price** to that family member as their principal residence
- Anyone who pays **less than a fair rental price** for the unit
- Anyone under an agreement that lets the taxpayer use some other unit

The IRS instructs taxpayers who rent property without a profit motive to report the income on **line 21, Other Income, on Form 1040.**[49] Related expenses are deducted on **Schedule A, *Itemized Deductions*.**

Deduction Limitations by Category[50]

Category	Type of Expenses	Where Deducted
1	Real estate taxes, mortgage interest, casualty losses	Designated lines on Schedule A
2	Other expenses not in Categories 1 or 3	Miscellaneous subject to 2% floor
3	Depreciation and amortization	Miscellaneous subject to 2% floor

49. IRS Pub. 527, *Residential Rental Property*.

50. IRS Pub. 535, *Business Expenses*.

Category 1 deductions are not limited by the not-for-profit rules, but they are subject to the limitations applicable to that type of expense. For example, the 10% AGI threshold applies to all personal casualty losses including those connected with property rented without a profit motive.

Category 2 deductions cannot exceed the profit remaining after Category 1 expenses are subtracted from rental income.

Category 3 deductions cannot exceed the profit remaining after expenses from the previous categories are subtracted from the rental income.

Example 11. Roger dotes over his granddaughter Ally. Ally has two small children and works as a waitress while her children are in school. When Roger moved to Florida in 2008, he let Ally and her children move into his former residence. He charges Ally only $200 per month in rent to help offset the cost of the real estate taxes and insurance. In 2010, the real estate taxes are $2,000 and the insurance is $800. Roger lacks a legitimate profit motive.

Tax Result. For 2010, Roger reports $2,400 ($200 × 12 months) of rental income on line 21 (other income), of his Form 1040. The allowable deductions on Schedule A are calculated as shown.

Total rental income	$2,400
Less: deductible real estate taxes	**(2,000)**
Remaining profit for category 2 and 3 expenses	$ 400
Lesser of remaining profit ($400) or Category 2 expenses ($800 insurance)	**(400)**
Remaining profit available for Category 3 expenses (depreciation)	**$ 0**

Roger deducts $2,000 on the real estate tax line of Schedule A and $400 of the insurance expense as a miscellaneous itemized deduction subject to the 2% floor. He does not deduct any depreciation because there is no profit remaining after the Category 1 and 2 expenses are deducted.

Observation. Reporting the $2,400 rental income on line 21 increases Roger's 2010 AGI. This may cause adverse tax consequences, especially if he cannot itemize.

There is a fine line between reportable income and reimbursement for out-of-pocket expenses. If Roger and Ally's agreement defines her payments to him as reimbursements, Roger could argue that none of the payments are includable in income. This argument is supported by court cases such as *Comm'r v. Glenshaw Glass Co.,*[51] which defined gross income as "an undeniable accession to wealth, clearly realized, over which a taxpayer has complete dominion."

It is also supported by the IRS conclusion in a chief counsel advice ruling.[52] It held that a taxpayer who received a partial rebate of real property taxes is not required to include the rebate in gross income.

If Roger takes this position, he must reduce his deductions by any reimbursements received. A tax practitioner taking this position should consider disclosing the position to avoid any potential preparer penalties if the treatment is disallowed in an audit.

51. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

52. CCA 200721017 (Feb. 8, 2007).

SELF-RENTAL INCOME

Taxpayers with suspended passive rental losses may try to generate passive rental profits to offset the losses. These taxpayers may attempt to rent property they own to a business entity they control. However, certain types of income are treated ("recharacterized") as nonpassive. If a taxpayer rents property to a business in which they materially participate, **net rental income is nonpassive and should not be reported on Form 8582, line 1a, as passive income.**[53]

Treas. Reg. §1.469-2(f)(6) states that if a taxpayer rents property to their own business, the rental profit is not treated as passive activity income. The *Cal Interiors, Inc.*[54] case explains the self-rental rule.

In this case, husband and wife owned five apartment buildings, each of which had net rental losses that were reported on the taxpayers' Schedule E. The taxpayers also wholly owned two auto-interior repair C corporations. Both of the taxpayers were full-time employees of their two corporations. During the year in question, the taxpayers rented a portion of their personal residence to the C corporations. Both C corporations paid substantial amounts of rent to the taxpayers for using a portion of their residence as the business offices of the corporations.

During 1999, the taxpayers reported a net rental profit of approximately $22,000 on their Schedule E for renting a portion of their residence to the corporations. **On their individual tax return, the taxpayers reported all six rental properties on their 1999 Schedule E as follows.**

Total of net rental losses for the 5 apartment buildings (assumed from given facts)	($65,000)
Net rental profit from renting part of their residence to the two C corporations	22,000
Schedule E net loss reported but not deducted due to Form 8582 limitations	**($43,000)**

In its examination, the IRS held that the self-rental rule applied and reclassified the $22,000 rental profit as **nonpassive** income. Thus, the $22,000 rental profit could not be used to offset the $65,000 loss on the rental of the other five rental properties. **The tax result, according to the IRS, was as follows.**

- The $22,000 nonpassive profit from renting a part of their residence **was taxable.**
- The $65,000 net rental loss on the other five rental properties was a **nondeductible passive loss** because the taxpayers' MAGI exceeded the $150,000 limitation for the Special Allowance for Rental Real Estate activities (shown in Part II, Form 8582). The $65,000 loss was treated as a **suspended** passive loss.

The court agreed with the IRS position and restated the opinion it had reached in five previous Tax Court decisions that found the self-rental regulation was valid.

