

Rental Activities and Passive Loss Guide

*What landlords need to know about income expenses losses and recordkeeping
A plain English guide for rental property owners*

The short answer A rental loss on paper does not always produce a current tax deduction. The result depends on how the property is used, how much you participate, your income, your investment at risk, and whether the activity is truly a rental under the passive-loss rules.

This guide explains the rules most individual landlords encounter, from the first tenant through the eventual sale. It also shows why good records are not optional when a rental reports a loss.

*Rental property can build wealth. It can also build a very impressive stack of receipts.
The receipts are the easier part to explain to the IRS.*

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THE BASIC RULE

Why a Rental Loss May Be Suspended

Most rental real estate is treated as a passive activity. Passive losses generally offset passive income, not wages, pensions, interest, or income from a business in which you materially participate. If the loss cannot be used this year, it usually carries forward rather than disappearing.

Layer	Question the tax return asks
Basis	Do you have enough tax basis to claim the loss?
At risk	Could you actually lose the money or debt supporting the deduction?
Passive activity	Is the loss allowed against this year's income, or must it be suspended?
Excess business loss	After the other limits, does the individual business-loss limit apply?

These limits apply in order. Passing one test does not guarantee a current deduction under the next test.

Example A loss that waits

Carlos has a \$12,000 rental loss and no passive income. He does not qualify for the special rental-real-estate allowance. The \$12,000 is generally suspended and carried forward. If the property produces passive income later, or Carlos has income from another passive activity, some or all of the suspended loss may become usable.

Suspended does not mean denied forever. It means the deduction is waiting for the right kind of income or a qualifying disposition.

ACTIVE PARTICIPATION

The Special Twenty Five Thousand Dollar Allowance

A taxpayer who actively participates in rental real estate may be able to deduct up to \$25,000 of rental loss against nonpassive income. Active participation is a practical management standard. It can include approving tenants, setting rental terms, authorizing repairs, and making other meaningful decisions.

- The taxpayer generally must own at least 10 percent of the activity.
- A limited partner generally does not qualify for this allowance.
- A spouse's participation counts, even when the spouses file jointly and only one spouse handles the property.
- Hiring a property manager does not automatically prevent active participation if the owner retains genuine decision-making authority.

Income phaseout

Modified adjusted gross income	Maximum allowance
\$100,000 or less	\$25,000
\$110,000	\$20,000
\$125,000	\$12,500
\$140,000	\$5,000
\$150,000 or more	\$0

The allowance generally falls by 50 cents for each dollar of modified adjusted gross income above \$100,000 and disappears at \$150,000. Special, less favorable rules apply to married taxpayers filing separately; spouses who lived together during the year generally receive no allowance.

Example Income reduces the allowance

Amy actively participates and has a \$20,000 rental loss. Her modified adjusted gross income is \$120,000. The \$25,000 allowance is reduced by \$10,000, leaving a maximum allowance of \$15,000. Amy may currently deduct \$15,000, subject to the other loss limits, and the remaining \$5,000 is generally suspended.

PARTICIPATION RULES

Active Participation Is Not Material Participation

The words sound similar, but they do different jobs. Active participation may unlock the special \$25,000 allowance. Material participation determines whether a trade or business activity is passive. Ordinary long-term rental real estate remains passive even when the owner materially participates, unless the owner also qualifies as a real estate professional.

Standard	What it generally means	Why it matters
Active participation	Meaningful management decisions; lower standard.	May permit the special rental-real-estate loss allowance.
Material participation	Regular, continuous, and substantial involvement under one of seven regulatory tests.	Can make a nonrental trade or business nonpassive and is required for a real estate professional to make rental activity nonpassive.
Real estate professional	More than half of the taxpayer's personal services and more than 750 hours are in qualifying real-property trades or businesses in which the taxpayer materially participates.	Rental real estate may be nonpassive if material participation is also established.

Common material-participation tests

- More than 500 hours during the year.
- Substantially all participation in the activity.
- More than 100 hours and at least as much participation as any other individual.
- Material participation in any five of the prior ten years.
- A facts-and-circumstances test requiring more than 100 hours and regular, continuous, and substantial participation.

Contemporaneous calendars, emails, invoices, mileage logs, and service records are stronger than a year-end estimate reconstructed after an IRS notice arrives.

