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Real Estate Industry - 2014 Planning: Rental Real Estate Activity Compliance

Dear Client:

Rental real estate offers tremendous tax advantages and opportunities for tax planning. Taxpayers, such as you, can depreciate property far exceeding your actual investment, deduct interest on borrowed capital, exchange rather than sell properties to defer tax on gains, use installment sales to defer tax on sales, and profit from preferential rates on long-term capital gains. Most importantly, you can generate "positive cash flow," or monthly income, with depreciation deductions that effectively turn actual income into tax losses.

In order to obtain these benefits, you must be able to navigate the tax limitations and take advantage of the exceptions. For example, real estate income and loss is generally considered passive income and loss for tax purposes. Taxpayers cannot use passive activity losses (PALs) to offset ordinary income from employment, self-employment, interest and dividends, or pensions and annuities.

However, you may be able to use one of two important exceptions to this rule:

1. *The rental real estate loss allowance.* As one exception to the PAL rules, taxpayers with adjusted gross incomes of $150,000 or less can claim a rental real estate loss allowance of up to $25,000 for property they actively manage. Active management does not require regular, continuous, or substantial involvement. However, it does require that the taxpayer own at least 10% of the property. Also, to qualify for the exception, married taxpayers must file jointly.

1. *The election to be treated as a real estate professiona*l. The second exception allows real estateprofessionals not to treat their rental activity as a passive

activity. Therefore, their losses are not limited to passive income. This exception requires material participation by the taxpayer which is demonstrated by meeting one of seven tests. These tests are complex and include the number of hours of participation and the facts and circumstances of the participation in the activity.

If your rental property is a vacation home, the rental income and deductions are determined under one of three sets of rules depending on the number of days you rent the property.

1. If you rent your vacation home for fewer than 15 days during the year, no rental income is includible in gross income and no deductions attributable to the rental are allowable.

1. If you rent the property for 15 or more days during the tax year and it is also used by you for the greater of (a) more than 14 days or (b) more than 10% of the number of days rented, the rental deductions are limited. Under this limitation, the amount of the rental activity deductions may not exceed the amount by which the gross income derived from such activity exceeds the deductions otherwise allowable for the property, such as interest and taxes.

1. If you rent the property for 15 or more days during the tax year but do not use the property for personal purposes for the greater of (a) more than 14 days or (b) more than 10% of the number of days rented, the property may be treated as true "rental" property in which losses are not limited to income.

Therefore, as you consider your tax plan for this year, you should keep in mind the rules that will allow you to take full advantage of the tax benefit of rental real estate outlined here. Your strategy may be to limit your adjusted gross income to claim the real estate loss allowance; or it may include a conscious plan to increase the number of rental days and/or decrease the number of personal use days for a vacation home. Regardless of your situation, we can help review all of the alternatives and offer suggestions to reduce your tax liability for the year. Please do not hesitate to call for an appointment.

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