passive and real estate activities

If you are an owner of a trade or business in which you do not materially participate, the passive activity rules can limit your ability to deduct losses. And, if you hold rental real estate investments, the losses are passive even if you materially participate, unless you qualify as a real estate professional. Income from passive activities including rental real estate may also be subject to the 3.8% Medicare Contribution Tax on net investment income.

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WHAT ARE PASSIVE LOSSES?

A passive loss is a loss from a business activity in which you do not materially participate. The most common ways you are deemed to materially participate in a business activity, and thereby avoid the passive activity limitation rules, are if:

- You participate more than 500 hours in the activity during the year,
- Your participation constitutes substantially all of the participation in the activity,
- You work more than 100 hours per year in the activity and not less than any other person, including non-owners, or
- You work more than 100 hours per year in each of several activities, totaling more than 500 hours per year in all such activities.

Passive activity losses are deductible only to the extent that you have income from other passive activities to offset the losses, or when you completely dispose of the activity. If you have passive losses that you cannot deduct in the current year, you can carry these losses forward to the following year, subject to the same passive loss rules and limitations.

Taxpayers should keep detailed records as to the time they spend on a particular activity, especially when they participate in several activities. Moreover, there are specific rules as to what kind of work qualifies as participation.

CONVERT PASSIVE LOSSES

If you fail the material participation tests and you have passive losses that are subject to a disallowance, there are things that you can do to convert the disallowed losses into tax-saving deductible losses:

Dispose of the activity
Sell any passive activity with current or suspended passive losses through a bona fide sale to an unrelated party. The losses become fully deductible when the activity is sold — including any loss on the disposition (subject to capital loss limitations). Even if you realize a gain on the sale, you can still save taxes as Tax Tip 14 illustrates. But you must also be aware of the phantom income trap discussed in Tax Tip 15.

Increase your participation in loss activities
For an activity that is generating losses, consider increasing your participation to meet one of the tests listed above, if possible, so you will not be subject to a passive loss limitation for the activity in that year.

Increase the hours you participate in real property trades or businesses
If you are engaged in real estate activities, increase your hours to meet the real estate professional test (discussed below). If you are a real estate professional, your real estate losses are no longer treated as passive losses, allowing you to deduct them in full.

tax tip 14 USE PASSIVE ACTIVITY CAPITAL GAINS TO RELEASE SUSPENDED ORDINARY LOSSES

If you have suspended passive activity losses, you may be able to dispose of a passive activity at a gain and not have to pay any taxes. In fact, you may actually reduce your taxes despite the gain.

As an example, assume you have suspended passive losses of $300,000 from an activity that you have held for more than one year. You dispose of the activity in 2016 and realize a capital gain of $340,000. You would actually save federal taxes of $50,800 as well as receiving the proceeds from the sale.

This very favorable result is due to the fact that the suspended losses reduce your ordinary income at a 39.6% rate, whereas the long-term capital gain from the sale would be taxed at no more than 20%. The suspended loss would therefore reduce your tax by $118,800 (39.6% of $300,000) but the capital gain would only increase your tax by $68,000 (20% of $340,000). If you have a net capital loss carryover that you might not be able to utilize, your savings would even be greater since the gain could be offset by the carryover loss, giving you the full tax benefit of the loss (but a reduced carryover).

The tax savings would be reduced by the 3.8% Medicare Contribution Tax in the amount of $1,520 (3.8% of $40,000, which is the difference between the $340,000 capital gain and $300,000 ordinary loss).

UTILIZE YOUR PASSIVE LOSSES

If you have passive losses from activities that you cannot convert into "material participation" activities as discussed above, you should consider taking the following steps to utilize your passive losses:

Decrease your participation in income activities
For an activity in which you materially participate that is generating non-passive income, limit your participation to less than 500 hours, if feasible. Therefore, the activity may become passive and you can use the income to offset your passive losses. However, make sure that you are not still considered active under the other tests. This may result in the additional 3.8% Medicare Contribution Tax to the extent that the income is not fully offset by passive losses. If you or your spouse have been materially participating in the activity for 5 out of the last 10 years, you will be deemed to be materially participating in the current year, even if you do not participate at all in the current year.

Invest in income-producing passive activities
Consider investing in an income-producing trade or business that you will not materially participate in. This creates passive income to you which can be offset until you utilize all of your passive losses from other unrelated passive activities. This may result in the additional 3.8% Medicare Contribution Tax to the extent that the income is not fully offset by passive losses.

tax tip

15 THE PHANTOM INCOME TRAP

Income in excess of your net proceeds can be triggered upon the disposition of real estate. This results from prior deductions based on indebtedness. Therefore, you may have deducted losses and/or received cash distributions in prior years that were greater than your actual investment in the property. This is sometimes referred to as negative capital.

Phantom income to the extent of your negative capital can also occur if you dispose of your interest in the pass-through activity, even if the underlying property remains unsold. However, to the extent your prior year's passive losses were suspended, you would have an ordinary loss to offset this income. As Tax Tip 14 demonstrates, this can actually be a tax savings opportunity.