Even though income is treated as nonpassive, it may offset suspended prior year passive losses from the same activity.[55]

Tax preparers should examine Schedule E for any property with net income and few expenses, indicating that the property might be under a net lease. Income from property leased to an entity for which the taxpayer works is often structured as a net lease.

The self-rental issue is a frequent IRS exam adjustment, as it is common practice for many professionals to own property personally and lease it to a corporation or partnership where they conduct business.

Example 12. Dr. Nomopaine is a dentist with a thriving practice. He personally owns the building that houses his dental practice and leases it to his C corporation dental practice business. The self-rental rule applies and his Schedule E rental profit is treated as nonpassive income.

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53. Treas. Reg. §1.469-2(f)(6).

54. *Cal Interiors Inc. v. Comm'r*, TC Memo 2004-99 (Apr. 7, 2004).

55. IRC §469(f)(1).

RENTAL TO EMPLOYER

The deduction for the business use of a home **is limited** if part of the home is rented to the taxpayer's employer and the taxpayer uses the rented part in performing services for the employer. The taxpayer/employee is limited to only deducting mortgage interest, qualified mortgage insurance premiums, real estate taxes, and personal casualty losses for the rented portion of the home, subject to any limitations. However, the taxpayer cannot deduct otherwise-allowable trade or business expenses, business casualty losses, or depreciation related to the use of the home in performing services for the employer.[56]

SELF-EMPLOYMENT INCOME

Rental income is not normally considered as earned income for SE tax purposes. However, this is not necessarily the case with all rentals.

RELATED-PARTY FARM REAL ESTATE RENTALS

Rental income from real estate is normally exempt from SE tax. However, rentals involving the production of agricultural or horticultural commodities are subject to SE tax if the taxpayer **materially participates** in the production or management of production on the land. The original case involving this type of rental was the *Mizell* case.[57]

The *Mizell* case involved an Arkansas farmer who rented 731 acres of farmland to a family partnership operated with his three sons. The father owned a 25% interest in the partnership and the partnership agreement specified that each partner had an equal vote in the management of the partnership operation and in the conduct of the farming business.

Each partner was required to devote full time to the operation, and the father was **active in the partnership** in the years in question and reported the distributive share of partnership income as net earnings from self-employment. The lease was on a 25% crop-share basis with the partnership paying all of the crop expense.

The father treated the activity as **nonmaterial participation** and did **not** report the rental amounts as self-employment income. The Tax Court focused on the language in IRC §1402(a)(1) providing an exception to the general rule that rentals from real estate are excluded from net earnings from self-employment if there is an "arrangement" with material participation by the owner in the "production or the management of the production" of agricultural commodities.

The court noted that **the father was materially participating in the partnership operations** and the statutory language referring to "an arrangement" necessarily included the father's involvement in the partnership as well as under the lease. **Thus, the rental income under the lease was subject to SE tax.** The type of lease, the court reasoned, was immaterial when the lessor was materially participating in the lessee entity.

Exceptions for 8th Circuit Taxpayers[58]

A 1996 technical advice memorandum[59] reached the same conclusion regarding a cash-rent lease to a corporation. Three letter rulings in 1998 were in accord.[60]

In three cases decided in 1999, the Tax Court applied *Mizell* and imposed SE tax on rents from land rented to a family farming operation.[61] On appeal, the three Tax Court cases were consolidated and were reversed in late 2000.[62]

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56. IRS Pub. 587, *Business Use of Your Home*.
57. *Mizell v. Comm'r,* TC Memo 1995-571 (Nov. 29, 1995).
58. Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota.
59. TAM 9637004 (May 1, 1996).
60. Ltr. Rul. 9917008 (Dec. 10, 1998); Ltr. Rul. 9917005 (Dec. 10, 1998); Ltr. Rul. 9917006 (Dec. 10, 1998).
61. *Bot v. Comm'r,* TC Memo 1999-256 (Aug. 3, 1999); *Hennen v. Comm'r,* TC Memo 1999-306 (Sep. 16, 1999); *McNamara v. Comm'r,* TC Memo 1999-333 (Oct. 4, 1999).
62. *McNamara v. Comm'r,* 236 F.3d 410 (8th Cir. 2000).

The 8th Circuit held that the lessor–lessee arrangements should stand on their own, apart from any employment relationship, and that if the rentals were "consistent with market rates for agricultural land" the rents were not "derived under an arrangement" and, therefore, SE tax was not due. The court pointed out that "the mere existence of an arrangement requiring and resulting in material participation in agricultural production does not automatically transform rents received" into SE income. The court further stated that rents consistent with market rates "very strongly suggest" that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an arrangement for participation in agricultural production. The court remanded the cases to the Tax Court to provide an opportunity for the IRS to show a connection between rents and the "arrangement."

On July 10, 2002, the Tax Court rendered its remand opinion holding that the rental arrangements reflected FMV and that no SE tax should be imposed.

> **Note.** Based on the 8th Circuit's opinion in *McNamara*, it is imperative that taxpayers potentially subject to challenge set the rental rates in keeping with rates in the area for comparable land. In addition, it is important that evidence of rental rates be preserved for use in any later audit.

Practice Pointers. For taxpayers occupying a dual status as lessor and lessee, it is important for the lease to be in writing with standard terms and conditions calling for a reasonable rental. Also, it is important for the status as partner, employee, or LLC member to be formally established and maintained.

While *Mizell* involved a partnership, a more general solution to the problem may be to convey the land to another type of entity (such as an LLC or LP); however, the regulations on handling SE income for such pass-through entities are still unsettled.

The key, outside the 8th Circuit, is to make sure that the taxpayer is not on "both sides of the equation" as both lessor and lessee. In the IRS's view, supported by the Tax Court opinion in *Mizell*, the question is whether the taxpayer's combination of involvement as lessor and lessee rises to the level of material participation. In the 8th Circuit (Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota) the key is to make sure the rental rate is representative of a fair market rental for comparable land.

