10 FINANCIAL THINGS TO REVIEW ANNUALLY

A lot can change in a year. Your financial goals may change. Your investment mix may shift. Your insurance needs may be different. Because things change, it's important to look over your finances every year or so to determine whether there are any adjustments you may want to make to help keep your finances on track and you and your loved ones protected. Here are ten things to review annually. For specific advice, please consult your TBC Advisor.

1. **Any new or revised goals?**

The start of a new year is a natural time to set new financial goals and to tweak existing goals.

Begin by reviewing your existing goals: Have they changed in the past year? For example, has your target retirement date changed? Whenever a goal changes or you add a new one, it's a good idea to review your financial plan with your financial professional to determine whether your savings and investment strategies need to be adjusted.

Are there any new financial goals that you want to set? If there are, you may find it helpful to clearly define each goal and then create a plan for pursuing it. The first step is generally to figure out how much money you may need and when you will need it. After you determine a dollar amount and a time frame, the next step is to estimate how much money you may need to save each month to have a good chance of reaching your goal in the time you've allotted. (A savings goal calculator or your financial professional can help with this.) Then it's time to create and implement a plan for how you will move toward your goal. With a plan in place, time on your side, and dedication on your part, you are all set to tackle your goals!

2. **Are you making the most of your retirement accounts?**

Contributing to an IRA and workplace retirement plan are two of the best ways to help build wealth for retirement. Are you making the most of these accounts?

If you are not contributing the maximum amount, consider whether you want to increase the amount you contribute.

Perhaps you recently received a pay raise or bonus, making it possible for you to increase the amount you save each year while still covering your everyday living expenses. Or perhaps you paid off your mortgage or made your last tuition payment and can afford to contribute more this year. Whatever the reason, increasing the amount you save now has the potential to improve your financial security in retirement.

If you are already contributing the maximum annual amount, keep in mind that contribution limits generally increase every few years, providing you with an opportunity to boost the amount you save for retirement.

Reaching age 50 also provides an opportunity to save more. Retirement plans and IRAs generally allow you to begin contributing an extra amount—known as a catch-up-contribution—beginning the year you reach age 50.

You can contribute to a traditional or Roth IRA right up to the due date for your federal tax return for the year. This means that you have until April 18, 2023 to contribute to an IRA for 2022, assuming you are eligible to contribute. With a workplace retirement plan, you may be able to change your contributions at any time during the year or you may be limited to a certain time. You can check the plan rules or contact your plan administrator to find out.

3. **Are you making the most of your savings account?**

As the Federal Reserve increased interest rates in 2022, some banks followed suit and increased the interest rates they pay on savings accounts, money market accounts, and certificates of deposit. If you haven't compared rates recently, now is a good time to do so. Interest rates can vary dramatically among banks, and you may earn considerably more interest at a bank that offers high-yield accounts.

Also, keep an eye on the amount you hold at any one bank. Remember, deposits are generally insured by the Federal Deposit Insurance Corp (FDIC), but only up to $250,000 per depositor, per insured bank, for each account ownership category. Exceed the limit, and you risk losing money if the bank ever fails.

4. **Is it time to adjust your asset mix?**

How you divide your portfolio among asset classes—stocks, bonds, and cash—can have a big impact on your portfolio's overall risk and growth potential. Reviewing your asset mix from time to time can help ensure that your portfolio is allocated appropriately for your goals, time frame, and risk tolerance.

Take a look at your asset mix: Has it changed? Differences in performance among stocks, bonds, and cash investments can cause your portfolio to stray from the target asset mix you chose. For example, if the stock market has declined recently, a portfolio that started out as 60% stocks and 40% bonds may now be 50% stocks and 50% bonds. When your portfolio's allocation strays from your target asset mix, your portfolio either has more risk or less potential for growth than you planned. In this example, it has less potential for growth because stocks now make up less of the portfolio.

If your portfolio has strayed from your target asset mix, rebalancing your portfolio—that is returning it to your target mix—can help keep your investment plan on track.

But before you rebalance, consider whether your target mix is still appropriate for you. If you've become more risk averse or if you are significantly closer to the time when you'll need your money, you may want to reduce risk in your portfolio by shifting to a more conservative asset mix. This typically means reducing the proportion of stocks in your portfolio.

