Passive Activity Losses Update

The Exception for Real Estate Professionals

By David M. Fogel, EA, CPA

In the April/May 2008 issue of the *California Enrolled Agent*, I discussed the exception in the passive activity loss rules for real estate professionals. Since that time, there's been quite a lot of additional guidance involving these rules, including numerous court decisions. As a result, I decided to update my previous article.

Introduction

Before 1986, there were practically no limitations placed on the ability of a taxpayer to use deductions from a particular activity to offset income from other activities. The top income tax rate for individuals was 50 percent, tax shelters had become rampant, and Congress had concluded that taxpayers were losing faith in the Federal income tax system.[1]

In response to this, Congress enacted §469 in the Tax Reform Act of 1986 to limit business losses if the taxpayer did not materially participate in the activity. Rental real estate activities were the primary vehicle for tax shelters,[2] so they were designated as *per se* passive regardless of whether the taxpayer materially participated in the activity.[3]

Treating rental activities as *per se* passive created a problem for real estate developers because they were unable to offset their income with losses generated from their rental properties due to the *per se* rule.[4] To alleviate this problem, Congress amended the passive activity rules in the Revenue Reconciliation Act of 1993 to provide that certain real estate professionals who owned rental property and who met two additional requirements could deduct the rental losses against their other active real estate income.[5]

Passive Activity Losses – General Rules

Section 469(a) generally disallows any passive activity loss for a taxable year. A passive activity is defined as any trade or business in which the taxpayer does not materially participate.[6] A "passive activity loss" is defined as the excess of the aggregate losses from all passive activities for the taxable year over the aggregate income from all passive activities for that year.[7]

The personal use rules of IRC §280A (i.e., more than 14 days of personal use during the year) must be applied first because they take precedence over the passive loss rules of IRC §469.[8]

Passive losses in excess of passive income are carried over ("suspended") to the next year.[9] Suspended losses are freed up and become deductible if there's a disposition of the activity to an unrelated party in a fully-taxable transaction.[10]

There are many rules covering particular dispositions. Here are just a few:

- Gain from the disposition is passive income if the property was used in the passive activity at the time of the disposition.[11]
- Transfer by gift will not release suspended losses; instead, they are added to the donee's basis of the property.[12]
- If a passive activity with suspended losses is disposed of in an installment sale, the suspended losses are deductible ratably as installment payments are received.[13]
- If a passive activity with suspended losses is transferred to the taxpayer's heir upon the taxpayer's death, the suspended losses are released and allowed on the decedent's final return only to the extent that the heir's basis exceeds the decedent's adjusted basis.[14]
- If the gain on disposition of the passive activity isn't recognized, such as in an IRC §1031 like-kind exchange, the suspended losses are transferred to the replacement property received in the exchange.[15]

Rental Activities

Any rental activity is automatically treated as a passive activity regardless of whether the taxpayer materially participates.[16]

The following activities aren't treated as rentals:

(1) if the average period of customer use is seven days or less;

(2) if the average period of customer use is 30 days or less and significant personal services are provided;

(3) if extraordinary personal services are provided;

(4) if the rental activity is incidental to a nonrental activity;

(5) if the taxpayer customarily makes the property available during business hours for nonexclusive use by customers; and

(6) if the property is provided for use by a partnership, S corporation or joint venture in which the taxpayer owns an interest.[17]

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If an activity is not treated as a rental, all this means is that the activity is not presumptively passive; the taxpayer must still materially participate in the activity before it can be treated as nonpassive.[18]

A taxpayer's passive losses from rental real estate activities in which the taxpayer "actively participates" (including prior-year disallowed passive losses) are limited to $25,000.[19] The $25,000 limit is reduced by 50 percent of the amount that the taxpayer's modified adjusted gross income (MAGI) exceeds $100,000.[20] Consequently, if a taxpayer's MAGI exceeds $150,000, none of the taxpayer's passive losses from rental real estate activities are allowable.

