

1031 Exchanges and Suspended Passive Losses

By Ed Horan, Certified Exchange Specialist®

Passive losses is not a topic that sets readers on fire. But if you have a rental property and your income is over one hundred thousand dollars, you should understand the treatment of suspended losses in a 1031 exchange.

For starters, IRC Section 469(c)(2) establishes all rental property as a passive activity. This section applies to all individuals, estates, trusts, closely held corporations, and personal service corporations. There are two kinds of passive activity. These are a trade or business in which you do not materially participate, and rental activities, regardless of your participation, unless you are a real estate professional. Your activity may not be a rental activity if the average period of customer use of the property is seven days or less. Also, if you personally use a rental property (vacation home) during the year for more than the greater of 14 days or 10% of the days actually rented, it is not a passive activity. IRS Publication 527 covers in detail the limits on rental losses if you had excessive personal use of the property.

Exception for Real Estate Professionals

IRC Section 469(c)(7) provides special rules for taxpayers in the real estate business. If you qualify as a real estate professional, rental real estate activities in which you materially participate are not passive activities. You qualify as a real estate professional for the year if you meet both of the following requirements: first, one half of all business services performed were in real property businesses in which you materially participated, and second, you performed more than 750 hours in real property businesses. For a full explanation of this very favorable rule, see Page 5, IRS Publication 925 available at www.irs.gov.

Special \$25,000 Allowance

If you or your spouse actively participated in a passive rental real estate activity, you can deduct up to \$25,000 of loss from the activity from your non-passive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. The maximum \$25,000 allowance is reduced if your modified adjusted gross income exceeds \$100,000 and you are married filing jointly.

What happens if my rental property expenses and depreciation exceed the rental income and due to my income I do not qualify for the special allowance? You have just joined the ranks of

taxpayers with passive activity losses, otherwise known as PALs. These become suspended passive losses and are reported on IRS Form 8582, Passive Activity Loss Limitations, as part of your regular federal tax return.

For each rental property activity (an activity may be one or more properties), the amount of loss or gain and losses carried over from prior years are posted to Form 8582 and attached worksheets. Gains from other passive activities can offset losses from rental real estate.

If you dispose of your entire interest in a passive activity or former passive activity to an unrelated person in a fully taxable transaction, the losses allocable to the activity for the year are not limited by the PAL rules. A fully taxable transaction is a transaction in which you recognize all the realized gain.

If you have significant losses in the rental activity you are selling your best option may be to sell the property outright rather than do a 1031 exchange. Then all of the suspended losses for that activity can be used to offset the recognized gain from the sale of the property.

If the rental property has significant realized gain, then the best option may be to do a 1031 exchange and use the suspended loss on that property to offset boot recognized in the exchange.

How does this work?

Let's say you have accumulated \$20,000 in suspended losses on the property in the current and/or past years. At settlement you can receive \$20,000 from the settlement agent thus creating \$20,000 in cash boot. Or you can reinvest \$20,000 less than the cash received from the relinquished property. At the end of the exchange the qualified intermediary will send you the \$20,000. This is recognized cash boot. Any boot recognized in the exchange transfer of the property is considered passive activity gain that can be used to offset suspended passive losses. This is reported by completing Part I of Schedule E through line 22 to determine the loss or gain for the current year. The result is posted to Worksheet 1 and Form 8582. Worksheet 1 shows the net income (say the \$20,000 cash boot), any loss for the year and prior years. Then Worksheet 6 shows the total allowed loss of \$20,000 that is placed on line 23, Schedule E and gets carried forward to Line 17 on Form 1040 to offset the gain from Schedule D and Form 8824 which are used to report the exchange.

If the property is not sold outright or boot recognized, then your third option is to do nothing and any suspended passive losses not used will be carried forward to the replacement property.

Taxpayers should take every effort to use up suspended passive losses. This article shows how to use suspended passive losses in an exchange or outright sale. Involved taxpayers should consult their tax advisor and IRS Publication 925 and the instructions for IRS Form 8582 for the multitude of exceptions and special rules pertaining to passive income and losses.

If you have suspended passive losses on your rental property, discuss all your options with your tax advisor before listing the property for sale.

-Ed Horan, CES® is Senior Exchange Consultant for Realty Exchange Corporation, Gainesville, VA, and author of
“How to Do a Like Kind Exchange Using a Qualified Intermediary”

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