5. **Is your insurance coverage keeping pace with the changes in your life?**

To make certain that your life insurance coverage and disability insurance coverage are still appropriate for your needs, it's a good idea to review them periodically and when major changes occur in your life.

For example, getting married or the arrival of a child may mean that more people are counting on your paycheck than before. It may be time to increase your life insurance coverage to better protect their financial security in the event of your death.

If you've recently taken out a mortgage on a new home for your family, you may also want to increase your life insurance coverage so that the policy's proceeds are sufficient to cover the mortgage payments.

If your salary increases, it's a good idea to review your life insurance coverage. A bump up in pay often results in a bump up in lifestyle, so unless you adjust your life insurance coverage, your family may one day find themselves struggling to cover their living expenses with the proceeds from a policy designed for leaner times.

It's also a good idea to review your long-term disability insurance coverage when your salary increases. This type of insurance is designed to replace part of your salary for a period of time when you are too sick or injured to work. The benefit payments you receive can help you cover your living expenses while you are unable to work. But as your salary increases, you may find that the benefit payments are not large enough for your needs. Supplementing your existing policy so that more of your income is replaced may be an option.

6. **Have you reviewed your credit reports recently?**

It's important to review them for accuracy at least once a year. Lenders and creditors use the information in these reports to decide whether to extend you credit and the interest rate you'll pay on that credit. Other companies, such as insurers, utilities, and landlords, may also use them when making decisions.

There are three major credit bureaus—Equifax, Experian, and TransUnion—that produce credit reports. Their reports can differ so it's a good idea to review all three reports. Under federal law, you are entitled to a free credit report annually from each of the credit bureaus. You can download them at .

During your review, look for errors in your accounts and payment histories. Also keep an eye out for signs of fraud, such as accounts that you didn't open.

7. **Are your estate planning documents up to date?**

It's a good idea to review your estate planning documents with your estate planning professional every few years and when major changes occur in your life. In the intervening years, consider reading over the documents yourself to determine whether changes are needed.

Your estate planning documents may include a will, trusts, powers of attorney for finances and health care, and a living will. As you read, ask yourself if the people you chose to act as an executor, trustee, guardian, attorney-in-fact, and health care proxy are still willing and able to serve. If they are not, your documents will need to be updated.

Next, ask yourself whether there have been any changes in your family, such as a marriage, birth, or death, or a major change in your assets. Or perhaps one of your heirs has become disabled. Each of these changes may signal the need for a formal review of your estate plan.

Even if there hasn't been a change in your family or assets, reading over your estate planning documents gives you an opportunity to determine whether you've simply changed your mind about any of the provisions in them.

If you spot anything that you'd like changed or that you have questions about, please contact your estate planning professional.

8. **Are your beneficiary designations up to date?**

It's important to review the beneficiary designations on your financial accounts at least once a year. The person, trust, or charity that you name as a beneficiary on an account will generally inherit the assets in that account regardless of any instructions to the contrary in your will. An annual review helps ensure that your beneficiary designations still reflect your thoughts on who should inherit the accounts.

Be sure to check the beneficiary designations on your retirement accounts, investment accounts, bank accounts, and health savings accounts. In some cases, a beneficiary designation may be referred to as a transfer-on-death, payable-on-death, or in-trust-for designation.

In addition to your financial accounts, you may have named beneficiaries on your life insurance policies and annuities so you'll want to check those also. And if you live in a state that allows you to name a beneficiary on your vehicle registration or real estate deed, review them too.

Please consult your estate planning professional for advice about naming beneficiaries.

9. **Does your emergency fund need topping up?**

It may if you dipped into it last year or if your living expenses have increased significantly.

An emergency fund is money that you set aside specifically to help cover expenses if you lose a job or face large, unexpected expenses, such as medical bills. One rule of thumb is to have enough cash to cover three to six months of living expenses. However, you may want to set aside more cash in some circumstances, such as if you work in a field where it may take longer than six months to find a new job.

10. **Do you know where your money is going?**

Knowing how much you spend each year and what you spend it on can help you develop a realistic budget for the year ahead. It may also help you identify areas where you can trim your spending in order to direct more money to pursuing the goals that are important to you.