"Actively participates" means that the taxpayer participates in making management decisions (such as approving new tenants, deciding on rental terms, approving capital or repair expenditures) or arranges for others to provide services (such as repairs) in a significant or bona fide sense.[21] A taxpayer must own at least a 10 percent interest in the activity to be an active participant.[22] Either spouse can be an active participant.[23]

Estates and trusts don't qualify for the $25,000 allowance. Instead, when the property is distributed, the suspended passive losses are added to the property's basis.[24]

The Exception for Real Estate Professionals

A taxpayer qualifies as a real estate professional if:

(1) more than 50 percent of the taxpayer's personal services performed in trades or businesses during the year are performed in real property trades or businesses in which the taxpayer materially participates; and

(2) the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.[25]

The phrase "personal services" generally means "any work performed by an individual in connection with a trade or business."[26] Real property trades or businesses are defined as "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."[27] Real estate agents are included.[28]

Material participation is defined as involvement in the operations of the activity that is regular, continuous, and substantial.[29] In determining whether a taxpayer materially participates in an activity, the participation of his or her spouse is taken into account.[30] But services performed as an employee don't count unless the employee owns at least 5 percent of the business.[31]

Don't ignore the importance of the 50 percent test. A few taxpayers who worked in a non-real property business full-time during the year, but who spent over 750 hours on their rental properties have attempted to claim to be real estate professionals; but they failed the 50 percent test because the 750 hours did not exceed the 2,000-or-so hours spent working full-time in the non-real property business.[32]

Material participation must be satisfied with regard to each separate interest in rental real estate unless the taxpayer has made an election to treat all interests in rental real estate as a single rental activity.[33] Such an aggregation election must be affirmatively made by filing a statement with the taxpayer's original tax return containing a declaration that the taxpayer is a qualifying taxpayer and is making the election under IRC §469(c)(7)(A).[34] The importance of making the election is that the real estate professional may combine all hours spent on rental properties in order to satisfy the material participation requirement.

Once made, the election is binding for the taxable year for which it is made and for all future years in which the taxpayer qualifies as a real estate professional, even if there are intervening years in which the taxpayer doesn't qualify as a real estate professional.[35] The election may be revoked if there is a material change in the taxpayer's facts and circumstances.[36]

Since the manner of making the election is outlined in regulations, if there is reasonable cause for not making the election on the original return, then taxpayers may request an extension.[37] Many taxpayers did just that, and the IRS approved such extensions in dozens of letter rulings. However, after 6/13/2011, taxpayers no longer need to request a letter ruling. They may simply file an amended return to make a late election.[38] To qualify, the taxpayer must have (1) failed to make the election on the original return, (2) filed all returns consistently as if the election had been made, (3) timely filed all returns affected by the election, and (4) reasonable cause for failing to make the election timely.

What happens to the suspended losses if, in a later year, the taxpayer qualifies as a real estate professional, makes the election to treat all interests in rental real estate as a single activity, then disposes of one of the rentals? The suspended losses are not released until there's a disposition of a substantial portion of the aggregated rental activities.[39]

The effect of qualifying as a real estate professional is that all real property trade or business activities are treated as nonpassive, except for rental real estate activities. A rental real estate activity is not treated as presumptively passive, but to treat it as non-passive, the real estate professional needs to satisfy the material participation test for each activity.[40]

California does not conform to the rules for real estate professionals.[41]

Material Participation

IRS regulations provide that an individual can satisfy the material participation requirement in any one of seven ways:

(1) the individual participates in the activity for more than 500 hours during the year;[42]

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(2) the individual's participation in the activity for the year constitutes substantially all of the participation of all individuals involved in the activity for the year;[43]

(3) the individual participates in the activity for more than 100 hours during the year, and such participation is not less than anyone else's participation, including non-owners;[44]

(4) the activity is a significant participation activity (i.e., more than 100 hours), and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours;[45]

(5) the individual materially participates in the activity for any five out of the previous 10 taxable years preceding the taxable year;[46]

(6) the activity is a personal service activity (the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting or any other business in which capital is not a material income-producing factor) and the individual materially participates in the activity for any three taxable years preceding the taxable year;[47] or

(7) based on all the facts and circumstances, the individual participates in the activity on a regular, continuous and substantial basis during the year and participates at least 100 hours during the year.[48] Management activities are not counted in this test unless (a) nobody else receives compensation for management activities, and (b) the taxpayer performs more management activities than anybody else.

