

# 2021 NATIONAL INCOME TAX WORKBOOK

CHAPTER 9: CURRENT REAL ESTATE  
TAX ISSUES



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## LEARNING OBJECTIVES

P. 341

- Explain the passive activity loss limitations and how they apply to a real estate professional
- Apply the special \$25,000 allowance for passive activity rental losses
- Allocate basis to subdivided lots
- Explain the factors that determine whether a real estate developer will be characterized as a dealer or investor
- Know when a taxpayer is subject to the net investment income tax, and calculate that tax

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## ISSUE 1:

P. 341

### REAL ESTATE RENTAL LOSSES

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## GENERAL PASSIVE ACTIVITY LOSS RULES

P. 342

- Current year deductible passive activity losses limited to passive activity income
- Unused losses are suspended and carried over
- Suspended losses deductible when entire interest disposed of in fully taxable disposition to unrelated third party
- Passive activity losses apply to:
  1. Any rental activity, regardless of material participation (w/2 exceptions)
  2. A trade or business in which the taxpayer does not materially participate

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## TAXPAYERS SUBJECT TO PAL RULES

PP. 342-343

The PAL rules apply to the following taxpayers:

1. Individuals
2. Estates
3. Trusts (other than grantor trusts)
4. Personal service corporations
5. Closely held C corporations

Practitioner Note: Closely Held C Corporation – special rules

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## RENTAL ACTIVITIES

P. 343

Rental activities - income received primarily for the use of tangible property and not for services

The following test determine whether income is rent:

1. Average period of customer use is 7 days or less, income is not rent
2. Average period of customer use is more than 7 days, but not more than 30 days, income is rent unless significant personal services
3. With a few exceptions, greater than 30 days of customer use, income is rent (unless extraordinary personal services)

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## REAL ESTATE PROFESSIONALS

PP. 343-344

Rent treated as nonpassive for materially participating RE professional:

1. Performs more than one-half of the personal services in real property trades or businesses in which the taxpayer materially participates and
2. Performs more than 750 hours of services during the tax year in real property trades or businesses in which he or she materially participates

A taxpayer may qualify as a real estate professional through a combination of real estate services

Practitioner Note: Not automatically nonpassive – need material participation

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## REAL PROPERTY TRADE OR BUSINESS

P. 344

- Real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business
- Real property operation is the day-to-day operations of a trade or business relating to the maintenance and occupancy of real property
- Real estate agent who brings together buyers and sellers of real property is engaged in a real property brokerage trade or business
- Mortgage broker who is a broker of financial instruments is not engaged in a real property trade or business
- Practitioner Note: Keep good records!

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## MATERIAL PARTICIPATION

P. 345

Seven material participation tests:

1. Participation exceeds 500 hours
2. Substantially all the participation in the activity
3. More than 100 hours and not less than anyone else
4. Significant participation activities (not applicable to rentals)

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## MATERIAL PARTICIPATION (CONTINUED)

PP. 344-346

- 5. Material participation for 5 of last 10 years
- 6. Material participation in personal service activity for 3 years
- 7. Facts and circumstances

Example 9.1- No Material Participation (p. 345)

Sandy has a condo in FL. Management co does reservations, rent, and repairs. Sandy does not materially participate.

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## DEFINITION OF PARTICIPATION

P. 346

- Work performed by an individual in connection with an activity in which the individual owns an interest at the time the work is performed, regardless of the capacity in which the individual performs the work
- Not if a principal purpose is avoidance of the PAL rules
- Not work in capacity as investor unless involved in day-to-day management or operations

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## AGGREGATING RENTAL REAL ESTATE ACTIVITIES

P. 346

- Real estate professional may elect to treat all rental real estate activities as one single activity
- Material participation is measured considering the entire rental portfolio

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## MAKING THE AGGREGATION ELECTION

P. 346

- File a statement with the taxpayer's original income tax return
- Declaration that the taxpayer is a qualifying taxpayer (a real estate professional) for the tax year and is making the election pursuant to I.R.C. Sec. 469(c)(7)(A)
- Election is binding for tax year it is made and all future tax years in which the taxpayer qualifies as a real estate professional
- Failure to make an election in a previous year does not preclude making one in the current year

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## EFFECT OF THE ELECTION

P. 347

- Treat all interests in rental real estate as a single rental real estate activity
- Taxpayers cannot elect grouping some rental properties and not others
- Measure material participation in the grouped activities

## Example 9.2 Measuring Material Participation for a Group

Bobby has 4 residential rentals and 1 commercial. Has prop. mgr. for residential. Material participation in commercial so material participation in all.