It may be easier than you expect to track your spending. Several banks and credit card issuers offer spending reports that break a customer's spending over the past year into categories, such as groceries, restaurants, clothing, and automotive. And there are expense tracker apps available that can collect information from your various accounts and provide you with a big-picture view of your spending and finances.

Please consult your financial professional for advice.

Reviewing your finances every year or so is a great way to help keep them on track. For specific advice regarding your finances and pursuing your financial goals, please consult your TBC Advisor.

Asset allocation does not ensure a profit or protect against loss in declining markets.

Copyright 2023 Quinn Communications Inc.

SEEING THE BIG PICTURE WITH YOUR BUSINESS EXIT

By: Stephen L. Ferraro, CPA/ABV/CFF, CEBC, MAFF, CVA
Partner, Ferraro, Amodio & Zarecki CPAs

The success of exiting a business depends greatly upon the mental perspective and preparation of an owner during the exit process. Business owners tend to fixate their thoughts only on running and growing their business. However, there is a tremendous amount of value in seeing the 'big picture' with your exit and thinking about the future and where you would like both the company, and yourself personally, to end up. The owner who is able to see the larger picture and understands that stepping out of a business is an opportunity to move both themselves and their company toward a new stage of life, will be best prepared to execute a successful business transition. This newsletter is written to help owners think through the 'big picture' and align their thinking and resources towards a successful exit.

The Transfer Timing Slots

One of the first 'big picture' concepts that owners should grasp is the idea of 'timing slots'. Much like a slot machine, you want to see if you can match up three (3) critical areas – (1) personal timing, (2) company preparedness, and (3) market timing. A solid 'big picture' of an exit considers all three.

Let's Begin with Market Timing

Markets run in cycles and timing is important. If a business is performing well because there is a favorable economy, all things being equal, this can be an optimal time to consider an exit. Valuation is high, employees are engaged, and – often times – buyers / investors have a high degree of interest and activity.

As the chart below indicates, the last three (3) decades have followed a similar market cycle and this decade is following suit.

Therefore, if you believe the information above, your 'big picture' in terms of market timing indicates that the next few years are ideal in terms of market timing.

Company Preparedness

The 2nd 'big picture' concept for an exit is Company preparedness. In other words, your business needs to be [at least somewhat] transferrable to have a successful exit.

There are a large number of items that can lead to poor timing for an exit and lack of company preparedness. For example, you may have recently had a departure of a key manager, or you may have lost a key customer and need time to replace that revenue. Alternatively, your CFO or controller may not have your finances in order, or you may have a lawsuit pending that should really be resolved before moving ahead with a transfer of the business.

While timing can rarely ever be perfect, it is important to think through the current and forecasted profitability and valuation to see that your company's preparedness is optimal for a successful transaction that will result in a valuation and deal structure that works for you personally.

Personal Timing

The final 'big picture' concept – and the third consideration in the timing slots of an exit – is personal readiness. In fact, it probably makes sense to begin the 'big picture' thinking of an exit with personal planning. The reason is that this can be the most complex and take the most amount of time to navigate. Also, how an owner thinks about an exit is what is most likely to drive the exit process. In other words, the market and company can be perfectly positioned for an exit, but if the owner does not want to leave, it is possible that an exit process will not begin.

A Vision for a Personal Future Without the Company

Prior to considering any of the various options for exiting your business, you must be able to recognize two key elements within yourself:

- Realization of where you are right now, and
- A clear vision of where you want to be after the exit.

As a successful business owner, you realize that you have created self-worth and profit for both the company and those around you, including your family members. In building a company, you have built a personal identity, perhaps the only one which is recognized by some family, friends, and business associates. Many owners, without properly considering their new, post-exit identities will be unable to successfully pursue a business exit because of their continued attachment to the business. In order to ensure a smooth transition, you want to be able to articulate both where you are in your business today and the personal challenges associated with getting you to where you want to be.

Developing Exit Skills

The key to achieving the vision – or the 'big picture' – for your exit is an understanding that the tools and skills which have enabled you to build your business will likely be of limited value in planning your exit from the business; you'll need to learn new skills. If you are using the same tools, skills, and thoughts that you used to run and grow your business, it is very difficult to move on to the next phase. The primary reason why this is true is that the development of business value is not entirely consistent with the development of fulfilling personal needs and values. A 'big picture' look at your situation will have you begin to ask questions about 'why' it is important to design an exit plan that meets the needs that you have defined.

