Duvall & Associates, Inc.

Taking Care of Business

IRS BI-POLAR ON RENTALS

**Shakespeare's Juliet purred to Romeo, "What's in a name? That which we call a rose by any other word would smell as sweet."
As demonstrated below, it's doubtful the IRS ever read Shakespeare.**

Federal tax law classifies real estate rental properties as either active or passive activities.

Rentals are classified as active if the owner performs "material" personal services with regard to the property (Special rules for vacation rentals also exist.). Losses from active rentals are fully deductible.

This stringent test throws most real estate rentals into the passive category. Passive losses can only be deducted against the income of other passive rentals. Unused losses are carried forward to future years, deductible against passive incomes of other rentals or the subject property.

If a taxpayer "actively" participates (a test less stringent than the above material service test) in a real estate rental, up to $25,000 losses can be annually deducted, so long as owner Adjusted Gross Income (AGI) is less than $100,000. If owner AGI is more than $100,000 - deduction is further limited by formula until zeroed out at $150,000.

Pretty simple – Eh? Just ingest an aspirin and continue reading.

For legal purposes, business owners often place owned buildings in an entity separate from their business company. The building is then leased to the business (self-rental).

Because owners could manipulate self-rentals to create positive income to deduct against otherwise limited passive losses - the IRS generally classifies such rental income as active. But if the business self-rental yields net losses, the IRS may treat the rental as passive and so limits loss deduction.

Bang! The IRS attempts to tax kill self-rentals either way. So if a self-rental building yields losses one year, income the next, then losses? The IRS could treat the building as passive, active, passive in successive years.

Shakespeare's retort? "Lord what fools these mortals be."

The best taxpayer defense – adjust self-rental leases to insure positive net income and thus avoid the IRS passive loss debate.

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