INVESTOR EDUCATION REPORT

The Short-Term Rental Tax Strategy

How a qualifying STR may help you reduce taxable income

7 DAYS OR LESS Average customer use	+	MATERIAL PARTICIPATION One of seven tests

POTENTIAL RESULT
Your legitimate loss may be nonpassive and available against W-2 or business income.

Based on IRC §469, Treasury regulations, IRS guidance, Tax Court decisions, and commentary from established real estate tax professionals.

EXECUTIVE OVERVIEW

A recognized strategy with specific requirements

If you own and actively operate a short-term rental, a recognized application of the federal passive-activity rules may allow qualifying losses to reduce your nonpassive income. The benefit is not automatic; it depends on two separate requirements.

1

THE SEVEN-DAY GATE

Your property's average customer use is seven days or less. The activity is therefore excluded from the passive-loss rules' definition of a rental activity.

2

MATERIAL PARTICIPATION

You satisfy one of seven participation tests. A common test requires more than 100 hours and at least as much participation as any other individual.

Your legitimate STR tax loss generally becomes nonpassive. Subject to other limitations, it may offset your household's W-2 wages, business income, and other nonpassive income - without requiring Real Estate Professional Status.

The most important precision point

The regulation requires you to participate for more than 100 hours - not exactly 100 hours and not merely 100 or more. Your participation must also be not less than that of any other individual.

Why this matters at higher incomes

- The $25,000 special allowance for ordinary rental losses is generally phased out by $150,000 of modified adjusted gross income.
- Real Estate Professional Status normally requires you to perform more than 750 hours and more than half of your personal services in qualifying real property trades or businesses.
- The STR route applies a different framework: the seven-day exception plus ordinary material participation.
- Cost segregation and bonus depreciation can increase the potential first-year loss, but do not determine whether it is passive or nonpassive.

PRIMARY AUTHORITY

How the law works - step by step

Your eligibility comes from the Internal Revenue Code and Treasury regulations. IRS guidance explains the rules, and court decisions show how they are applied to actual taxpayer records.

RULE	WHAT IT DOES	INVESTOR IMPACT
IRC §469	Limits passive losses and generally treats rental activities as passive.	Your long-term rental losses generally cannot offset W-2 income unless another exception applies.
Treas. Reg. §1.469-1T	Excludes an activity from 'rental activity' treatment when average customer use is seven days or less.	Your activity is no longer automatically passive merely because customers use your property.
Treas. Reg. §1.469-5T	Provides seven alternative tests for material participation.	If you satisfy one test, your activity may be nonpassive.
Other limits	Basis, at-risk, personal-use, excess-business-loss, and other rules still apply.	Nonpassive classification does not guarantee that every dollar of your loss is currently deductible.

The IRS's own explanation

> “Your activity isn’t a rental activity” if average customer use “is 7 days or less.”
>
> IRS PUBLICATION 925, PASSIVE ACTIVITY AND AT-RISK RULES

How to calculate your average

Total days in all customer rental periods ÷ number of separate rentals during the tax year

Example: 240 rented nights ÷ 48 stays = a five-day average. Your actual annual customer-use average matters; simply advertising your property as an Airbnb does not satisfy the rule.

A second, less common exception may apply if your average customer use is 30 days or less and you provide significant personal services. The seven-day route described here is more common.

MATERIAL PARTICIPATION

Seven tests - one must be satisfied

After the seven-day exception removes the automatic rental label, you must establish material participation. The following tests are alternatives; you need to satisfy only one.

1	More than 500 hours You participate in the activity for more than 500 hours during the year.
2	Substantially all Your work constitutes substantially all participation in the activity.
3	More than 100 + comparative You participate more than 100 hours and not less than any other individual.
4	Significant-participation activities More than 100 hours in this activity, with more than 500 hours across qualifying significant-participation activities.
5	Five of the prior ten years You materially participated in the activity in any five of the preceding ten tax years.
6	Prior personal-service activity A specialized historical test for certain personal-service activities; uncommon for STR operations.
7	Facts and circumstances Participation is regular, continuous, and substantial; additional limitations make this test less predictable.