Concluding Thoughts

Seeing the "big picture" in your exit involves taking the time to reflect on goals of the business, the timing of the market, but most importantly, your interests and objectives outside of the business. Exploring your personal goals allows you to confidently move forward to the next phase of life, which may or may not include continued involvement with the company. As in so many aspects of one's life, perspective is key to ultimate success. By viewing your exit as an opportunity to a begin a new lifestyle instead of as a loss of your business identity, you can begin developing a 'big picture' for your exit.

Stephen Ferraro is a partner with Ferraro, Amodio & Zarecki CPAs, based in Saratoga Springs, NY. FAZ is a boutique accounting firm specializing in forensic accounting, business valuations and exit & growth planning. If you are interested in learning more, please contact your TBC Advisor

---

TEAL, BECKER & CHIARAMONTE CELEBRATES 50TH ANNIVERSARY

Albany, NY: 2021 has marked the 50th anniversary for Teal, Becker & Chiaramonte, CPAs, P.C. (TBC), the largest CPA firm based in the Capital Region. TBC has been serving thousands of clients for five decades in the areas of accounting, auditing, tax and advisory services, as well as other specialty services including pension

administration services, employee benefit plan audits, estates and trust planning and administration, business valuations, forensic accounting and cost segregation studies. Over the last 50 years, the firm has grown significantly and will be continuing that growth.

Ron Teal, Larry Becker, and John Chiaramonte founded TBC in 1971, hence where the Firm gets its name. The Firm started with only four employees- the three founders and a secretary. One aspect of the Firm that has certainly changed is its size, which now has 95 employees and 58 CPAs.

Albany Mayor Kathy Sheehan recently proclaimed December 14, 2021 Teal, Becker & Chiaramonte Day in honor of their 50 years in business.

A longtime member of CPAmerica, Inc., as a member of Crowe Global, they offer a full range of services that supports providing customized accounting, tax and comprehensive financial expertise that enables superior financial performance of their client's business or organization. They have been recognized by *Forbes* as America's Best Tax and Accounting Firms in 2021 and 2022. Listed as a "Top Workplace" by the *Times Union* for ten consecutive years and the "Best Places to Work" by the *Albany Business Review*. They are included on *Inside Accounting* as a Top 300 Firm.

****

NEW LEASE STANDARDS EFFECTIVE FOR PRIVATE COMPANIES

In April 2020, Financial Accounting Standards Board (FASB) voted to defer the effective date of Accounting Standards Codification (ASC) 842, *Leases* for certain entities. Now effective for fiscal years beginning after December 15, 2021, all private companies will be required to adopt the new standard which will impact the way most lease agreements are reported and disclosed.

The principal change to lease reporting under ASC 842 is that lessees will be required to recognize assets and liabilities on the balance sheet for leases that were previously classified as operating leases. Previously, operating lease payments were recognized as an expense over the term of the lease and future obligations were disclosed in the notes to the financial statements. Lessees will now recognize a liability to make lease payments and a right-of-use asset that represents its right to use the underlying asset over the term of the lease. The amounts recorded on the balance sheet must be measured at the present value of the lease payments, and amortization and interest expense must be recognized separately on the statement of comprehensive income.

Private companies have decisions to make in determining the calculation of interest rates related to leases. ASC 842 instructs companies to use the implicit rate, or the interest rate being charged by the lessor, if it is available. Often times this rate is not accessible to the lessee so, in these situations, private companies are allowed to use either their incremental borrowing rate or the risk-free rate. The incremental borrowing rate is the interest rate a company would receive if it were to borrow an amount of money equal to the total of the lease payments over the lease term. The risk-free rate is the rate that investors expect to earn from an investment that carries zero risk over a period of time, such as government treasury bills. When choosing between these two options, companies should be aware that a lower interest rate will result in a higher liability on the company's balance sheet.

It is important to note that when calculating the asset and liability, the lessee should include payments for optional extension periods as well, but only if there is reasonable certainty that the option will be exercised. For leases that have a term of 12 months or less, a lessee may elect to recognize lease expense on a straight-line basis over the lease term instead of creating an asset and liability.

For lessors, the accounting for operating leases remains fundamentally the same under Generally Accepted Accounting Principles (GAAP). Operating lease income should continue to be recognized on a straight-line basis over the terms of the lease.