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## LIMITED PARTNERSHIP INTERESTS

P. 347

- If grouped activities include real estate interest owned through a limited partnership, combined rental real estate activity may be treated as a limited partnership interest

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## FORMER PASSIVE ACTIVITIES

PP. 347-348

- Suspended PALs or passive activity credits continue to be treated as arising from a passive activity
- Real estate professional who elects to aggregate rental activities may use suspended PALs from a formerly passive rental activity to offset the net income from the grouped activities

## Example 9.3 - Grouping Former Passive Activities

Carlos has 2020 suspended PAL, carries to 2021. Materially participates in 2021 and can use the suspended PAL.

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## DISPOSITIONS OF GROUPED ACTIVITIES

P. 348

- Upon disposition of taxpayer's entire interest in a passive activity, any current-year losses and suspended losses are not subject to the PAL rules and are treated as losses that are not from a passive activity.
- If the election to aggregate was made, the section 469(g) disposition rules apply to the single combined rental real estate activity.
- Suspended losses are not freed up until the taxpayer completely disposes of all the properties.

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## REVOCATION OF ELECTION

P. 348

- Only in a tax year in which there is a material change in the taxpayer's facts and circumstances, or in a subsequent year in which the facts and circumstances are still materially changed
- File a statement with the original tax return for the year of revocation

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**\$25,000 SPECIAL ALLOWANCE**

P. 348

- The PAL limitations do not apply to up to \$25,000 of passive losses (or the deduction equivalent of the passive activity credit) from rental real estate activities if:
  - Taxpayer is natural person
  - Taxpayer actively participates in rental real estate activity
- Allowance begins to phase out if MAGI is over \$100,000 (lower for MFS)
- Estates can qualify in 2 years after the date of death

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**ACTIVE PARTICIPATION**

P. 349

- Does not require regular, continuous, and substantial involvement in operations
- Taxpayer must participate in management decisions or arrange for others to provide services (such as repairs)

Practitioner Note - Ownership Requirements

No active participation if less than 10%

Example 9.4 Active Participation Test

Cole has a vacation home with a property manager but retains right to approve tenants and hire for repairs. Active participation test met.

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**ORDERING RULES**

P. 350

- Combine net income and net losses from active participation real estate rental activities
  - Apply the prior year's unused losses
  - Net income is offset first by losses before the \$25,000 allowance is used
  - Example 9.5 Application of \$25,000 Allowance
- Alex has retail rental and commercial rental. Uses prior year losses first. Then uses special allowance to offset nonpassive income with passive losses.

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ISSUE 2:

P. 351

### Qualified Business Income Deduction and Losses

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### QBI DEDUCTION FOR REAL ESTATE

P. 351

- I.R.C. Section 199A QBI deduction for a real estate rental trade or business
  - Trade or business under I.R.C. Section 162
  - Cross Reference - QBI Deduction
- See chapters in 2019 NITW for details on the calculations.

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### TRADE OR BUSINESS

P. 351

- Facts and circumstances
- Relevant factors include:
  1. The type of rented property (commercial vs. residential)
  2. The number of properties rented
  3. The owner's or the owner's agent's day-to-day involvement
  4. Types and significance of any ancillary services
  5. Terms of the lease

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## REV. PROC. 2019-38 SAFE HARBOR

PP. 351-352

- Safe harbor under which a rental real estate enterprise may be treated as a trade or business for section 199A
- Hold the interest directly or through a disregarded entity
- Vacation rentals subject to section 280A limitations and triple net lease properties are not eligible
- Practitioner Note - Triple Net Leases  
May still qualify as a trade or business

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## AGGREGATION FOR SAFE HARBOR

P. 352

- Either treat each rental property as a separate enterprise or treat all similar properties as a single enterprise
- Cannot group commercial and residential properties
- Practitioner Note - Aggregating Rental Real Estate  
QBI aggregation rules apply

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## SAFE HARBOR TEST

P. 353

- At least 250 hours of services in 3 of 5 tax years
- Services include:
  - Advertising to rent or lease
  - Negotiating and executing leases
  - Verifying information in applications
  - Collection of rent
  - Daily operation, maintenance, and repair
  - Management of the real estate
  - Supervision of employees and independent contractors

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## RECORDKEEPING AND REPORTING

P. 353

Maintain separate books and records to reflect income and expenses for each real estate enterprise

Contemporaneous records to document:

1. Hours of all services performed
2. A description of all services performed
3. Dates on which such services were performed
4. Who performed the services

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## PN - FACTS AND CIRCUMSTANCES TEST

P. 354

Safe harbor has stringent requirements so better to choose facts and circumstances test?

