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PASSIVE ACTIVITY LOSSES (PAL)

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Passive activity loss rules were designed to limit losses from certain activities including commercial and residential rental units. It limits our ability to deduct losses and causes some of us pay more taxes. Unexpectedly, it also benefits certain taxpayers who do not need rental losses by suspending losses for use in future years when there are gains from disposition instead of wasting it during years of low income.

With this in mind, let us review a few rules:

1. Passive activity is defined as any trade or business where the taxpayer does **not materially participate** which is primarily describes as working less than 500 hours per year in that activity. Losses from passive activities can only be offset against other passive activities.
2. The rules allow a **\$25,000 special allowance for rental real estate with active participation**.
3. To qualify for this \$25,000 exception, the taxpayer must:
 - A. Own at least 10% of the property.
 - B. Be actively involved with the management including determining rental rates, authorizing repairs, arranging for services. You don't have to actually perform these services as long as you manage & control the units.
 - C. Have modified AGI of less than \$100,000.
 - D. Not be a limited partner in a rental real estate activity.
 - E. Not use the filing status of married filing separately if living together at anytime during the taxable year.
4. This special allowance is **phased out** at \$1 for every \$2 of Adjusted Gross Income (AGI) over \$100,000; therefore, this special allowance disappears when modified AGI reaches \$150,000.
5. Any unused rental losses are fully **suspended**.
6. The suspended losses can be **carried forward** when there is a net passive income or when the activity is completely disposed of in a taxable transaction.
7. You may **deduct suspended losses when there is a sale, a complete disposition in a taxable transaction**:
 - A. A sale to a related party is not considered a taxable disposition if sold at a loss.
 - B. A gift is not considered a taxable disposition.
 - C. The bankruptcy of a partnership is considered a taxable disposition.
 - D. A 1031 exchange that features no current taxable income is not a taxable disposition.
 - E. An installment sale is not a complete disposition and would only allow recognition of suspended passive losses in the same ratio as installment gain is reported.
 - F. The following transactions are not considered taxable disposition: Replacement of a personal residence under section 1034, contributions to partnerships in exchange for partnership interests, transfer to a controlled corp.
 - G. A complete abandonment of a rental or partnership interest is a taxable disposition that triggers the deductibility of the suspended passive losses.
 - H. Under a new revenue regulation, the disposition of a substantial part of an activity is treated as a complete disposition. For example, if the basis (cost minus depreciation) at date of death is \$100,000 but the appraisal at date of death is \$120,000, there is a step-up in basis of \$20,000. If accumulated suspended losses at date of death are \$30,000, you can only deduct excess losses of \$10,000 on the decedent's final return, not \$30,000.
8. If you **convert your rental property to a personal residence**, the suspended losses remain suspended until its disposition in a taxable transaction.
9. The Budget Reconciliation Act allows **real estate professionals to deduct losses** from real property trades or businesses. You are no longer subject to restrictions imposed by Passive Activity Losses (PAL) if:
 - A. More than 50% of their personal services are performed in real estate trade or business, and
 - B. You perform more than 750 hours of service in the real property trade or business.
10. California does not conform to the federal provision for real estate professionals. All rental activities are considered passive, regardless of the level of participation.

Developments:

- Hours spent running short-term rental property and **"on call" time didn't count** for purposes of meeting the **real estate professionals** 750-hour test under PAL rules.

- IRS allows certain real estate professionals to make a **late election** to treat all rental real estate interests as a single activity for PAL rules.

As you can see, passive rules are not the easiest provisions to understand and apply; in fact, they are rather complicated. Do not attempt to prepare your own return. Instead, go to your own tax preparer for the arithmetic and some planning ideas. The key to minimizing the impact on your taxes is planning, as always.