Additional disclosures will also be required for the purpose of increasing transparency in financial reporting, including a breakdown of all operating and finance leases, as well as the current and noncurrent portions of their respective liabilities. Future minimum rental payments will continue to be disclosed as they were prior to ASC 842. New disclosures will include a summary of weighted-average remaining lease terms and the weighted-average discount rate used to calculate the lease liability.

Please contact your trusted TBC Advisor for more information about the impact that these new lease standards may have on you.

TBC ANNOUNCES NEW SHAREHOLDERS

Albany, N Y: Sarah Robinson, CPA, Gretchen Guenther, J.D. M.S., CPA, and Ryan McEvoy, CPA have recently been named as Shareholders for Teal, Becker & Chiaramonte, CPAs, P.C. (TBC). The promotion for Robinson, Guenther, and McEvoy took place on April 1st. Robinson joined in 1999, while Guenther joined the TBC team for the first time in 2000, and McEvoy joined in 2009.

Robinson with a Bachelor of Business Administration in Accounting, from The College of Saint Rose, manages all aspects of accounting for a diverse client base in several different industries. She is involved with training and education of staff through in-house seminars and mentorship programs. Robinson is actively involved with the TBC Employee Benefit Plan and Auto Committee. Outside of work, Sarah is on the Board of Directors for the Ronald McDonald House Charities. She resides in Cobleskill with her two sons.

Guenther with a Bachelor and a Master of Science Degrees from the College of Saint Rose, along with a Juris Doctorate from Albany Law School, manages and oversees all aspects of corporate, partnership, and individual tax compliance and planning. Guenther also finds herself being the director of the Firm's Tax Department and participates as an instructor in the Firm's various educational seminars. Outside of work Gretchen is the Treasurer of the Board of Directors of the Albany Damien Center and a member of The College of Saint Rose Golden Knights Athletic Advisory Council.

McEvoy with a Bachelor of Business Administration in Accounting from Siena College, manages accounting and tax engagements for a diverse client base, focused in manufacturing, construction, distribution, renewable energy, and technology. McEvoy is actively involved in the Firm's internal manufacturing committee. McEvoy enjoys traveling with his family and is an avid follower of the Yankees and Knicks. He has a one-year-old son and a seven-year-old black lab mix that keep him happily busy at home.

TBC is the largest CPA firm in the Capital district with 56 CPAs. A longtime member of CPAmerica, they offer a full range of services that supports providing customized accounting, tax and comprehensive financial expertise that enables superior financial performance of their client's business or organization. TBC serves thousands of clients in the areas of accounting, auditing, tax and advisory services. They also offer specialty services such as trusts and estates, business advisory, valuation, litigation support services, forensic accounting, and pension services. They have been recognized as a "Top Workplace" by the *Times Union* for ten consecutive years and "Best Places to Work" by the *Albany Business Review*. They are included in *Inside Accounting* as a Top 300 Firm.

####



COVID-19’S IMPACT ON STATE AND LOCAL GOVERNMENTS

The pandemic has had a huge impact on the economy. The impact has been far and wide affecting individuals and businesses. State and local governments have also been severely impacted. The pandemic has created significant declines in sales and other taxes and fees because consumption of goods and services have fallen. People are staying home which means that revenues from taxes and fees have been significantly lower than in any period in recent times. As an example there has been an increase in purchases of food at the grocery store, which typically are not subject to sales tax, versus spending at restaurants which is typically taxed more heavily. Not only are the restaurants suffering but the lack of tax generated on these sales is having a large impact on governments. No spending means no sales tax revenue at the state and local level. Revenues are down at a time where governments have encountered large unbudgeted costs in response to the pandemic. Governments have had to spend money on developing public safety standards, maintenance and materials, and large amounts of personal protective equipment.

General sales tax makes up, on average, about one quarter of state and local tax revenue. Federal aid may help offset some revenue losses that state and local governments have experienced in 2020. As the pandemic continues into 2021, and the economy remains depressed, local governments will need additional aid to avoid cutting services and raising taxes. The reality of the situation is that there will most likely be a greater need for services. Governments will likely be forced to confront tough budget choices for many years as a result of COVID-19. Expect to see budget cuts in education, adult and elderly care, and mental health support, to name a few.