The Seven Hundred Fifty Hour Rule Is Only the Beginning

Qualifying as a real estate professional does not automatically make every rental loss deductible. The taxpayer must first satisfy both annual qualification tests and then materially participate in each rental activity whose loss is claimed as nonpassive.

Annual qualification test	Requirement
More-than-half test	More than half of the personal services the taxpayer performs in all trades or businesses must be in qualifying real-property trades or businesses in which the taxpayer materially participates.
Hours test	The taxpayer must perform more than 750 hours in those qualifying real-property trades or businesses during the year.
Material participation	Each rental is generally tested separately unless a valid election treats all rental-real-estate interests as one activity.

For a joint return, one spouse must independently satisfy the two real-estate-professional qualification tests. The spouses' combined participation can then count when testing material participation in a rental activity.

Grouping election

A qualifying taxpayer may elect to treat all interests in rental real estate as one activity. That can make material participation easier to establish, but it can also delay release of suspended losses until the entire grouped activity is disposed of. This is a long-term election, not a box to check casually.

Lenny's take

"I own rentals, so I am a real estate professional" is not the test. The tax law wants hours, activities, participation, and records. Titles are inexpensive; documentation is what earns the deduction.

SHORT TERM RENTALS

When an Airbnb May Not Be a Rental Activity

For the passive-loss rules, certain activities involving rented property are not classified as rental activities. That does not mean the income disappears. It means the activity is tested like a trade or business, and material participation becomes especially important.

Average customer use	General passive-activity treatment
7 days or less	Not treated as a rental activity for section 469 purposes.
30 days or less with significant personal services	Not treated as a rental activity for section 469 purposes.
Longer stays with customary landlord services	Usually treated as rental activity and generally passive unless the real-estate-professional exception applies.

The average stay is calculated using all rental periods, not simply the shortest or longest reservation. “Significant personal services” means more than ordinary landlord services such as cleaning common areas, repairs, trash collection, or providing utilities.

Schedule E or Schedule C

Short stays do not automatically force Schedule C treatment. Schedule C and self-employment tax generally become concerns when substantial services are provided primarily for the guest’s convenience, similar to a hotel or bed-and-breakfast operation. The reporting answer depends on both the services and the facts of the operation.

A short-term rental can be nonpassive when the owner materially participates, even though an ordinary long-term rental would remain passive for a non-real-estate-professional.

PERSONAL USE

Vacation Homes Family Rentals and the Fourteen Day Rules

Two different 14-day concepts are often confused.

Rule	Plain English result
Rented fewer than 15 days	If the dwelling is also used as a home and is rented for fewer than 15 days during the year, rental income generally is not reported and rental expenses generally are not deducted.
Used as a residence	A dwelling is generally treated as a residence if personal use exceeds the greater of 14 days or 10 percent of the days rented at fair rental value. Rental deductions may then be limited to rental income.
Rented to relatives	A relative's use generally counts as personal use unless the property is the relative's principal home and fair rent is paid.
Below-market rent	Days rented below fair rental value generally count as personal-use days, and deductions may be restricted.

Example Ten percent can exceed fourteen days

A cabin is rented at fair value for 200 days. Ten percent is 20 days. If the owner uses it personally for 18 days, the personal use does not exceed 20 days, so it is not treated as a residence under this test. If personal use is 21 days, it generally is treated as a residence.

Count family use, owner stays, reciprocal arrangements, and below-market use carefully. A calendar marked only "occupied" does not tell the tax preparer who used the property or why.

INCOME AND EXPENSES

What Goes on the Rental Schedule

Rental income is broader than the monthly rent deposited into the bank account. Rental expenses must be ordinary, necessary, properly allocated, and supported.

Item	Usual treatment
Advance rent	Income when received, even if it covers a later year.
Security deposit	Not income when the landlord expects to return it; income when retained under the lease for damage or unpaid rent.
Tenant-paid owner expense	Generally rental income and potentially a rental expense.
Lease cancellation payment	Generally rental income when received.
Repairs and maintenance	Usually deductible when they keep property in ordinary operating condition and do not materially improve it.
Improvements	Capitalized and recovered through depreciation rather than deducted all at once.
Travel and mileage	Potentially deductible when primarily for rental business and properly documented; commuting and personal travel are not.
Owner labor	The value of the owner's own labor is not deductible.

Common deductible expenses include advertising, insurance, management fees, legal and tax-preparation fees related to the rental, mortgage interest, property taxes, utilities, supplies, repairs, and depreciation. Mixed personal and rental costs must be allocated.