Another approach may be to transfer the land to a nonparticipating spouse and have the spouse lease the land to the farming business under a passive lease. There are several other income tax and estate tax implications to consider with this approach.

RENTS FROM PERSONAL PROPERTY

A note on Part 1 of Schedule E, Form 1040 states, "If you are in the business of renting personal property, use Schedule C or C-EZ." This raises concerns about the proper reporting of retired farm or business owners' rentals from personal property such as machinery rented to children or others. Several high-profile audits in which examining agents have taken a relatively aggressive stance on the issue have added to the concerns.

> **Note.** IRC §1402 imposes SE tax on net earnings from self-employment derived by an individual from any trade or business. Excluded from this definition are *"rentals from real estate and from personal property leased with the real estate . . ."* The statutory language does not provide exclusion for the rental of personal property apart from the real estate. The statute requires an individual to be engaged in a trade or business in order for income to be SE income. For a taxpayer to be engaged in a trade or business, they must be engaged in an activity for the primary purpose of producing income or profit and must be involved in the activity with continuity and regularity.

When a farmer or business owner retires, they may decide to rent their machinery and equipment rather than sell it and face depreciation recapture in the year of sale. If they are retired and the equipment is not leased with the farmland, the IRS may question whether they are in the trade or business of renting equipment. If the IRS determines the taxpayer is in a trade or business, the rental income is subject to SE tax. The taxpayer must report the income and any related expenses on Schedule C or F.

If the taxpayer is **not** in a trade or business, the rent is **not** subject to SE tax and the rent is reported on Form 1040, line 21 (other income) and identified as personal property rental income. Deductible expenses related to income on line 21 from rental of personal property engaged in for profit should be reported in the total amount entered on Form 1040, line 36. The amount of the expenses and "PPR" should be entered on the dotted line next to line 36.

> **Example 13.** Clem, a retired contractor, rented his bulldozer to a neighbor for $250. The neighbor used the bulldozer to level a building site. Clem should report the $250 received for rent of his bulldozer on Form 1040, line 21. Clem is not engaged in the trade or business of renting machinery. If Clem rents the bulldozer to his neighbor **every year,** the IRS may make the case that Clem is in the trade or business of renting bulldozers.

Practice Pointers. For clients who rent machinery to others, **the key is whether the client as lessor is carrying on a trade or business**. If the client is carrying on a trade or business, personal property rentals should be included in the client's SE income and should, therefore, be reported on Schedules C or F. If the client is not carrying on a trade or business, any net rental property should not be included in SE income.

For retired clients renting both machinery and land, including both in the same lease should strengthen the argument that the amounts received are **not** subject to SE tax. The statutory language of IRC §1402 should be strong enough to specifically exclude the rental income from SE tax if the taxpayer is not materially participating.

For clients who rent personal property but want to avoid SE income, the lease should be drafted to place responsibility on the lessee for maintenance and repair of the rental property. The client as lessor should avoid involvement in management or decision-making relative to the property under the lease. The net income should then be reported on the "Other Income" line of Form 1040 (or on Form 4835 or Schedule E) with the income reported as "net income from passive rental activity." Even in this case, the IRS may argue that the rental activity is a trade or business.

SPACE

Whether the rental of space is considered to be SE income is another litigated question. One argument is that space is a part of real estate and should be exempt from SE tax. However, the exemption is very much a facts-and-circumstances issue. The Code explains that the term "net earnings from self-employment" means the gross income less deductions from any trade or business.[63] In computing net earnings from self-employment, rentals from real estate less any attributable deductions are excluded, unless the rentals are received in the course of a trade or business as a real estate dealer under IRC §1402(a)(1).[64]

Payments for the use of rooms or other space where services are also rendered to the occupant are not rentals from real estate.[65] Examples include hotel rooms, tourist homes and camps, space in parking lots, and storage units. Generally, services are considered rendered to the occupant if they are for the occupant's convenience and are other than those ordinarily rendered with the rental of rooms or other space for occupancy. Furnishing maid service is such a service, while furnishing heat and lights is not considered services rendered to the occupant.

63. IRC §1402(a).

64. Treas. Reg. §1.1402(a)-4(a).

65. Treas. Reg. §1.1402(a)-4(c)(2).

In the *Bobo* court case,[66] the taxpayers rented space in a trailer park. The court ruled that the rental real estate income was exempt from SE tax. The taxpayer furnished sewerage, vacant mobile home maintenance (for the trailers owned by the park and used as rentals), trash collection, grounds maintenance, and a laundry facility with equipment owned by a concessionaire. The court looked to determine whether the services were provided for the convenience of the tenant or if they were required to maintain the space in a condition for occupancy. The court agreed that all of the services, except the laundry facility, were provided to keep the premises in a condition for occupancy. The court ruled the laundry service was an insignificant part of the rental and did not raise the level of the activity to a trade or business.

In a letter ruling[67] which cited the *Bobo* case, the IRS ruled against a taxpayer who rented out space in an antique mall. This taxpayer rented space to house her antique mall. She then subleased the floor space to up to 60 antique dealers. The rent was based on the location and square footage used. In addition, dealers were required to pay the taxpayer 10% of the sale price of merchandise sold from the space.

The mall owner was at the antique mall most of the hours it was open. If she was not there, she hired a person to be present. She answered buyers' questions, wrote up sales receipts, and collected the money and sales tax from the sale. She also advertised the mall. The dealers visited their space to restock, organize their antiques, and meet with customers. The IRS ruled the taxpayer **was liable for SE tax** for both the floor space charge and the 10% commission.