To try and avoid deeper cuts, many state and local officials are trying a variety of strategies to be able to continue to deliver services. They include closely monitoring budgets, reducing expenditures, borrowing money, using reserves and increasing tax rates or creating new taxes or fee structures. Many state and local governments will have to turn to the federal government for assistance if the economy does not recover quickly enough.

For more information on this, please consult your trusted TBC advisor.

CARES ACT CHANGES FOR ELIGIBLE RETIREMENT PLANS

The Coronavirus Aid, Relief, and Economic Security Act (CARES) brings changes and relief to eligible retirement plans for qualifying emergencies and adverse financial consequences related to the current pandemic.

Certain highlights of the Cares Act include:

- The CARES Act relaxes early distribution rules allowing distributions up to $100,000, waiver of the 10% early withdrawal penalty for distributions prior to age 59-1/2, and elimination of the mandatory 20% federal tax withholding.
- The CARES Act enhances loan rules allowing an increase in the loan limit from $50,000 to $100,000, and in accordance with the Plan, for loans made from March 27, 2020 through September 22, 2020 and suspension of loan payments due March 27, 2020 through December 31, 2020 for up to one year.
- The CARES Act suspends required minimum distributions (RMD) for 2020, participants whose first RMD was required in 2019 but who did not take it would not be required to take their 2019 RMD or their 2020 RMD.

These new rules can be adopted immediately for all plans. A plan amendment will be required but can be retroactively applied as long as the amendment is in effect by the last day of your plan’s year end beginning on or after January 1, 2022.

For more information please call our Employee Benefit Plan Audit specialists at (518) 456-6663.

NEW YORK INVESTMENT CREDIT

One of the major benefits of being a manufacturer in New York is the various tax credits that New York offers to businesses whose primary purpose is the production of goods within the state. Among the most beneficial of these credits is the New York Investment Tax Credit ("ITC"). Manufacturers who place in service qualified tangible property that is used primarily to produce goods in New York State are eligible for a 5% credit (4% for S Corporations) on the cost basis of the property ("investment credit base") that was placed in service up to $350 million, and if the base is over $350 million an additional 4% on the amount that exceeds this threshold. For purposes of this credit "qualified tangible property" refers to machinery, equipment and facilities primarily used for production purposes. It is important to note, when calculating the investment credit base, the cost basis must be reduced by the amount of section 179 depreciation taken on that property during the tax year to prevent a double tax benefit at the state level.

In addition to the ITC discussed above, entities eligible for the ITC may also be eligible for the Employment Incentive Credit (EIC). The EIC offers a further tax benefit of 1.5%-2.5% of the original credit base so long as an entity can demonstrate that its average number of New York State employees was at least 101% of the average number of employees employed by the entity in the year prior to the year the property was placed in service. The increase in employees must occur in the first two years following the year the qualified tangible property was placed in service.

It is important to note that while the ITC and EIC cannot reduce a taxpayer's New York State tax liability below the fixed dollar minimum tax, any unused credit can be carried forward 15 years (10 years for S-Corporations) and used to offset future New York State in tax liabilities. In addition, a portion of the ITC allowed in a previous year may be required to be recaptured if the underlying property is disposed of prior to the end of its useful life. For these reasons, it is important for companies who take advantage of the ITC to keep detailed records of the qualified property purchased in each year, the amount of credit that is allowable, and the amount of credit actually used to reduce the taxpayer's tax liability in any given year.

For more information on this, or any other credits available to manufacturers in NY, please consult your trusted TBC advisor.

NEW FORM FOR 2020

New for 2020 – the IRS has created a new Form for 2020 to report Miscellaneous Compensation only – This is Form 1099 NEC (Non-Employee Compensation). The 1099 MISC. has been revised and box numbers rearranged and is still applicable for other reporting.

To get more information about the 1099-NEC please view it HERE. You can access the instructions related to the 1099-NEC and the form itself. As a note, you can get your forms online directly through the IRS HERE.

WHAT DOES IT MEAN TO BE A REAL ESTATE PROFESSIONAL?