A payment is not deductible merely because it came out of the rental bank account. The expense still needs a business purpose and the right tax treatment.

REPAIRS AND IMPROVEMENTS

Deduct Now or Depreciate Over Time

A repair generally keeps property in its ordinary efficient condition. An improvement generally better the property, restores it, or adapts it to a new or different use. The invoice label does not control; the work performed does.

Usually a repair	Usually an improvement
Fixing a small roof leak	Replacing the entire roof
Repairing a broken window	Replacing all windows with upgraded units
Patching and repainting damaged wall area	Major remodel or new room configuration
Replacing a minor component of an appliance	Installing a new appliance
Routine HVAC service	Replacing the HVAC system

Depreciation basics

Residential rental buildings are generally depreciated over 27.5 years using the straight-line method and mid-month convention. Land is not depreciable. Appliances, furniture, fencing, landscaping improvements, and other components may have different recovery periods.

Converted homes

When a former personal residence becomes a rental, the depreciation basis is generally the lower of adjusted basis or fair market value on the conversion date. A reliable appraisal and the original purchase and improvement records can prevent a painful basis reconstruction years later.

Depreciation is “allowed or allowable.” Skipping the deduction generally does not avoid reducing basis when the property is sold.

SPECIAL SITUATIONS

Rules That Surprise Rental Owners

Situation	What to watch
Self-rental	Net rental income from property rented to a business in which the taxpayer materially participates is generally recharacterized as nonpassive. A net loss generally remains passive.
Property manager	Using a manager does not automatically eliminate active participation, but the owner must retain and exercise real decision-making authority.
Room rental	Allocate shared expenses between rental and personal use. Services, average stay, and access to common areas may affect reporting.
Foreign rental	U.S. taxpayers generally report worldwide rental income. Foreign residential property may use different depreciation rules, and foreign reporting may apply.
Related-party rent	Fair rental value and actual use matter. Below-market arrangements can create personal-use days and limit deductions.
Refinancing proceeds	Interest follows the use of the borrowed money, not merely the property used as collateral.
Publicly traded partnerships	Passive income and losses from each PTP generally stay in a separate bucket and do not freely offset other passive activities.

Net investment income tax

Passive rental income and gain may be subject to the 3.8 percent net investment income tax when the taxpayer's income exceeds the applicable threshold. Nonpassive treatment does not automatically settle every net-investment-income question, so higher-income owners should review this before a sale or large rent increase.

SELLING THE PROPERTY

What Happens to Suspended Losses

Suspended passive losses may be released when the taxpayer disposes of the entire interest in the activity in a fully taxable transaction to an unrelated person. The losses first offset income or gain from that activity, then other passive income, and then may offset nonpassive income.

Transaction	General planning concern
Fully taxable sale to an unrelated buyer	Suspended losses may be released if the entire activity is disposed of.
Sale of only part of the activity	Usually does not release all suspended losses.
Like-kind exchange	A fully tax-deferred exchange generally does not create the same full release because the transaction is not fully taxable.
Installment sale	Suspended-loss release may be limited as gain is recognized; review before signing.
Gift	Suspended losses generally are not currently deducted and may affect the recipient's basis under special rules.
Death	Special basis and suspended-loss rules apply; do not assume all losses simply appear on the final return.

Depreciation and gain

Gain attributable to depreciation may be taxed as unrecaptured section 1250 gain at a maximum federal rate of 25 percent. Other gain may receive long-term capital-gain treatment, while section 1231 and other rules can change the result. State tax and the 3.8 percent net investment income tax may also apply.

Before listing the property, assemble the original closing statement, improvement history, depreciation schedules, suspended-loss carryovers, refinancing records, and prior exchange documents. The sale calculation begins years before the “For Sale” sign goes up.

RECORDKEEPING

The Landlord Tax File

Keep records by property and by year. Permanent basis records should be retained for as long as the property is owned and through the limitation period for the return reporting its sale.

- ☐ Purchase closing statement, deed, settlement costs, and original allocation between land and building.
- ☐ Invoices and proof of payment for improvements, appliances, furniture, and major repairs.
- ☐ Annual rent ledger, lease agreements, deposits, and tenant reimbursements.
- ☐ Mortgage interest, property-tax, insurance, utility, HOA, and management statements.
- ☐ Mileage log showing date, destination, business purpose, and miles.
- ☐ Calendar identifying rented days, available days, personal days, family use, and average guest stay.
- ☐ Participation log showing date, task, hours, location, and supporting document.
- ☐ Prior returns, depreciation schedules, Form 8582 worksheets, at-risk schedules, and suspended-loss carryovers.
- ☐ Appraisal and photographs when a residence is converted to rental use.
- ☐ Sale, exchange, casualty, insurance, and refinancing documents.

