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2008 Planning - Rental Real Estate Activity Compliance

Dear Client:

Rental real estate offers tremendous tax advantages and opportunity 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 turn the actual income into tax losses.

However, real estate income and loss is generally considered "passive" income and loss for tax purposes. Taxpayers generally cannot use "passive" losses to offset "ordinary" income from employment, self-employment, interest and dividends, or pensions and annuities. The rental real estate loss allowance and "real estate professional" status are two important exceptions to this rule. In addition, the tax consequences of renting out your vacation home depend upon the amount of time the home is rented and the amount of time you use the home for personal purposes.

As one exception to the passive loss rules, taxpayers with adjusted gross incomes of $150,000 or less can claim up to $25,000 in rental loss allowance from 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 and married taxpayers must file jointly.

The second exception allows real estate professionals 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.

Vacation homes are taxed under one of three sets of rules depending on how long the homeowner rents the property. If you rent your vacation home for fewer than 15 days during the year, no rental income is includible in gross income. If you rent the property for 15 or more days during the tax year and it is used by you for the greater of (a) more than 14 days or (b) more than 10% of the number of days during the year for which the home is 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.

If you have any questions as to how the rental real estate rules apply to your particular situation, please do not hesitate to call for an appointment. We can assist you in taking advantage of the available tax benefits and develop an overall tax plan.

Sincerely yours,

Kevin T. Miller