TAX & WEALTH STRATEGY

Passive Activity Rules and Limitations

Why a real estate tax loss may not be deductible today

One of the attractive characteristics of real estate is that an investment may generate depreciation and other deductions while still producing positive cash flow.

That can sometimes result in a Schedule K-1 showing a tax loss. But there is an important second question:

THE IMPORTANT IDEA
A tax loss allocated to you and a tax loss you can deduct today are not necessarily the same thing. For many passive apartment investors, the answer may be: not yet.

01 WHAT IS A PASSIVE ACTIVITY?

For a typical passive apartment investor, rental real estate activity is generally treated as passive. If you invest as a limited partner or passive member and are not involved in operating the property, the tax classification is usually consistent with the economic reality: you invested capital and someone else operates the property.

02 WHY DOES PASSIVE CLASSIFICATION MATTER?

Because passive losses are generally limited in how they can be used. In broad terms, passive activity losses are generally used against passive activity income. If your passive losses exceed your passive income, the excess is typically not deductible against nonpassive income for that year and may be carried forward.

THE QUESTION
What type of income do I have available for this loss to offset?

03 A SIMPLE EXAMPLE

Cash Distributions	$8,000
K-1 Passive Tax Loss	($20,000)
Salary Income	$400,000
Other Passive Income	$0

It would be incorrect to automatically conclude that $20,000 of salary is now sheltered. Depending on the investor's circumstances, the passive loss may instead be suspended and carried forward for potential future use.

04 SUSPENDED PASSIVE LOSSES

The loss may be deferred rather than lost. If you cannot currently use a passive loss, it may carry forward. In a later year, passive income may allow some of the previously suspended loss to be used. Any remaining unused amount may continue to carry forward.

THE IMPORTANT IDEA
Suspended does not mean gone. It generally means: not deductible yet.

05 PASSIVE INCOME CAN MAKE SUSPENDED LOSSES MORE USEFUL

An investor may own several passive investments. One may generate a passive loss while another generates passive income. Subject to the applicable rules, passive losses may generally offset passive income. That is why your CPA needs to see the whole picture rather than reviewing one K-1 in isolation.

06 THREE DIFFERENT LIMITATIONS CAN MATTER

Passive activity rules are not the only test. A partnership loss may have to pass through several limitations before it becomes deductible. A useful high-level way to think about the sequence is:

1. BASIS	Do I have enough tax basis to support the loss?
2. AT RISK	How much of the investment is considered economically at risk?
3. PASSIVE ACTIVITY	If the loss passes the first two tests, can I use it under the passive activity rules?

07 BASIS LIMITATIONS

In general, a partner cannot deduct partnership losses beyond the partner's adjusted tax basis in the partnership interest. Basis can be affected by capital contributions, allocated income or losses, distributions, and certain partnership liabilities.

QUESTION FOR YOUR CPA
Do I have enough tax basis to use the loss allocated to me?

08 AT-RISK LIMITATIONS

A second set of rules can limit losses based on the amount the taxpayer has at risk in the activity. Debt treatment can be technical, and not every dollar of property debt automatically increases an investor's at-risk amount.

QUESTION FOR YOUR CPA
How much of my investment is considered at risk for tax purposes?

09 THE PASSIVE ACTIVITY LIMITATION

Once basis and at-risk rules are considered, the passive activity rules can still limit the loss. For many passive real estate investors, passive losses generally offset passive income. If there is not enough passive income, the unused loss may be suspended and carried forward.

This is why two investors in the same deal can have different tax outcomes. Both may receive the same proportional K-1 loss, but one investor may have passive income from other investments while another may have none.

10 WHAT ABOUT THE $25,000 RENTAL REAL ESTATE EXCEPTION?

There is a special rule that can allow certain taxpayers who actively participate in rental real estate to deduct a limited amount of rental real estate losses against nonpassive income, subject to income limits and other requirements. Passive syndication investors should not assume that this exception applies to them.

DO NOT ASSUME

If you invest as a passive limited partner, ask your own tax adviser whether any active-participation exception applies to you. For many higher-income passive investors, it may provide little or no current benefit.