In *Hopper,*[68] the Tax Court ruled in favor of the taxpayer in a case involving the rental of self-storage units. The taxpayer was a partner in a group of investors owning 900 self-storage units in two separate locations. Each site had a manager that lived on the premises. Services provided to tenants included a soft drink machine; pest control; contents insurance; and the sale of locks, packaging materials, and pallets. The case hinged on whether the services provided were more than those necessary to maintain the property in a condition for occupancy. In this case, the court ruled the income was from a rental activity rather than a trade or business and was **not SE income.**

Rental of Property with Services

An arrangement in which the landlord agrees to **furnish services** in conjunction with the rental of property can result in SE tax.

Example 14. Wanda owned Water-Tite Storage Units and reported her income and expenses on Schedule C each year. Wanda has no employees and manages the property herself. She collects the rents, keeps the outside premises clean, and does whatever is needed to run the business.

Wanda only has a 55% occupancy rate and is having trouble meeting her mortgage payments. She discussed her financial problems at a bridge game with her friend Patsy. Patsy, a marketing expert, believes the occupancy rate could be increased to 95% with the proper promotion.

Patsy offers to rent the entire unit for $30,000 per year if Wanda continues to manage and operate the business. Wanda does not receive any additional money for her services. Wanda accepts the offer since it will provide her with enough cash flow to meet her payments, and she doesn't think Patsy can increase occupancy. If occupancy does increase, Wanda is not obligated to extend the lease at the end of the year.

Wanda must continue to report the $30,000 of income and any deductions on Schedule C. The net income is reported on Schedule SE, *Self-Employment Tax*.

Note. Wanda could avoid SE tax if she had two separate agreements, one for the rental and one for her services.

Example 15. Larry owns property near a college campus. He rents a room to a student each semester. The rental fee includes all utilities, an Internet connection, and daily room cleaning. Larry must report the rental activity as self-employment income due to the type of services he provides.

66. *Fabian and Florence Bobo v. Comm'r,* 70 TC 706 (Aug. 17, 1978).

67. Ltr. Rul. 9421001 (Dec. 21, 1993).

68. *Roger G. Hopper v. Comm'r,* 94 TC 542 (Mar. 27, 1990).

HUSBAND AND WIFE JOINT VENTURES

The 2010 instructions for Schedule E include some confusing directions for jointly owned rental real estate, and some tax software programs generate errors if the user indicates that Schedule E property is jointly owned. The instructions read:

> *Do not use Schedule E to report income and expenses from a rental real estate business that is a qualified joint venture conducted by you and your spouse, if you file a joint return for the tax year.*
>
> *If you and your spouse each materially participate as the only members of a jointly owned and operated business and you file a joint return for the tax year, you can make an election to be taxed as a qualified joint venture instead of a partnership. This election in most cases will not increase the total tax owed on the joint return, but it does give each of you credit for social security earnings on which retirement benefits are based and for Medicare coverage. For an explanation of "material participation," see the instructions for Schedule C, line G.*
>
> *To make the election, you must divide all items of income, gain, loss, deduction, and credit attributable to the business between you and your spouse in accordance with your respective interests in the venture. Each of you must file a separate Schedule C or C-EZ. On each line of your separate Schedule C or C-EZ, you must enter your share of the applicable income, deduction, or loss. Each of you also must file a separate Schedule SE to pay SE tax, as applicable (but see the Note below regarding rental income reported on Schedule E). See the instructions for Schedules C or C-EZ and SE and Pub. 527 for more details.*

Note. Rental income reported on Schedule E is not taxable for SE tax purposes. Electing qualified joint venture status and using the Schedule C or C-EZ does not alter the application of the SE tax or the passive loss limitation rules.

The following is the probable IRS reasoning for these Schedule E instructions.

- Partnership returns are required for most joint ventures.
- The Code exempts husband-wife joint ventures from partnership treatment if each spouse reports "such spouse's respective share of such items as if they were attributable to a trade or business conducted by such spouse as a sole proprietor."[69]
- Therefore, rental real estate activities owned jointly by spouses should be reported on Schedule C.

However, the Regulations[70] provide another exception to partnership treatment for **participants in an investment activity who can accurately compute their income without filing a partnership return.** To qualify, the participants must:

1. Own the property as co-owners;
2. Reserve the right separately to take or dispose of their shares of any property acquired or retained; **and**
3. Not actively conduct a business or irrevocably authorize another person to purchase, sell, or exchange the investment property.

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69. IRC §761(f)(1)(C).

70. Treas. Reg. §1.761-2.

The Regulations explain how to properly make the election for such treatment. However, they also provide that a venture is deemed to have made the election "if the members of the organization owning substantially all of the capital interest report their respective shares of the items of income, deductions, and credits of the organization on their respective returns (making such elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from subchapter K beginning with the first taxable year of the organization."[71]

The IRS Schedule E instructions state that the rental activity is not subject to SE tax even when reported on Schedule C. However, if a profitable rental activity is reported on Schedule C and no SE tax is paid, the taxpayer may receive an error notice from the IRS. The instructions for Schedules E, C, and SE all indicate the income is exempt from SE tax, but none say how it should be marked to avoid a letter from the IRS indicating an error was made in calculating SE tax. **However, there is a checkbox on both the Schedules C and C-EZ indicating the rental income is not subject to SE tax.**

SCHEDULE C (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business
(Sole Proprietorship)
▶ **Partnerships, joint ventures, etc., generally must file Form 1065 or 1065-B.**
▶ **Attach to Form 1040, 1040NR, or 1041.** ▶ **See Instructions for Schedule C (Form 1040).**