Participation by both spouses is counted, regardless of whether a joint return is filed for the particular year.[49]

For purposes of tests (2) and (3), time spent by the taxpayer doesn't include time spent by workers hired by the taxpayer.[50] Time spent by others doesn't include on-call time, but rather, actual time spent working on the taxpayer's activity.[51]

Work done in the capacity of an investor isn't treated as participation in the activity unless the individual is directly involved in the day-to-day management or operations of the activity.[52]

The IRS's current position on travel time is that time spent traveling to and from the passive activity is commuting and may not be counted as material participation.[53] But the Tax Court has rejected this position.[54] The expense does not have to be deductible in order for the time to count as material participation.

Some IRS examiners contend that time spent investigating to acquire other rental properties does not constitute material participation because expenses relating to this activity are capital expenditures. But there is nothing in the Code or regulations that supports this theory, and in fact, IRC §469(c)(7)(C) specifies that the "acquisition" of real estate constitutes a real estate trade or business.[55]

Material participation of a trust depends upon the trustee's involvement in the activity.[56] However, this applies to a non-rental activity. Since a rental activity is *per se* passive under IRC §469(c)(2), no amount of material participation, even by the trustee, will take it out of the passive category. As stated earlier, passive losses of a trust aren't deductible.

Substantiation of Material Participation for Real Estate Professionals

The 50 percent and 750-hour tests may be established "by any reasonable means."[57] Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means.[58] "Reasonable means" includes the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.[59] While lawyers and certain other professionals are accustomed to maintaining detailed records of how they spend their work days, the IRS recognizes that most individuals do not customarily maintain such records, which is why taxpayers need not keep contemporaneous records of their hours of participation in each activity.[60]

Many taxpayers have been unable to prove that they qualify as real estate professionals because they didn't maintain adequate records of their participation in their rental activities.[61] While the regulations may be somewhat ambivalent concerning the types of records that must be maintained by taxpayers, the courts have ruled that taxpayers may not make a post-event "ballpark guesstimate" of their participation in the rental activities.[62] The taxpayer's records of time spent on real estate activities must be believable. In one case, the taxpayer's log of real estate activities was so incredulous that it was disregarded in its entirety.[63] I recommend that a taxpayer who wants to qualify as a real estate professional should keep contemporaneous records of his or her activities, including a description of the activities and the number of hours spent each day on those activities.

Material Participation — Interest in a Limited Partnership

What if the taxpayer is a limited partner in a limited partnership that is engaged in a rental activity? Can the taxpayer's participation in a limited partnership be treated as material participation in a rental activity so that the time may be counted towards the 750 hours of material participation required for a real estate professional?

A limited partner is presumed to not materially participate.[64] But IRS regulations contain an exception that provides, in essence, that a limited partner is treated as materially participating if he or she satisfies either (1), (5) or (6) of the material participation tests listed above.[65]

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In addition, if the taxpayer makes the election to treat all interests in rental real estate as a single rental activity, and at least one interest in rental real estate is held by the taxpayer as an interest in a limited partnership, then all of the taxpayer's interests in rental real estate will be treated as an interest in a limited partnership for purposes of the material participation rules.[66] The regulations contain a *de minimis* exception to this rule: if the taxpayer's share of gross rental income from the limited partnership is less than 10 percent of the taxpayer's share of gross rental income from all interests in rental real estate.[67] If this exception applies, then the taxpayer needs only to satisfy one of the material participation tests listed above.[68]

While a limited partner is presumed to not materially participate, what about a member of a limited liability company (LLC) or a limited liability partnership (LLP)? The courts have held that such individuals do not fall under the IRC §469(h)(2) presumption for limited partners.[69] In response to these court decisions, the IRS issued proposed regulations providing that an interest in an entity such as an LLC will be treated as an interest in a limited partnership if (1) the entity in which the interest is held is classified as a partnership under the "check the box" regulations, and (2) under the law of the jurisdiction in which the entity was organized and under the entity's governing agreement, the holder of the interest doesn't have rights to manage the entity at all times during the entity's tax year.[70]

