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What is a real estate professional (REP) and why it means so much today?

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The real estate industry was dealt a severe body blow in 1986, when Congress enacted the passive activity rules, which provided that losses from a passive activity could only be deducted to the extent of the taxpayer's net income from other passive activities. Excess passive losses were not deductible until the taxpayer generated net passive income, or disposed of the interest in the loss activity.

While these rules were originally intended to limit losses related to activities in which the investor was merely a passive investor (such as abusive tax shelters), real estate was hit particularly hard for two reasons: (i) rental real estate activities (RREAs) traditionally generate tax losses, even from rental properties that generate positive cash flow, predominantly because depreciation (a non-cash deduction) is usually a material deduction in calculating the property's taxable income or loss; and (ii) RREAs were deemed to be per se passive activities. As a result, the real estate industry was up in arms and rightfully so. After all, many real estate entrepreneurs and others were actively engaged in RREAs on a full-time basis. How could Congress treat them like passive investors? As a result, the real estate professional rules were enacted in 1993.

What is a real estate professional (REP)?

To be a REP, two requirements must be satisfied: (1) more than one half of the taxpayer's "personal services" during the taxable year must be performed in "real property trades or businesses" in which the taxpayer materially participates for the year; and (2) the taxpayer must perform more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. Real property trades or businesses consist of real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage.

Personal services performed as an employee are not counted as services performed in a real property trade or business, unless the employee owns more than five-percent of the employer. For example, if an individual works full-time for a real estate management company in which the individual has no ownership stake, those services do not count in determining whether the individual is a REP. Also, for a married couple filing jointly, if either spouse qualifies as a REP, the other spouse qualifies as well; and while the spouses' participation is aggregated in determining whether they materially participate in an activity, they are not aggregated in applying the other aspects of the tests. Finally, an election is available to treat all RREAs as one activity, for purposes of the passive activity rules, which should make it easier for an individual with interests in multiple RREAs to be a REP (that is, these tests can be met with respect to the entire portfolio of properties rather satisfy them for each activity).

Once classified as a REP, his or her material participation in any RREA will result in the activity not being treated as passive.

Why being a REP means so much today?

Qualifying as a real estate professional has always been beneficial for owners of RREAs. As mentioned above, net income and losses from these properties have been treated as non-passive, and therefore, have been deductible against all types of income.

The REP classification has taken on even greater importance, beginning with the 2013 tax year, because of the new 3.8% surtax on the net investment income of high-income taxpayers. While the surtax was primarily intended to subject net investment income (such as interest, dividends, and capital gains) to the 3.8% Medicare tax, it also looks to impose the surtax on net income from certain trades or businesses that are otherwise exempt from the Medicare Tax. Included in this latter category is net passive income. Since the net income from rental real estate is treated as non-passive income, a REP's net income from rental real estate will avoid the 3.8% surtax.

As such, it would appear that investors in rental real estate, who have otherwise not satisfied the tests to qualify as a REP, should consider taking steps to spend more time (keeping contemporaneous records) in providing qualifying services to the real estate activities so as to meet the various thresholds. You should consult a qualified tax professional to be certain this makes sense for you.

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