OMB No. 1545-0074
2010
Attachment Sequence No. **09**

Name of proprietor | **Social security number (SSN)**

A Principal business or profession, including product or service (see instructions) | **B Enter code from pages C-9, 10, & 11** ▶

C Business name. If no separate business name, leave blank. | **D Employer ID number (EIN), if any**

E Business address (including suite or room no.) ▶
City, town or post office, state, and ZIP code

F Accounting method: **(1)** ☐ Cash **(2)** ☐ Accrual **(3)** ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2010? If "No," see instructions for limit on losses ☐ **Yes** ☐ **No**

H If you started or acquired this business during 2010, check here . . . ▶ ☐

Part I Income

1	Gross receipts or sales. **Caution.** See instructions and check the box if: • This income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, or • You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see instructions for limit on losses. . . ▶ ☑	1	
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	
4	Cost of goods sold (from line 42 on page 2)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7	**Gross income.** Add lines 5 and 6 . . . ▶	7	

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8 Advertising . . . 8 | 18 Office expense . . . 18

Note. A husband and wife owning rental real estate in an LLC must either file a partnership return or make an election for alternate tax reporting.

71. Treas. Reg. §1.761-2(b)(2)(ii)(b).

PREPAID RENT

RECEIVED

Rentals paid in advance are usually income in the year of receipt whether the taxpayer files on the cash or accrual basis.[72] Depending on the circumstances, there could be an exception if restrictions are placed on the use of the funds.

Security deposits paid by a tenant are not reported as income until the deposit is forfeited. However, the terms of the lease must show the deposit is returnable if the terms of the lease are met. The deposits are only income when the landlord has unrestricted use of the deposit. Indications that the deposit is not income when received include a requirement that interest be paid on the security deposit or a requirement that the deposit be kept in a separate account.

PAID

Normally, cash basis taxpayers may take a deduction in the year that expenses are paid. However, there are certain exceptions. One of the exceptions is the advance payment of rents.[73] Only the portion of the rental payment for the current year is deductible in the year paid. This applies to both cash- and accrual-based taxpayers. A cash basis taxpayer cannot deduct the rent expense until it is paid.

Example 16. Diego signs a 10-year lease for a Christmas tree lot. He is required to pay $1,000 per year. Upon signing the lease, he not only pays the first year's rent but he pays for the remaining nine years as well. Diego may only deduct $1,000 in 2010 and ratably deduct the additional $9,000 over the remaining nine years.

Example 17. On September 1, 2010, Andria rents a chair in a beauty salon at a rate of $600 per month. She is required to pay the first year's rent at the time of signing the lease. She makes a payment of $7,200 to the shop owner. Andrea may only deduct $2,400 in 2010 ($600 × 4 months). The remaining $4,800 is deductible in 2011.[74]

SALE OF RENTAL REAL ESTATE

When rental property is sold, the seller generally recognizes a gain or a loss. A gain results when the amount realized from a sale or exchange of property is more than its adjusted basis. A loss results when the adjusted basis of the property is more than the amount realized.

PROPERTY USED ENTIRELY FOR BUSINESS OR RENTAL

Basis

A taxpayer must know the basis of their property to determine whether they have a gain or loss from its sale or other disposition. The basis of purchased property is usually the purchase price. However, if the taxpayer acquired the property by gift, inheritance, or in some way other than buying it, the basis is determined in accordance with applicable transfer rules.

Adjusted Basis

The adjusted basis of property is the original cost or other basis plus certain additions and minus certain deductions, such as depreciation and casualty losses. In determining gain or loss, the costs of transferring property to a new owner, such as selling expenses, are added to the adjusted basis of the property.

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72. Rev. Rul. 60-85 as modified by Rev. Rul. 71-299.

73. Treas. Reg. §1.263(a)-4(d)(3).

74. *Bloedel's Jewelry, Inc. v. Comm'r,* 2 BTA 611 (Sep. 28, 1925).

Amount Realized

The amount realized from a sale or exchange is the total of all money received plus the FMV (defined below) of all property or services received. The amount realized also includes any liabilities that were assumed by the buyer and any liabilities to which the transferred property is subject, such as real estate taxes or a mortgage.

Fair Market Value

FMV is the price at which the property would change hands between a willing buyer and a willing seller when both have reasonable knowledge of all the necessary facts and neither has to buy or sell. If parties with adverse interests place a value on property in an arm's-length transaction, that is strong evidence of FMV. If there is a stated price for services, this price is treated as the FMV unless there is evidence to the contrary.

Example 18. Eunice used a building in her business that cost her $70,000. She made certain permanent improvements at a cost of $20,000 and deducted depreciation totaling $10,000. She sold the building for $100,000. The buyer assumed her real estate taxes of $3,000 and a mortgage of $17,000 on the building. The selling expenses were $4,000. Her gain on the sale is calculated as follows.

Amount realized:		
Cash	$100,000	
Real estate taxes assumed by buyer	3,000	
Mortgage assumed by buyer	17,000	
Total amount realized	$120,000	$120,000
Adjusted basis:		
Cost of building	$ 70,000	
Improvements	20,000	
Total	$ 90,000	
Minus depreciation	(10,000)	
Adjusted basis	$ 80,000	
Plus: selling expenses	4,000	
	$ 84,000	(84,000)
Gain on sale		**$ 36,000**

Amount Recognized

The gain or loss realized from a sale or exchange of property is usually a recognized gain or loss for tax purposes. **Recognized gains must be included in gross income.** Recognized losses are deductible from gross income. However, gain or loss realized from certain exchanges of property is not recognized for tax purposes. Also, a loss from the sale or other disposition of property held for personal use is not deductible, except in the case of a casualty or theft.