Section 162 trade or business or self-rental, then the recordkeeping and reporting requirements do not apply. However, the taxpayer still bears the burden to show the right to a claimed deduction.

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## SELF-RENTALS

P. 354

- Rental or licensing of tangible or intangible property to a related trade or business that is an individual or RPE is treated as a trade or business if the rental or licensing and the other trade or business are commonly controlled
- Allows aggregation of business with associated rental properties
- 50% or more tests applied for individuals, partnerships, and S corporations
- Practitioner Note - Rental to an SSTB  
Real estate rental is separate SSTB

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## QBI LOSSES

PP. 354-355

- Offset net positive QBI with net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses with positive QBI
- Adjusted QBI then used to apply the W-2 wage and capital limit
- No QBI deduction if individual's total QBI is less than zero
- Negative total QBI is treated as negative QBI from a separate trade or business in succeeding tax years
- Practitioner Note - Accrual Method Taxpayers

Accrue unpaid rent during the eviction moratorium. Bad debt deduction in the year that debt becomes partially or totally worthless. May generate negative QBI.

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## CURRENT-YEAR QUALIFIED BUSINESS LOSS

PP. 355-356

- Loss from a qualified business offsets income from other qualified businesses
- Example 9.6 - Susan has 3 different businesses. Negative from real estate rental offsets positive from farm and furniture businesses.
- Example 9.7 - Susan's loss exceeds income. Carries over to next year.
- Example 9.8 Tiara's suspended PAL not included in QBI in one year may be considered a QBI net loss carryforward from a separate business in a future year.
- Cross-Reference - Aggregating a Loss Business

Doesn't affect netting of income and loss but may affect wage and capital limit

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## PREVIOUSLY DISALLOWED LOSSES

P. 356

- Use previous year losses on a FIFO basis.
- Not included in QBI if from a tax year ending before January 1, 2018

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## ATTRIBUTES OF LOSS OR DEDUCTION

P. 357

- Taxpayer's section 469 groupings may differ from taxpayer's section 199A aggregations
- Regulations provide previously disallowed losses are treated as a loss from a separate trade or business
- Example 9.9 Suspended SSTB Loss

Maria uses her 2021 taxable income (above the threshold) to determine use of SSTB loss in 2022 (within the phase-in range).

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## PARTIALLY ALLOWED LOSSES

PP. 357-358

- To the extent a loss is partially disallowed, QBI in the year of disallowance is reduced proportionately.
- Portion of loss or deduction that is allowed is considered in determining QBI for that year.
- Example 9.10 - Calculating a Partially Allowed Loss
- 80% of Andre's loss is attributable to QBI and reduces amount taken into account proportionately.

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## ISSUE 3:

P. 359

## Tax Issues for Real Estate Developers

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## ALLOCATING COSTS: SUBDIVIDED LAND

PP. 359-360

- Allocate the basis of original purchase price among subdivided lots
- Can only be equal if the lots are identical
- Practitioner Note - Acquisition Costs  
Legal fees, title policies, surveys, and realtors' commissions are capital expenditures that are added to basis

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## ALLOCATING COSTS: IMPROVEMENTS

P. 360

- Allocate the cost of improvements, such as roads and utilities, to the subdivided lots
- Three methods:
  - Relative sales value method
  - Average cost method
  - Square footage method

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## UNIFORM CAPITALIZATION (UNICAP) RULES

P. 360

- Capitalization of direct costs and portion of indirect costs to produce certain real property
- Apply to real property built by a developer for sale to customers
- Exception if average annual gross receipts for the 3-tax-year period ending with the tax year that precedes the current tax year does not exceed \$26,000,000 (for 2021)

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## REAL ESTATE DEALER OR INVESTOR

P. 361

- Real estate investor is taxed on sale of real estate at preferential capital gains tax rate
- Investors can benefit from like-kind exchanges and installment sale rules
- Investors may be subject to PAL limitations if they do not materially participate
- Real estate dealer taxed at ordinary rates
- Example 9.11 Floyd purchased to resell and is dealer
- Example 9.12 Jen and Joel purchased to develop as rental but sold lots. Initial purpose was investment.