Grouping Rules

As mentioned above, a taxpayer who qualifies as a real estate professional may make an election to treat all interests in rental real estate as a single rental activity. This can be an important election, because in general, a taxpayer who qualifies as a real estate professional may not group a rental activity with any other activity.[71]

For example, if a taxpayer develops real estate, constructs buildings, and owns one or more interests in rental property, the taxpayer's interest in the rental property may not be grouped with the taxpayer's development or construction activities.[72] The taxpayer's participation in the development and construction activities may not be used to determine whether the taxpayer materially participates in the rental activity.[73]

IRS regulations outline the general rules for grouping trade or business activities and grouping rental activities.[74] Once the taxpayer groups the activities, that grouping must be followed in subsequent years unless a material change in the facts and circumstances makes it clearly inappropriate.[75]

The regulations provide that trade or business activities may be grouped together and treated as a single activity if the activities constitute an "appropriate economic unit."[76] Whether the activities constitute an "appropriate economic unit" depends upon all the relevant facts and circumstances.[77] The following factors are given the greatest weight:

(1) the similarities and differences in types of businesses;

(2) the extent of common control;

(3) the extent of common ownership;

(4) geographical location; and

(5) interdependencies among the activities.[78]

For tax years beginning on or after 1/25/2010, original groupings, addition of new activities to existing groupings, and regroupings must be disclosed in a statement attached to the return.[79]

A taxpayer who does not qualify as a real estate professional may not group a rental activity with a trade or business activity unless the activities constitute an "appropriate economic unit" ***and*** one of the following situations exists:

(1) the rental activity is insubstantial in relation to the trade or business activity;

(2) the trade or business activity is insubstantial in relation to the rental activity; or

(3) each owner of the trade or business activity has the same proportionate ownership interest in the rental activity.[80]

The term "insubstantial" refers to factors more than just the gross income from the activity.[81]

A taxpayer who qualifies as a real estate professional may not group a rental activity with a trade or business activity unless the activities constitute an "appropriate economic unit" ***and*** either (1) the rental activity is insubstantial in relation to the trade or business activity, or (2) each owner of the trade or business activity has the same proportionate ownership interest in the rental activity.[82]

Conclusion

The passive activity rules for qualifying as a real estate professional are complicated, and the IRS's regulations don't help to clarify them; in fact they make the rules even more complex, as demonstrated by the large amount of litigation that has occurred. However, what's important to remember is that if you have a client who is engaged in a real estate business and who owns rental properties that operate at a loss:

(1) consider whether the client qualifies as a "real estate professional";

(2) if the client qualifies as a "real estate professional," consider making the election to treat all interests in rental real estate (including such interests held as a limited partner) as a single rental activity;

(3) if the client qualifies as a "real estate professional," make sure that the client possesses the required substantiation to prove material participation; and

(4) consider whether the client's activities should be grouped appropriately.

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[1] *S. Rept. No. 99-313, H.R. 3838 (99th Cong., 2d Sess., 5/29/86).*

[2] *Gerald J. Robinson, Federal Income Taxation of Real Estate (6th Ed. 2007), ¶6.08[1].*

[3] *IRC §469(c).*

[4] *Richard M. Lipton, "IRS Issues Final Regulations On Passive Loss Relief for Real Estate Professionals," Taxes (Feb. 1996), pp. 91-92.*

[5] *H. Rept. No. 103-11, H.R. 2141 (103rd Cong., 1st Sess., 5/18/93).*

[6] *IRC §469(c)(1).*

[7] *IRC §469(d)(1).*

[8] *IRC §469(j)(10).*

[9] *IRC §469(b).*

[10] *IRC §469(g)(1).*

[11] *Temp. Reg. §1.469-2T(c)(2)(i)(A); Letter Ruling 9406010.*

[12] *IRC §469(j)(6).*

[13] *IRC §469(g)(3).*

[14] *IRC §469(g)(2).*

[15] *See S. Rept. No. 99-313 (1986), 1986-3 C.B. (Vol. 3) 1, 726-727; General Explanation of the Tax Reform Act of 1986, Joint Committee on Taxation, JCS-10-87, 229-230 (5/7/87).*