PROPERTY USED PARTLY FOR BUSINESS OR RENTAL

If a taxpayer sells or exchanges property that was used partly for business or rental purposes and partly for personal purposes, the gain or loss must be calculated on the sale or exchange as though the taxpayer had sold two separate pieces of property. The selling price, selling expenses, and the basis of the property must be allocated between the business or rental part and the personal portion. The taxpayer must subtract depreciation they took or could have taken from the basis of the business or rental portion.

Gain or loss on the sale of the business or rental portion of the property may be a capital gain or loss or an ordinary gain or loss. Any gain on the personal portion of the property is a capital gain. Taxpayers cannot deduct a loss on the personal portion of the property.

Example 19. Benjamin sold a condominium for $57,000. He bought the property nine years earlier for $30,000. He used two-thirds of it as his home and rented out the other third. He claimed depreciation of $3,272 for the rented portion during the time he owned the property. He made no improvements to the property. His selling expenses for the condominium were $3,600. He computes his gain or loss as follows.

	Rental ⅓		Personal ⅔	
Selling price	$19,000		$38,000	
Minus: selling expenses	(1,200)		(2,400)	
Amount realized (adjusted sales price)	$17,800	$17,800	$35,600	$35,600
Basis	$10,000		$20,000	
Minus: depreciation	(3,272)		(0)	
Adjusted basis	$ 6,728	(6,728)	$20,000	(20,000)
Gain		**$11,072**		**$15,600**

Note. The 1/3 rental gain of $11,072 is reportable on Form 4797, and is taxable. The 2/3 personal gain of $15,600 is excludable under IRC §121.

PROPERTY CONVERTED TO BUSINESS OR RENTAL USE

There are a number of reasons that people convert their homes to rental property. The decline in the housing market caused some taxpayers to convert their homes to rental properties instead of selling the houses. Some taxpayers rent out their homes while they temporarily work in other geographical areas. Others may see a conversion as an opportunity to deduct a tax loss on the sale of business property versus incurring a nondeductible loss for the sale of a personal residence. However, it is possible that converting a home to rental property can create a taxable gain if values increase.

How to Depreciate a Former Residence[75]

Property that is placed in service and taken out of service in the same year cannot be depreciated.[76] Therefore, there is no depreciation deduction for taxpayers who temporarily rent out their homes during the year and stop renting it during the same year.

Residential rental property is depreciated using the mid-month convention, straight line method over 27.5 years using MACRS. Depreciation begins when the property is ready and available for rent.

Note. See Chapter 4 in this book for a thorough discussion of depreciation.

Example 20. Mike and Carol build the perfect new home for their family of eight. It has a master suite, six bedrooms, and a cottage for their live-in housekeeper. Unfortunately, they haven't been able to find a buyer for their former 4-bedroom home.

They move into the new home in July. They spend most of August and September repairing the wear and tear on their former home caused by their six children. On October 1, they place rental ads in the local paper. The house is finally rented on December 1.

Tax Result. Repairs were completed and the house was available for rent on October 1. Therefore, this is the date depreciation begins.

75. IRS Pub. 527, *Residential Rental Property*.

76. Treas. Reg. §1.168(d)-1(b)(3)(ii). See also IRS Pub. 946, *How to Depreciate Property*.

The basis for depreciation purposes is the **lesser of cost or FMV.** Cost includes the original purchase price, the cash outlay for permanent improvements, and decreases to basis from tax benefits such as residential energy credits.

Example 21. Herman accepts a promotion that will involve relocating his family to Buffalo. Mr. and Mrs. Addams offer to rent Herman's home as a playhouse for their children. Herman and the Addams family are unrelated. At the time the Addams family takes possession of the home, it is **worth $80,000** according to a recent appraisal.

Herman and his wife, Lily, purchased their home on Mockingbird Lane in 1964 for $13,000 with $1,000 attributed to land. Over the years, they have made significant improvements, including a handicapped-accessible dungeon and a state-of-the-art laboratory. The roof has been replaced several times after explosions from Grandpa's experiments. Lily provides their tax accountant with the following information to calculate the cost basis.

Original purchase price including lot (1964)	$13,000
Kitchen remodel (1968)	2,000
Landscaping (2009)	4,000
Dungeon addition (1970)	8,000
Laboratory remodel (1972)	13,000
Roof replacement (1966)	500
Roof replacement (1973)	800
Roof replacement (1996)	5,000
Total cost of home	**$46,300**

Tax Result. The property's FMV is $80,000 and the family's investment is $46,300. The lesser of the two is cost. However, not all of the costs can be included in the depreciable basis of the home. After discussing the nature of the improvements and repairs with the couple, their tax advisor computes the depreciable cost of the home as shown here.

Original purchase	$13,000
Less: lot value at time of purchase	(1,000)
Kitchen remodel	2,000
Dungeon addition	8,000
Laboratory remodel	13,000
Roof replacement (1996)	5,000
Total depreciable basis of home	$40,000
Depreciable basis of landscaping	4,000
Total depreciable basis of property	**$44,000**

Only the final roof replacement can be included in the depreciable basis. In addition, to be considered an improvement instead of a repair, the replacement must significantly add to the value of the property or prolong its life. In this case, the new metal roof with a 30-year warranty was a significant improvement to the previous asphalt-shingled roof.

The $4,000 for landscaping is a separate depreciable item from the residence. This $4,000 cost is depreciated using MACRS half-year/mid-quarter convention, 150% declining balance, over 15 years.

Property Sold at a Loss

Generally, a loss on the sale of personal property **is not** deductible.[77] However, a loss on the sale of income-producing property **is** deductible.[78] There is no definitive rule that specifies when a former residence becomes rental property for purposes of claiming a loss when it is sold. According to the Tax Court, this determination is based on the facts and circumstances surrounding the sale.