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## INVESTOR VS. DEALER JUDICIAL FACTORS

PP. 361-362

1. The purpose for the purchase and the duration of the ownership
2. The continuity, extent, volume, and frequency of sales
3. The sales activity of the owner
4. Subdivision or development activities
5. Other sources of income
6. The taxpayer's status as a dealer
7. The taxpayer's purchase of other property at the time of the sale

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## SECTION 1237

P. 362

- Section 1237 allows a taxpayer, other than a C corporation, to subdivide and sell and maintain investor status.
- The taxpayer must meet the following requirements:
  1. Did not previously hold the tract primarily for sale to customers in the ordinary course of business and, during the year of sale, does not hold any other real property primarily for sale in the ordinary course of business
  2. Did not make any improvements that substantially enhances the value of the lot or parcel sold
  3. Holds the lot or parcel (except for inheritance or devise) for at least 5 years

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## INSTALLMENT SALES

P. 363-364

- One payment is to be received in a tax year after the year of disposition
- Not for losses
- Practitioner Note - Default Method

The installment method is the default method unless elected out and income is recognized as payments are received.

Taxpayers calculate a gross profit percentage to determine inclusion each year payments are received.

Example 9.14 Zara reports \$16,254 gain each year.

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## RELATED PARTY SALES

P. 366

Related persons may use the installment sale method, but the seller must recognize part or all the gain if a second disposition occurs before the end of the earlier of the following time periods:

1. Before all payments are made for the first sale
2. Within 2 years after the date of the related party sale

Non-tax avoidance exceptions

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## SECOND DISPOSITION

P. 366

- The following are not treated as second dispositions:
  - An involuntary conversion (when the threat occurred after the first disposition)
  - A disposition after the earlier of the death of the person making the first disposition, or the death of the person acquiring the property in the first disposition

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## OTHER EXCEPTIONS

P. 366

- Second disposition was forced
- Second disposition was also an installment sale with substantially similar terms

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## ISSUE 4:

P. 367

## NET INVESTMENT INCOME TAX

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## NET INVESTMENT INCOME TAX

P. 367

- Real estate developer with status as investor may be subject to net investment income tax (NIIT)
- A taxpayer with real estate rental income or disposition gains may also be subject to the NIIT
- NIIT 3.8% tax on lesser of net investment income or MAGI over the following thresholds (not indexed for inflation):
  - \$250,000 for MFJ
  - \$125,000 for MFS
  - \$200,000 for all other taxpayers

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## NET INVESTMENT INCOME

P. 367

- Income from interest, dividends, annuities, royalties and rents unless derived from the ordinary course of an active trade or business that is not a passive activity
- Net gain attributable to the disposition of property other than property held in an active trade or business
- Income from businesses that generate passive income under section 469

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## REAL ESTATE RENTAL INCOME

P. 367

- Reminder: Net investment income includes gross income from rents other than rents from the ordinary course of an active trade or business.
- Real estate professional status on its own does not indicate that all rental real estate activities rise to the level of an active trade or business.
- Gross rental income that is treated as not passive because of self-rental rules or grouping with an active trade or business is not subject to NIIT.
- Same rule for gain or loss on disposition of property.

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## REAL ESTATE PROFESSIONALS

P. 368

Safe harbor exclusion of rental income from the NIIT if:

1. Participate (same definition as material participation test) in a rental real estate activity for more than 500 hours during the tax year, or
2. Participate in rental real estate activities for more than 500 hours in any 5 tax years during the tax years immediately preceding the current tax year.

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## PASSIVE TRADE OR BUSINESS INCOME

P. 368

- Income from a passive trade or business is subject to the NIIT.
- To determine whether gross income is derived in a trade or business:
  1. For an individual, estate, or trust that owns or engages in a trade or business directly (or indirectly through ownership of an interest in a disregarded entity), the determination is made at the individual, estate, or trust level
  2. For an individual, estate, or trust that owns an interest in a passthrough entity (e.g., a partnership or S corporation), determination at the owner level

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## CALCULATING NIIT

PP. 368-370

- Calculate and report the NIIT on Form 8960, Net Investment Income Tax—Individuals, Estates, and Trusts
- Daria and Dakota have:
  - \$480,00 wages
  - \$85,000 real estate rental income
  - \$20,000 in expenses allocable to the rental income
- Calculate NIIT on \$65,000 net investment income
- \$2,470

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QUESTIONS?

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