IDENTIFY YOUR ACTUAL PASSIVE LOSSES

When identifying your net passive losses, take into account the following:

- Investment and trading partnerships, S corporations and LLCs that only generate portfolio income, such as capital gains, interest and dividends, are not passive activities, even if you do not participate in the activity. Therefore, the investment income cannot offset your passive losses.
- Interest expense on money borrowed to fund your investment in a passive activity is treated as an additional passive activity deduction, subject to the same disallowance rules.
- Portfolio income, such as interest and dividends, from a passive activity cannot offset the passive losses from the activity.

LOSSES FROM LIMITED LIABILITY COMPANIES ("LLCS") AND LIMITED LIABILITY PARTNERSHIPS ("LLPS")

Generally, limited partners of an LLP are presumed to not be materially participating in the business, and thus these activities would be considered passive. There is an exception to the presumption of no material participation where an individual holds an interest in a limited partnership as both a limited partner and a general partner. In this case, such person can avoid the passive loss rules with respect to the limited partnership interest.

The courts have addressed whether the rules that apply to limited partnership interests also apply to members of an LLC. Although the IRS does not concur, recent cases have held that such members are not limited partners for purposes of determining their material participation in these activities. Rather, the facts and circumstances must be examined to ascertain the nature and extent of the participation of the member.

PASSIVE ACTIVITY CREDITS

Tax credits from passive activities, such as rehabilitation and low-income housing credits, can reduce your regular tax liability. However, for properties placed into service prior to 2008, these credits are limited to the amount of your regular tax attributable to your net passive income, and cannot be used to reduce your AMT. For post-2007 investments, both the qualified Rehabilitation Tax credit as well as the low-income housing credit can offset both regular tax and AMT to the extent of your tax attributable to passive activity income. If you have a net overall passive loss, the disallowed credits are carried forward and can be used to offset

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16 DEFER YOUR GAIN USING THE INSTALLMENT SALE METHOD

In 2016, you sell a nonresidential building for $2,000,000, net of closing costs, which you bought in 1998 for $600,000 (including subsequent improvements). At the time of the sale, you had accumulated depreciation of $400,000. Therefore your taxable capital gain is $1,800,000 ($2,000,000 less the cost of $600,000 plus the accumulated depreciation of $400,000). You will receive a 20% down payment of $400,000 before the end of the year and receive a mortgage from the buyer for the balance, with the first payment due in January of 2017. By using the installment sale method, you will defer $290,000 of federal tax to future years as the mortgage is paid down by the buyer.

	Full payment in current year	Installment sale method
Taxable gain in year of sale	**$ 1,800,000**	**$ 360,000**
Federal tax cost this year	**380,000**	**90,000**
Deferred tax		**290,000**

The taxable gain using the installment sale method is computed by multiplying the down payment of $400,000 by the gross profit ratio of 90%. The gross profit ratio is the taxable gain of $1,800,000 divided by the total proceeds of $2,000,000.

Caution: *You are subject to a tax rate of 25% on the portion of the gain that is attributable to previous non-accelerated depreciation deductions on real property on a "first in first out" (FIFO) method. Also, this method may not be advantageous when the tax rates of future years' installments are expected to increase.*

Note: *The 3.8% Medicare Contribution Tax on net investment income, which is not reflected in the above illustration, may apply to the gain and related interest net investment income.*

your taxes in future years. If you have net passive income but the credits are limited because of the AMT, you can carry the credits forward to offset your regular tax in future years when you are not in the AMT.

REAL ESTATE ACTIVITIES

Real estate activities are passive by definition, unless you qualify as a real estate professional. Regardless of whether you are a real estate professional or not, there are ways you can defer the tax from the gain on the sale of real estate properties, as discussed below. A separate rule allows you to deduct up to $25,000 of losses each year if you actively participate in a rental real estate activity. This special allowance is reduced, but not below zero, by 50% of the amount by which the taxpayer's AGI exceeds $100,000. It is completely phased out when AGI reaches $150,000.

REAL ESTATE PROFESSIONAL RULES

If you are a real estate professional, you can deduct rental real estate losses in full since you are not subject to the passive loss limitations. To qualify, you must annually:

- Perform more than 50% of your personal services in real property trades or businesses in which you materially participate, and
- Have more than 750 hours of service in these businesses.

In addition, you must materially participate in the rental real estate activity in order for that activity to be considered nonpassive. For example, a real estate broker who owns one or two apartments for rent might be a real estate professional but might not be considered to materially participate in the rental activity.

In the case of a joint return, the real estate professional requirements are satisfied if, and only if, at least one of the spouses separately satisfies both requirements. In regards to the material participation test though, work performed by a taxpayer's spouse in a trade or business is treated as work performed by the taxpayer.

Real estate professionals are not subject to the 3.8% Medicare Contribution Tax on net investment income, including capital gains, from rental real estate activities in which they materially participate.