> *Whether a former residence used for personal purposes has been converted in the hands of the same taxpayer to property held for the production of income is a question of fact to be resolved with reference to the surrounding facts and circumstances . . . Five factors have been identified by this Court and other Federal Courts in deciding previous cases involving similar questions; those* ***factors include****:*
>
> 1. *The length of time the house was occupied by the individual as his residence before placing it on the market for sale;*
> 2. *Whether the individual permanently abandoned all further use of the house;*
> 3. *The character of the property (recreational or otherwise);*
> 4. *Offers to rent; and*
> 5. *Offers to sell.*
>
> *. . .* ***No one factor is determinative; rather, all the facts and circumstances must be considered.*** *(emphasis added)*[79]

The amount of deductible loss is also limited to the loss incurred during the period the property was held for the production of income.[80] This is an issue when the FMV at the time of conversion is **less** than the cost basis. The depreciation schedule should show the correct basis to calculate the deductible loss, because **the depreciable basis is the lesser of cost or FMV.**

Caution. Taxpayers should be sure to carefully document the FMV of property on the date of conversion.

Example 22. Jethro purchased a condominium in Beverly Hills, California, in 1999 for $300,000. He lived in the home until December 31, 2006, when he moved to Pigeon Forge, Tennessee, for a job opportunity at Dollywood.

At the time of the move in 2006, the condo's FMV was only $200,000. Jethro refused to list the property for sale, despite advice he received from his real estate agent, Mr. Drysdale. Jethro believed that the value would increase. His friend, Jane, agreed to manage the condo as a rental property. It was first rented in January 2007. The renter was not related to Jethro and the rent charged was the fair rental value.

Unfortunately, Beverly Hills property values continued to decline. In August 2010, Jethro sold the condo for $150,000.

Tax Result. Jethro's tax advisor determines that the condo was fully converted to rental in January 2007. Therefore, the 2010 sale is a sale of business-use property and the loss is deductible. This sale is reported in Part I of Form 4797. The deductible loss calculation is shown on the following page.

77. Treas. Reg. §1.262-1(b)(4).

78. IRC §1231.

79. *Philip A. Saunders v. Comm'r,* TC Memo 2002-143 (Jun. 10, 2002).

80. IRS Pub. 544, *Sales and Other Dispositions of Assets.*

Calculation of adjusted basis	
Lesser of cost/FMV on date converted to rental property (January 2007)	$200,000
Less: depreciation allowed or allowable (2007 through 2010)	(26,061)
Adjusted basis at time of sale	**$173,939**
Calculation of deductible loss	
Sale price	$150,000
Less: adjusted basis	(173,939)
Deductible loss (Part I of Form 4797)	**($23,939)**

Observation. The condo was rented over three and a half years (January 2007 through July 2010). Therefore, it is clear that it was actually converted to rental property. The loss of $23,939 incurred during the rental period is fully deductible. However, the $100,000 loss in value during the time Jethro lived in the condo is not deductible.

Property Qualifying as Principal Residence and Sold at a Gain

Under IRC §121, a taxpayer may exclude up to $250,000 of gain on the sale of a principal residence if the home was owned and used as the taxpayer's principal residence in two out of the last five years ending on the date of the sale.[81] **However, any gain attributable to nonqualified use after December 31, 2008, is taxable.** Nonqualified use does not include any period after the last date the property is used as the principal residence by the taxpayer or spouse. In addition, any depreciation allowed or allowable after May 6, 1997, is taxable up to the amount of the gain.

Example 23. Hank and Peggy purchased their Texas residence on July 1, 1991, for $40,000. On June 30, 2010, they relocated to Lexington, North Carolina, where Hank was appointed commissioner of the annual Lexington Barbeque Festival. Unsure whether they would be happy outside of Texas, they kept the Texas house and advertised it for rent on July 1, 2010. At that time, the property's FMV was $80,000.

The depreciable basis in their home is calculated as shown.

Lesser of cost ($40,000) or FMV ($80,000)	$40,000
Less: lot value at time of purchase	(4,000)
Depreciable basis of Texas home	**$36,000**

On their 2010 and 2011 tax returns, they claim a total of $1,855 in depreciation. On December 31, 2011, the house is sold for $90,000 to the Landry Memorial Committee, which plans to convert the house to a tourist attraction devoted to Tom Landry.

Tax Result.

Step 1. Hank and Peggy's tax preparer first calculates the adjusted basis.

Original cost	$40,000
Less: depreciation claimed	(1,855)
Adjusted basis	**$38,145**

81. IRC §121.

Step 2. Next, total gain is calculated.

Sales price	$90,000
Less: adjusted basis from Step 1	(38,145)
Total gain realized	$51,855
Less: §121exclusion	(50,000)
Total gain recognized	**$ 1,855**

Because Hank and Peggy met the two-out-of-five-year test and used the home as a principal residence after December 31, 2008, there is no nonqualified usage for the subsequent period when it was used as a rental property. **Thus, the only gain recognized is the unrecaptured §1250 depreciation of $1,855,** which is covered later in this chapter.

The excludable portion of $50,000 is shown in Part I of Form 4797, *Sales of Business Property.* The description on line 2(a) is **§121 exclusion** and the excluded amount is entered on line 2(g).[82] The sale is reported in Part III. The completed form follows.