[16] *IRC §§469(c)(2) and (4).*

[17] *Temp. Reg. §1.469-1T(e)(3)(ii).*

[18] *See Misko v. Commissioner, T.C. Memo. 2005-166; Assaf v. Commissioner, T.C. Memo. 2005-14; Bailey v. Commissioner, T.C. Memo. 2001-296; Bailey v. Commissioner, T.C. Sum. Op. 2011-22; Jende v. Commissioner, T.C. Sum. Op. 2011-82, TAM 9505002; TAM 9543003.*

[19] *IRC §469(i).*

[20] *IRC §469(i)(3)(A).*

[21] *See S. Rept. No. 99-313 (1986), 1986-3 C.B. (Vol. 3) 1, 737-738; Madler v. Commissioner, T.C. Memo. 1998-112.*

[22] *IRC §469(i)(6)(A).*

[23] *IRC §469(i)(6)(D).*

[24] *IRC §469(j)(12).*

[25] *IRC §469(c)(7)(B).*

[26] *Treas. Reg. §1.469-9(b)(4).*

[27] *IRC §469(c)(7)(C).*

[28] *See Agarwal v. Commissioner, T.C. Sum. Op. 2009-29. While a T.C. Summary Opinion is not treated as precedent (IRC §7463(b)), the IRS is following Agarwal in California.*

[29] *IRC §469(h)(1).*

[30] *IRC §469(h)(5).*

[31] *IRC §469(c)(7)(D)(ii); Bahas v. Commissioner, T.C. Sum. Op. 2010-115.*

[32] *See, e.g., Specks v. Commissioner, T.C. Memo. 2012-343; Chambers v. Commissioner, T.C. Sum. Op. 2012-91.*

[33] *See IRC §469(c)(7)(A) and Treas. Reg. §1.469-9(e)(1).*

[34] *Treas. Reg. §1.469-9(g)(3). See also Kosonen v. Commissioner, T.C. Memo. 2000-107 (no election was made where taxpayer did not explicitly state on the return that the election was made).*

[35] *Treas. Reg. §1.469-9(g)(1).*

[36] *Treas. Reg. §1.469-9(g)(3).*

[37] *See Treas. Reg. §§301.9100-2 and 301.9100-3*

[38] *See Rev. Proc. 2011-34, 2011-24 I.R.B. 875.*

[39] *See CCH Std. Fed. Tax Rptr. ¶21,966.033 and page 5-2 of the IRS's Audit Technique Guide on Passive Activity Losses.*

[40] *IRC §469(c)(7)(A); Perez v. Commissioner, T.C. Memo. 2010-232; Shiekh v. Commissioner, T.C. Memo. 2010-126; Kosonen v. Commissioner, supra.*

[41] *See sections 17561(a) and 24692(b) of the Revenue & Taxation Code.*

[42] *Temp. Reg. §1.469-5T(a)(1).*

[43] *Temp. Reg. §1.469-5T(a)(2). See also Misko v. Commissioner, supra (attorney who leased office equipment to his wholly owned C corporation was the only person who participated in the leasing activity).*

[44] *Temp. Reg. §1.469-5T(a)(3). See also Pohoski v. Commissioner, T.C. Memo. 1998-17 (only the actual services performed by a management company for the taxpayer are counted towards another person's participation, thus the time that front desk personnel were available at the taxpayer's resort condominium complex was irrelevant).*

[45] *Temp. Reg. §1.469-5T(a)(4).*

[46] *Temp. Reg. §1.469-5T(a)(5).*

[47] *Temp. Reg. §1.469-5T(a)(6).*

[48] *Temp. Reg. §1.469-5T(a)(7).*

[49] *Temp. Reg. §1.469-5T(f)(3).*

[50] *See Chapin v. Commissioner, T.C. Memo. 1996-56 (rental agent, cleaning service and repairmen); Pohoski v. Commissioner, supra (on-site manager).*

[51] *Pohoski v. Commissioner, supra.*

[52] *Temp. Reg. §1.469-5T(f)(2)(ii)(A). See also Iversen v. Commissioner, T.C. Memo. 2012-19; Lapid v. Commissioner, T.C. Memo. 2004-222; Barniskis v. Commissioner, T.C. Memo. 1999-258; Toups v. Commissioner, T.C. Memo. 1993-359;Goshorn v. Commissioner, T.C. Memo. 1993-578, cases where investor-type work did not qualify. See also Fitch v. Commissioner, T.C. Memo. 2012-358; Assaf v. Commissioner, supra, cases where such work did qualify because the taxpayers were involved in the day-to-day management of their rental properties.*