11 WHAT ABOUT REAL ESTATE PROFESSIONAL STATUS?

Rental real estate can potentially be treated as nonpassive when a taxpayer satisfies specific real-estate-professional requirements and materially participates in the applicable activity. This is not simply a job title, and owning real estate does not automatically qualify someone.

THE QUESTION

Does my involvement actually meet the applicable tax requirements? This is a facts-and-circumstances determination for your tax adviser.

12 WHAT HAPPENS WHEN THE INVESTMENT IS SOLD?

Suspended losses can become important when an investment is eventually disposed of. In general, disposing of an entire interest in a passive activity in a fully taxable transaction to an unrelated party may allow previously suspended passive losses associated with that activity to become deductible, subject to the applicable rules and other limitations.

Example: If you accumulated $40,000 of suspended passive losses over several years, those losses may become relevant when the entire investment is ultimately sold. A partial sale does not necessarily create the same result.

13 CASH, TAX LOSSES AND SUSPENDED LOSSES CAN ALL COEXIST

Cash Distributions Received	$10,000
K-1 Tax Loss	($25,000)
Loss Currently Deductible	$0
Suspended Passive Loss	$25,000

14 COST SEGREGATION CAN INCREASE THE LOSS - BUT NOT NECESSARILY THE CURRENT BENEFIT

A cost-segregation study may accelerate depreciation and increase the tax loss allocated to investors. But accelerating a deduction and being able to use that deduction today are two separate questions.

A SIMPLE ILLUSTRATION

If accelerated depreciation increases your K-1 loss from ($10,000) to ($35,000), but the passive activity rules prevent you from currently using either amount, the immediate tax benefit may still be limited. You may instead accumulate a larger suspended loss.

15 WHY YOUR PERSONAL TAX SITUATION MATTERS SO MUCH

Two investors can contribute the same amount to the same apartment partnership and receive the same proportional K-1 allocation, yet have very different tax outcomes. One may have substantial passive income from other investments. The other may have primarily salary income and no other passive income.

THE IMPORTANT IDEA

The investment can be identical. The tax benefit may not be. That is why there is no universal answer to the question: "How much will this investment save me in taxes?"

ROBERT'S PERSPECTIVE

I WANT TO KNOW WHETHER THE TAX BENEFIT IS USABLE - NOT JUST WHETHER IT EXISTS

It is easy to show an investor a large projected depreciation loss and describe it as a major tax benefit. But that is only half the analysis. My next question is: Can I actually use it?

If the answer is no, that does not necessarily mean the deduction has no value. It may be suspended and potentially useful later. But I want to understand the difference.

MY RULE

Never confuse a projected tax deduction with a current tax savings. First understand the investment. Then understand the tax attributes. Then ask your own tax adviser how those attributes apply to you.

QUESTIONS TO ASK YOUR TAX ADVISER

PASSIVE ACTIVITY	• Will this investment be passive for me? • Do I currently have other passive income? • Can losses from this investment offset that income?
SUSPENDED LOSSES	• Do I already have suspended passive losses? • How much and which investments generated them? • How are they being tracked?
BASIS	• Do I have sufficient basis to use the allocated loss? • How are distributions affecting my basis?
AT RISK	• Are any losses limited by the at-risk rules? • How does the investment's debt affect my at-risk amount?
FUTURE YEARS	• If I cannot use the loss today, when might I be able to? • What happens if the investment generates passive income later?
SALE	• What could happen to suspended losses when the investment is sold? • Does the structure of the sale affect their treatment?

FIVE THINGS TO REMEMBER

1. A K-1 loss is not automatically a current deduction.

Several tax limitations may apply.

2. Passive losses generally offset passive income.

They generally cannot simply be used against salary or other nonpassive income.

3. Unused losses may be suspended.

They can potentially carry forward to future years.

4. Basis and at-risk rules come before the passive activity test.

There is more than one limitation to consider.

5. The same investment can produce different tax results for different investors.

Your individual circumstances matter.

THE MOST IMPORTANT TAKEAWAY

There are three different questions:
1. Was a tax loss created?
2. Was that loss allocated to me?
3. Can I use that loss today?

The tax benefit is not just the deduction shown on the K-1. The real issue is when, and whether, that deduction can be used in your individual tax situation.

EDUCATIONAL PURPOSE

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