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184

2011

Attachment Sequence No. **27**

Name(s) shown on return: **Hank & Peggy**

Identifying number: **333-33-3333**

1	Enter the gross proceeds from sales or exchanges reported to you for 2011 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	**90,000**

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
Sec. 121 exclusion	**07/01/91**	**12/31/11**				**(50,000)**

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft.	6	**51,855**
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	**1,855**
	Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	

82. Instructions for Form 4797, *Sales of Business Property.*

For Example 23

Form 4797 (2011) Page 2

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255 (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Residential real estate	07/01/1991	12/31/2011
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	90,000			
21 Cost or other basis plus expense of sale	21	40,000			
22 Depreciation (or depletion) allowed or allowable	22	1,855			
23 Adjusted basis. Subtract line 22 from line 21	23	38,145			
24 Total gain. Subtract line 23 from line 20	24	51,855			
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a	0			
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c	51,855			
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	51,855
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	51,855

Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation (see instructions)	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2011)

SALE TO RELATED PERSONS

A loss on the sale or exchange of property between related persons is not deductible. This applies to both direct and indirect transactions but not to distributions of property from a corporation in a complete liquidation.

If a sale or exchange is between related persons and involves the lump-sum sale of pieces of property, **the gain or loss must be figured separately for each piece of property.** The gain on each item is taxable. The loss on any item is nondeductible. Gains from the sales of any of these items may not be offset by losses on the sales of any of the other items.

Related Persons

The following is a list of related persons for this purpose:[83]

1. Members of a family, defined as only brothers, sisters, half brothers, half sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.)
2. An individual and a corporation if the individual directly or indirectly owns more than 50% in value of the outstanding stock of the corporation
3. Two corporations that are members of the same controlled group as defined in IRC §267(f)
4. A trust fiduciary and a corporation if the trust or the grantor of the trust directly or indirectly owns more than 50% in value of the outstanding stock of the corporation
5. A grantor and fiduciary, and the fiduciary and beneficiary, of any trust
6. Fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts
7. A tax-exempt educational or charitable organization and a person who directly or indirectly controls the organization, or a member of that person's family
8. A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest or profits interest in the partnership
9. Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation
10. Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation
11. An executor and a beneficiary of an estate unless the sale or exchange is in satisfaction of a pecuniary bequest
12. Two partnerships if the same persons directly or indirectly own more than 50% of the capital interests or profits interests in both partnerships
13. A person and a partnership if the person directly or indirectly owns more than 50% of the capital interest or profits interest in the partnership

DEPRECIATION RECAPTURE ON §1250 PROPERTY

Gain on the disposition of IRC §1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property.

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83. IRS Pub. 544, *Sales and Other Dispositions of Assets.*

IRC §1250 Property Defined

IRC §1250 property includes all real property, including a leasehold of land, that is subject to an allowance for depreciation and that is not and never has been §1245 property. A fee simple interest in land is not included because it is not depreciable.

If §1250 property becomes §1245 property because of a change in its use, it can never again be treated as §1250 property.

Additional Depreciation

If §1250 property is held **longer than one year,** the additional depreciation is the actual depreciation adjustments that are **more** than the depreciation computed using the straight line method.

If §1250 property is held for one year or less, all the depreciation is additional depreciation.

There is no additional depreciation if any of the following conditions apply to the disposed property.

- Depreciation is computed using the straight line method.
- A method of depreciation is used that does not result in depreciation greater than the straight line method.
- The property was placed in service after 1986 (or after July 31, 1986, if MACRS is used).

There is additional depreciation if any of the following conditions apply to the disposed property:

- The property was placed in service prior to 1981 and there is additional depreciation in the year of sale.
- The property is residential rental property placed in service after 1980 and before 1987, and there is additional depreciation in the year of the sale.
- There is **any** depreciation from using an accelerated method in the year of the sale on nonresidential real property placed in service after 1980 and before 1987.

Depreciation Taken by Other Taxpayers or on Other Property

Additional depreciation includes **all** depreciation adjustments to the basis of §1250 property whether allowed to the taxpayer **or another person** (as carryover-basis property).

> **Example 24.** Jeffrey Johnson gives his son §1250 property on which he took $2,000 in depreciation deductions, of which $500 is additional depreciation. Immediately after the gift, the son's adjusted basis in the property is the same as his father's and reflects the $500 additional depreciation. On January 1 of the next year, after taking depreciation deductions of $1,000 on the property, of which $200 is additional depreciation, the son sells the property. At the time of sale, the additional depreciation is $700 ($500 allowed the father plus $200 allowed the son).

Depreciation Allowed or Allowable

The greater of depreciation allowed or allowable (to any person who held the property if the depreciation was used in computing its adjusted basis in the taxpayer's hands) generally is the amount to use in computing the part of the gain to be reported as ordinary income. If the taxpayer can show that the deduction allowed for any tax year was less than the amount allowable, the lesser figure is the depreciation adjustment for figuring additional depreciation.

SUSPENDED LOSSES

As discussed previously, a rental property may have suspended passive losses. These losses can offset current passive income on the same property. It was also discussed that a taxpayer can elect to group all rental properties. In that case, the gains and losses of all properties would be netted but could still result in a net suspended loss.

Example 25. Augustas owns three rental properties. The following rental losses were incurred in 2009:

	Gain	Loss
Property A		$ 60,000
Property B		30,000
Property C		10,000
Total	$ 0	$100,000

Due to the MAGI limitation, Augustas's 2009 rental losses are suspended and must be carried forward to 2010.

Example 26. Augustas, from **Example 25,** has **never made a grouping election.** Therefore, when he sells Property A for a $150,000 gain in 2010, he can only deduct its $60,000 suspended loss. The suspended losses on Properties B and C remain suspended unless they generate positive rental income in 2010.

Example 27. Augustas, from **Example 25, made a valid grouping election** on his 2009 return. He cannot use the $100,000 of 2009 suspended losses against the sale of a property until all three properties are sold.