Observation: *If you fail either test and you have real estate losses, try to increase your hours of service to meet the tests. For purposes of the real estate professional test, a taxpayer can elect to aggregate all of their real estate rental activities for purposes of determining material participation. Once the election is made, it continues unless the IRS consents to its revocation.*

INSTALLMENT SALE REPORTING BENEFITS

An installment sale can be a very tax-efficient method to defer a gain on the sale of real estate for future years. If you are contemplating a sale of real estate, consider agreeing to receive one or more payments after the year of the sale so that you are eligible to report the gain on the installment sale method. By doing so, you can defer much of the tax to future years.

The installment method allows you to report gain only as you receive principal payments. By simply deferring one payment until next year, you can defer the tax on that portion of the sales price by a full year (see Tax Tip 16). The gain you report in future years retains the same character as when it was sold. Therefore, if property that is sold had a long-term holding period, the gain reported in future years will also be long-term except for the interest element if interest is not stated on the deferred payments. You may also be entitled to interest payments on seller-financed mortgages or loans. The interest payments are taxable as ordinary income when received. You can use the installment sale method even if you owned the property through an entity in which you hold an interest if the entity does not elect out of the installment method. However, if the face amount of all installment receivables you own at December 31 exceeds $5 million, an interest charge on the deferred tax (assessed as an additional tax) will apply.

Caution: *Even if no payments are received in the year of sale, any recapture income under Internal Revenue Code ("IRC") sections 1245, 1250, or 751 is recognized immediately. Furthermore, when the deferred gain on the sale of real estate is attributable to both unrecaptured section 1250 gain (maximum tax rate of 25%) and regular capital gain (maximum tax rate of 20%), the unrecaptured section 1250 gain is reported first upon the receipt of principal payments.*

LIKE-KIND EXCHANGES

If you exchange investment or business property for property of a like-kind (same nature or character), you do not realize taxable gain at the time of the exchange, except up to the amount of any cash or other boot received (such as unlike property). The like-kind exchange rule gives you the opportunity to defer taxes until you sell the property that you receive in the exchange.

Like-kind exchanges typically are used when selling real estate and can yield substantial tax benefits. Even though the definition of like-kind property allows for a certain amount of flexibility, such as permitting an exchange of land for a building if both are held for investment purposes, specific and complex rules govern like-kind exchanges. These rules include a requirement that you cannot directly receive any cash or other consideration and must identify the replacement property with the qualified intermediary holding the funds within 45 days after the sale.

Caution: *Like-kind exchanges do not apply to the sale of stocks, bonds, other securities and other intangible assets such as a partnership interest. Also, the sale of your principal residence does not qualify for a like-kind exchange.*

Note: *Like-kind exchange reporting is not elective. Consider not engaging in a like-kind exchange if a taxable event is the better approach (e.g., when you have expiring losses, or state tax considerations).*

NEW LEGISLATION

Some 15 provisions of PATH specifically address a variety of technical and policy considerations of REITs. One such noteworthy provision deals with tax-free spinoffs involving REITs. The provision provides that a spinoff involving a REIT will qualify as tax-free only if immediately after the distribution both the distributing and the controlled corporation are REITS. In addition, neither a distributing nor controlled corporation in a tax-free spinoff transaction that is not a REIT is permitted to elect to be treated as a REIT for 10 years following the tax-free spinoff. The provision applies to distributions made on or after December 7, 2015, but will not apply to any distribution pursuant to a transaction described in a ruling request initially submitted to the IRS on or before that date, which request has not been withdrawn and with respect to which a ruling has not been issued or decided in its entirety as of such date.

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17 LIKE-KIND EXCHANGES FOR VACATION HOMES

Like-kind exchanges for vacation homes that are converted to rental property are tricky, but can be worthwhile. It is possible for you to do a like-kind exchange if you turn a vacation home into a rental property. For example, if you stop using your vacation home, rent it out for a substantial period of time and then exchange it for other real estate and conduct the rental of that real estate as a business, then you have converted it to an investment property. This conversion could allow for a like-kind exchange. Of course, the timing and facts must support such a conversion. In addition, if the property swapped for is intended to be a new second or primary home, you are not allowed to move in immediately. In 2008 the IRS issued Rev. Proc. 2008-16, which includes a safe harbor rule under which it said it would not challenge whether a replacement dwelling qualified as investment property for purposes of a like-kind exchange. In order to meet this safe harbor, you must have held the relinquished property for at least 24 months and in each of the two 12-month periods immediately after the exchange: (1) you must rent the dwelling unit to another person for a fair rental for 14 days or more; and (2) your own personal use of the dwelling unit cannot exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental. In addition, after successfully swapping one vacation/investment property for another, you cannot immediately convert it to your primary home and take advantage of the $500,000 primary residence exclusion. If you acquire property in the like-kind exchange and later attempt to sell that property as your principal residence, the exclusion will not apply during the 5-year period beginning with the date the property was acquired in the 1031 like-kind exchange.

Your specific fact pattern must support a position in which your vacation property or second home was in fact held for rental, investment, or business use and would therefore qualify for tax-deferred exchange treatment. The more rental, investment or business use activity, the stronger the facts will be that the property was converted and held for rental or investment. The more you can substantiate that the property was held, treated and reported as rental or investment property, the better your position will be to support tax-deferred exchange treatment.