How the comparative test works

OWNER	PROPERTY MANAGER	CLEANER	HANDYMAN
110 hours	**90 hours**	**85 hours**	**25 hours**
Potentially passes Test 3 because the owner's 110 hours exceed 100 and no single person worked more.			

The comparison is generally person-by-person, not the owner's hours versus everyone else's combined hours. A full-service property manager can nevertheless make Test 3 difficult if that individual participates more than the owner.

TAX IMPACT

Why the strategy can be powerful

The seven-day and material-participation rules determine whether your loss is passive or nonpassive. Your operating deductions, depreciation, and accelerated depreciation determine its size.

1	**QUALIFYING PROPERTY**	You place an income-producing STR in service and operate it with a profit motive.
2	**LEGITIMATE DEDUCTIONS**	You record interest, taxes, insurance, repairs, utilities, supplies, management, and depreciation.
3	**ACCELERATED DEPRECIATION**	A defensible cost segregation study may identify your shorter-life assets eligible for faster deductions and potential bonus depreciation.
4	**NONPASSIVE TREATMENT**	The seven-day exception plus your material participation may allow the otherwise deductible loss to offset nonpassive income.

Illustrative tax effect

HOUSEHOLD W-2 INCOME (MFJ)	QUALIFYING STR LOSS	ASSUMED FEDERAL RATE	ASSUMED STATE RATE
$500,000	**$140,000**	**32%**	**5%**
Potential combined federal + state tax effect		37% combined	**$51,800**

Illustrative calculation: $140,000 × 32% = $44,800 assumed federal savings; $140,000 × 5% = $7,000 assumed state savings; $51,800 combined.

Most states imposing a broad individual income tax begin with federal AGI or federal taxable income, so a qualifying federal loss often affects the state tax base as well. The 5% rate is an illustrative nationwide-average assumption across all 50 states, including states without a broad individual income tax. Actual state savings may be higher, lower, or zero because rates, residency, sourcing, federal conformity, bonus-depreciation addbacks, and other adjustments vary by state.

Illustration only. Your actual benefit also depends on your marginal rates, basis, at-risk amount, personal use, excess-business-loss rules, and other facts.

Current bonus-depreciation context

The IRS announced that permanent 100% additional first-year depreciation is available for eligible property acquired after January 19, 2025. The building itself generally does not qualify; appropriately classified shorter-life components may qualify. Bonus depreciation changes the timing and size of deductions - not the material-participation analysis.

Accelerated depreciation is usually a timing benefit. It reduces remaining basis and can increase depreciation recapture when the property is sold.

INDUSTRY RECOGNITION

What established tax and real estate educators say

The law comes from the Code and regulations. These professional observations show that the same regulatory framework is broadly recognized and taught across the real estate tax community.

> "If your average stay is 7 days or less, and you materially participate, the activity becomes non-passive."
>
> **ANDERSON BUSINESS ADVISORS | VIEW SOURCE**

> "If done properly, short-term rentals can offset directly against this ordinary income without the real estate professional status."
>
> **HALL CPA / THE REAL ESTATE CPA | VIEW SOURCE**

> "If you materially participate, those losses can offset any income - including W-2, business income, everything."
>
> **TOM WHEELWRIGHT, CPA | VIEW SOURCE**

> "Properly structured, it can convert a real estate investment into a substantial federal tax deduction in the first year of ownership."
>
> **PAUL DONOVAN, JD, CPA | VIEW SOURCE**

> "You do not need REPS - you simply need to meet one of the material participation tests and have an average guest stay of seven days or fewer."
>
> **SEMI-RETIRED MD | VIEW SOURCE**

> "Big tax perks are back for short-term rental owners, but only if you qualify as a material participant."
>
> **AIRDNA | VIEW SOURCE**

Quotations are brief excerpts for education. Follow each source link for its complete context, qualifications, and disclaimers.