A credit-card statement proves payment. It does not always prove what was purchased, where it was used, or whether it was a repair or improvement. Keep the invoice too.

PLANNING TIPS

Questions to Ask Before Year End

- Will modified adjusted gross income reduce or eliminate the special \$25,000 allowance?
- Is there passive income that can absorb suspended rental losses?
- Have personal-use days, family stays, and average short-term-rental stays been documented?
- Will a planned repair cross the line into an improvement?
- Does the participation log support the tax position being claimed?
- Should a real-estate-professional grouping election be considered, and what happens when one property is sold?
- Would a sale, installment sale, gift, or exchange change the treatment of suspended losses?
- Are estimated taxes and withholding sufficient for rental income or a property sale?

Coffee with Lenny

A rental loss can be completely real and still be unavailable on this year's tax return. The roof was repaired, the mortgage was paid, and the bank account is lighter. The passive-loss rules simply decide when the tax deduction gets its turn.

That is why I like to review rentals before the return is sitting on my desk with a filing deadline. Income, participation, personal use, repairs, and a possible sale can all change the answer. A little planning in November is usually cheaper than archaeology in April.

And if your participation log says “worked on rental - 400 hours,” we need to talk. The IRS appreciates detail almost as much as landlords appreciate tenants who pay before the reminder text.

QUESTIONS CLIENTS ASK

Frequently Asked Questions

Why did my rental loss disappear

It probably did not disappear. It may be suspended by the basis, at-risk, passive-loss, or excess-business-loss rules and carried forward.

Can rental losses offset my wages

Sometimes. The special allowance may permit up to \$25,000 for active participants, subject to income phaseout and other limits. A real estate professional who materially participates may also have nonpassive rental losses.

Does hiring a property manager make me passive

Not automatically. You may still actively participate if you retain and exercise significant management decisions. Material participation is a separate and more demanding test.

Is every Airbnb reported on Schedule C

No. Average guest stay affects the passive classification, while the nature and extent of guest services help determine Schedule C, Schedule E, and self-employment-tax treatment.

Can I deduct the value of my own repair work

No. You may deduct qualifying materials and amounts paid to others, but not the value of your own labor.

What if I forgot depreciation

Basis is generally reduced by depreciation allowed or allowable. Correcting missed depreciation may require a method-change filing rather than simply adding it to the current return.

Do suspended losses become deductible when I sell

Often, after a complete taxable disposition to an unrelated buyer. Gifts, exchanges, installment sales, and partial sales require special review.

Can I rent to my child and claim a loss

Fair rent and the child's use matter. Below-market or non-principal-home use by a relative may count as personal use and limit deductions.

THE BOTTOM LINE

Treat the Rental Like a Business

Report all rental income, separate repairs from improvements, depreciate the correct basis, document personal use and participation, and keep suspended-loss schedules from year to year. Before a major renovation, change in rental strategy, related-party lease, refinancing, gift, or sale, ask how the decision affects both the current return and future gain.

Professional Use Note

This guide is for general educational purposes and is not legal, investment, or tax advice for a particular owner or property. Rental classification and loss limitations depend on the facts, ownership structure, services provided, participation, financing, personal use, and prior tax history. Obtain individualized advice before acting.

REFERENCES

Authoritative Sources

- [IRS Publication 527 Residential Rental Property](#)
- [IRS Publication 925 Passive Activity and At-Risk Rules](#)
- [IRS Publication 946 How To Depreciate Property](#)
- [IRS Publication 544 Sales and Other Dispositions of Assets](#)
- [IRS Topic 414 Rental Income and Expenses](#)
- [IRS Topic 415 Renting Residential and Vacation Property](#)
- [IRS Topic 425 Passive Activities Losses and Credits](#)
- [IRS Instructions for Form 8582](#)
- [IRS Instructions for Schedule E](#)
- [IRS rental income deductions and recordkeeping tips](#)
- [Treasury Regulation section 1.469-1T](#)
- [Treasury Regulation section 1.469-5T](#)
- [Internal Revenue Code section 469](#)