In order to understand what this designation means we need to look back in history to see why it is so important. Prior to 1986, real estate “tax shelters” were used to reduce the taxable income of individuals who were not engaged in the business of real estate. Anyone willing to be a landlord or willing to invest in tax shelter investments were able to use tax losses from real estate to reduce their income or potentially completely erase it in a given year. Congress, recognizing what they deemed an abuse of the system, enacted a series of regulations culminating in the Tax Reform Act of 1986 (the Act). This Act created a new Internal Revenue Code Section 469 to deal with passive activities. To put it succinctly, the aforementioned individual would no longer be allowed to deduct the losses from these tax shelters.

The Act designated rental activities as inherently passive activities. Therefore, losses from rental activities can only offset income from other passive activities. Knowing that there is an entire industry based around real estate, Congress did carve out a special set of rules for those individuals whose business is real estate. These people were designated as real estate professionals and could deduct the passive losses against other non-passive income because with this designation, real estate would not be treated as passive. However, these professionals had to meet a strict set of requirements and had to achieve a level of “material participation” in order to qualify.

In order to materially participate in an activity, it must be regular, continuous, and substantial. Otherwise, the activity would be considered passive by nature. For example, if you own a marketing business and that is your sole source of income it can be confidently said that you materially participate in that business. If in the same situation you happen to also own a duplex that you rent out, that rental activity, if it generates a loss, cannot be used to offset your marketing income because you do not materially participate in that rental activity. So the question becomes, how do I materially participate in an activity?

The Seven Ways to Achieve Material Participation

1. You participate in the activity for more than 500 hours during the year.
2. Your participation in the activity constitutes substantially all of the participation by all individuals (including non-owners) in the activity for the year.
3. Your participation is more than 100 hours during the year, and no other individual (including non-owners) participates more hours than you.
4. The activity is a significant participation activity in which you participate for more than 100 hours during the year and your annual participation in all significant participation activities is more than 500 hours. [A significant participation activity is generally a trade or business activity (other than a rental activity) where you spend more than 100 hours during the year but do not qualify for material participation based on any of the other ways to achieve material participation.]
5. You materially participated in the activity for any five tax years (whether or not consecutive) during the 10 immediately preceding tax years.
6. For a personal service activity, you materially participated for any three tax years (whether or not consecutive) preceding the current tax year, or:
7. A generic facts and circumstances test which is subjective.

Based on the seven factors above, there appears to be several ways to meet the threshold to be able to say that rental activities are non-passive. However, as previously stated, real estate professionals have to meet a higher threshold before they can get out of the passive activity designation. Before we determine that, we must know the definition of a real property trade or business (RPTB). You can only be a real estate professional if you work in a RPTB. Those are business activities in the development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage of real property. This is a very expansive list and can encompass a lot of different scenarios for qualifying as a real estate professional.

Before continuing, we should note that hotels/motels, storage spaces, dormitories, or property where the average customer use is less than seven days is not considered a rental activity.

For illustrative purposes, assume that you are in one of those businesses. Your next step is to determine your material participation based on one of the previously mentioned seven ways. Assuming you meet the 500-hour participation requirement, you must then elevate your threshold to a higher 750-hour requirement and more than 50-percent of your working time spent test. This means that if you work at least 750-hours and more than half of your working time is spent in a RPTB you could pass. Therefore, you would think that you can achieve real estate professional status – and you would be correct. You've met the requirements and you can happily deduct as much rental losses as you have EXCEPT for one small, minor, and inconvenient next step.

The final step is to determine your level of participation **ONLY** in rental activities. This means if you're a real estate agent or a contractor who owns a couple of rental properties on the side you must be able to show that you meet the increased level of material participation in those activities specifically. You qualify as working in a RPTB but you do not qualify as a *materially participating real estate professional* with respect to rental activities only. Therefore, you would fail the test and your rental activities would continue to be treated as passive. However, if you work solely in the rental of real property then you would pass this last test.

By a technicality you must meet the 750-hour requirement for each *individual* rental activity. If you only have a few rentals it would become nearly impossible to work 750-hours in each rental. Knowing this, the US Treasury released regulation which allows you to group all of your individual rental activities together into one single activity. So as long as the combined activities total at least 750-hours of participation and passes the more than 50-percent test you would qualify.

If you made it this far, congratulations, you are a real estate professional!

There are numerous nuances to the real estate professional designation and specifically the material participation threshold. Consult your tax advisor for your unique situation.