JUDICIAL APPLICATION

The courts recognize the framework - and demand proof

Court decisions confirm the legal pathway while showing why your participation records must be specific, reasonable, and credible.

T.C. Memo. 2025-128

The Tax Court agreed that the property met the short-term-rental exception. The taxpayers nevertheless lost the nonpassive-loss position because they failed to substantiate material participation adequately.

The court rejected standardized estimates and large blocks of time recorded merely as being 'on call.' Only actual participation time counts.

What this means for you

ACCEPTED FRAMEWORK	COMPLIANCE DECIDES THE OUTCOME
The seven-day exception is expressly stated in Treasury regulations and IRS Publication 925.	You must separately prove material participation with reasonable, credible records.

Earlier judicial treatment

In Bailey v. Commissioner, the court treated an inn with an average customer stay of approximately three days as excluded from rental-activity treatment under the same regulation. The case arose in the Real Estate Professional Status context, but it illustrates judicial application of the customer-use rule.

The strategy is not 'audit-proof.' It rests on written rules that courts apply, and your outcome depends on your actual facts and documentation.

COMPLIANCE PLAYBOOK

Build your records before filing

Keep separate support for your annual average-stay calculation, participation hours, underlying deductions, and any personal use.

AVERAGE-STAY FILE	PARTICIPATION FILE
• Airbnb, Vrbo, and direct-booking reports • Check-in and checkout dates • Rental nights for every reservation • Number of separate stays • Written annual average calculation	• Date and specific task performed • Actual time spent • Property involved • Supporting emails, receipts, or calendars • Known hours of managers and contractors

OPERATIONAL ACTIVITIES THAT MAY COUNT	HOURS THAT ARE OFTEN PROBLEMATIC
• Guest communications • Reservation and calendar management • Pricing and listing decisions • Coordinating turnovers • Cleaning or restocking you perform • Handling guest problems • Arranging and supervising repairs • Operational bookkeeping and supply purchases	• General investment research • Reviewing statements solely as an investor • Arranging financing • Studying potential acquisitions • Commuting • Being available without actually working • Inflated or reconstructed estimates • Travel dominated by personal activity

Practical standard

The regulation permits participation to be established by reasonable means, but contemporaneous records are substantially more persuasive than estimates reconstructed after an IRS inquiry. Use a dated log tied to objective records such as bookings, messages, invoices, receipts, and calendars.

GUARDRAILS AND REFERENCES

Powerful does not mean unlimited

Even when your activity is nonpassive, the loss must clear every other applicable limitation. Evaluate the property's economics independently of the tax benefit.

✓ Tax basis and at-risk limitations	✓ Excess business loss limitations under IRC §461(l)
✓ Vacation-home and personal-use limitations under IRC §280A	✓ Profit motive, capitalization, and placed-in-service requirements
✓ State adjustments or nonconformity with federal bonus depreciation	✓ Depreciation recapture and your eventual exit strategy
✓ Activity grouping and ownership-structure considerations	✓ Potential self-employment tax when substantial guest services are provided

The strategy in one paragraph

Federal tax regulations provide that an activity with an average customer-use period of seven days or less is not treated as a rental activity under the passive-loss rules. If you also materially participate, your legitimate loss may be treated as nonpassive and used against W-2 or business income, subject to other tax limitations.

Primary and professional sources

- IRC §469 - Passive Activity Losses and Credits Limited
- Treas. Reg. §1.469-1T - Seven-Day Customer-Use Exception
- Treas. Reg. §1.469-5T - Material Participation Tests
- IRS Publication 925 - Passive Activity and At-Risk Rules
- IRS Notice 2026-11 Announcement - 100% Bonus Depreciation
- Mirch v. Commissioner Analysis - T.C. Memo. 2025-128
- Journal of Accountancy - Bailey v. Commissioner
- Tax Policy Center - State Individual Income Tax Starting Points
- Anderson Business Advisors - STR Deductions
- Hall CPA / The Real Estate CPA - STR Rules and Risks