[53] *See pages 4-9 of the IRS's Audit Technique Guide on Passive Activity Losses citing Truskowsky v. Commissioner, T.C. Sum. Op. 2003-130.*

[54] *See Shaw v. Commissioner, T.C. Memo. 2002-35; Moss v. Commissioner, 135 T.C. 365 (2010); Bosque v. Commissioner, T.C. Memo. 2011-79.*

[55] *In Bailey v. Commissioner, T.C. Sum. Op. 2011-22, the Tax Court counted time spent on such activities.*

[56] *Letter Ruling 201029014; Stangeland v. Commissioner, T.C. Memo. 2010-185.*

[57] *Temp. Reg. §1.469-5T(f)(4).*

[58] *Id.*

[59] *Id.*

[60] *See the preamble to Treasury Decision 8175, 1988-1 C.B. 191 (2/19/88).*

[61] *See D'Avanzo v. United States, 67 Fed.Cl. 39 (Ct.Fed.Cls. 2005), aff'd per curiam 215 Fed. Appx. 996 (Fed. Cir. 2007); Lee v. Commissioner, T.C. Memo. 2006-193; Fowler v. Commissioner, T.C. Memo. 2002-223; Shaw v. Commissioner, supra; and Mowafi v. Commissioner, T.C. Memo. 2001-161.*

[62] *See, e.g., Moss v. Commissioner, supra at 369; Harnett v. Commissioner, T.C. Memo. 2011-191, aff'd per curiam under unpublished rules 2012 TNT 221-15 (11th Cir. 2012); Jordan v. Commissioner, T.C. Memo. 2009-223; Assaf v. Commissioner, supra; Bailey v. Commissioner, T.C. Memo. 2001-296; Carlstedt v. Commissioner, T.C. Memo. 1997-331; Speer v. Commissioner, T.C. Memo. 1996-323; and Goshorn v. Commissioner, supra.*

[63] *Jafarpour v. Commissioner, T.C. Memo. 2012-165.*

[64] *IRC §469(h)(2). A limited partner holding a general partnership interest is not treated as a limited partner. Temp. Reg. §1.469-5T(e)(3)(ii).*

[65] *Temp. Reg. §1.469-5T(e)(2).*

[66] *Treas. Reg. §1.469-9(f)(1).*

[67] *Treas. Reg. §1.469-9(f)(2).*

[68] *Treas. Reg. §1.469-9(f)(1) and Temp. Reg. §1.469-5T(e)(2).*

[69] *See Garnett v. Commissioner, 132 T.C. 368 (2009); Newell v. Commissioner, T.C. Memo. 2010-23; Gregg v. United States, 186 F. Supp. 2d 1123 (Dist.Ore. 2000); Thompson v. United States, 87 Fed. Cl. 728 (Ct.Fed.Cls. 2009), acq. in result only, AOD 2010-02 (3/9/2010); Hegarty v. Commissioner, T.C. Sum. Op. 2009-153.*

[70] *See Prop. Reg. §1.469-5(e)(3) (11/28/2011)*

[71] *Treas. Reg. §1.469-9(e)(3).*

[72] *Id.*

[73] *Id.*

[74] *Treas. Regs. §§1.469-4(c) through (f).*

[75] *Treas. Reg. §1.469-4(e).*

[76] *Treas. Reg. §1.469-4(c)(1).*

[77] *Treas. Reg. §1.469-4(c)(2).*

[78] *Id.*

[79] *See Rev. Proc. 2010-13, 2010-4 I.R.B. 329.*

[80] *Treas. Reg. §1.469-4(d)(1)(i).*

[81] *See the preamble to T.D. 8565 (10/3/94). See also the examples at Treas. Reg. §1.469-4(d)(1)(ii). See also Candelaria v. United States, 2007 TNT 225-6 (W.D. Tex. 2007) for what constitutes "insubstantial."*

[82] *Treas. Reg. §1.469-9(b)(3).*