Passive Activity Losses:

The Exception for Real Estate Professionals

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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 decided to limit the use of losses from business activities in which the taxpayer did not materially participate against positive income sources such as salary and portfolio income, and thus in the Tax Reform Act of 1986, they enacted the passive activity rules (IRC §469).

IRC §469 limits a taxpayer's deductions when they arise from "passive" activities. An activity is generally considered passive if it involves a business activity in which the taxpayer does not materially participate. Deductions for losses from rental activities are limited to $25,000 (or less) if the taxpayer materially participates in the activities.

Real estate rental activities were targeted by the Tax Reform Act of 1986 because they were the primary vehicle for tax shelters.[2] Accordingly, IRC §469 designated real estate rental activities as per se passive activities regardless of whether or not the taxpayer materially participated in the activity.[3]

However, the treatment of rental activities as per se passive created a problem for real estate developers. Specifically, a full-time real estate developer receiving fees from developing and managing real estate would not be able to offset that income by losses generated from rental properties because the rental losses were considered passive losses.[4] To alleviate this unfairness, 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]

A taxpayer who meets these requirements is not subject to the IRC §469 limitations on losses from rental activities. The rental activities are not considered passive activities, but rather, are treated as trade or business activities.

What are the rules for qualifying for this "real estate professional" exception in the passive activity rules, and what are the potential audit issues that may arise if a taxpayer claims to be a "real estate professional"?

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] Any rental activity is treated as a passive activity regardless of whether the taxpayer materially participates.[8]

A taxpayer's passive losses from rental real estate activities in which the taxpayer materially participates (including prior-year disallowed passive losses) are limited to $25,000.[9] The $25,000 limit is reduced by 50 percent of the amount that the taxpayer's modified adjusted gross income exceeds $100,000.[10] Accordingly, if the taxpayer's modified adjusted gross income exceeds $150,000, none of the taxpayer's passive losses from rental real estate activities are allowable.

However, if a taxpayer qualifies as a real estate professional, then his or her rental activities are not considered passive activities and the rental losses are not subject to the limitations.[11] Instead, the rental activities are treated as trade or business activities.[12]

The Exception for Real Estate Professionals

A taxpayer qualifies as a real estate professional if —

1. more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable 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.[13]

The phrase "personal services" generally means "any work performed by an individual in connection with a trade or business."[14] Work done by an individual in his or her capacity as an investor in an activity shall not be treated as participation in the activity unless the individual is directly involved in the day-to-day management or operations of the activity.[15]

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."[16]

Material participation is defined as involvement in the operations of the activity that is regular, continuous, and substantial.[17] In determining whether a taxpayer materially participates in an activity, the participation of his or her spouse is taken into account.[18]

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.[19] 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).[20] Without making this election, a taxpayer would have to satisfy the requirements of being a real estate professional (including the 750 hours of material participation) with respect to **each** separate interest in rental property.[21] If the taxpayer makes the election, the 750 hours of material participation may be satisfied by looking at ***all*** of the rental properties in the aggregate.

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;[22]
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;[23]
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;[24]
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;[25]
5. the individual materially participates in the activity for any 5 out of the previous 10 taxable years preceding the taxable year;[26]
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 3 taxable years preceding the taxable year;[27] 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. [28]

Substantiation of Material Participation for Real Estate Professionals

What kind of proof is required to show that a real estate professional spent more than 750 hours of material participation in the rental activities? The regulations state that the extent of an individual's participation in an activity may be established by any reasonable means.[29] According to the

regulations, although contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation can be established by "other reasonable means," the term "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.[30] Well, that's certainly as clear as mud.

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.[31] While the regulations may be somewhat ambivalent concerning the types of records that must be maintained by taxpayers, the courts have ruled that a taxpayer may not make a post-event "ballpark guesstimate" of their participation in the rental activities.[32] 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 or Limited Liability Company

What if the taxpayer is a limited partner in a limited partnership or a member of a limited liability company that is engaged in a rental activity? Can the taxpayer's participation in these entities 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?

The Code provides that except as provided in regulations, no interest as a limited partner in a limited partnership shall be treated as an interest in which the taxpayer materially participates.[33] 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.[34]

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.[35] The regulations contain a de minimis exception to this rule. This exception applies 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.[36] If this exception applies, then the taxpayer need only satisfy one of the material participation tests listed above. If the exception does not apply, the taxpayer must satisfy either (1), (5) or (6) of the material participation tests listed above.[37]

The regulations do not address material participation for a member of a limited liability company. In *Gregg v. United States*,[38] the U.S. district court for the District of Oregon ruled that an interest as a member of a limited liability company is not the same as an interest as a limited partner in a limited partnership for purposes of applying the material participation rules in the regulations. The court said that the taxpayer need only satisfy one of the 7 material participation tests listed above.

Potential Audit Issues for a Taxpayer who Claims to be a Real Estate Professional

There are two potential audit issues that come to mind for a taxpayer who claims to be a real estate professional — it increases the chances of an IRS audit, and it increases the chances that the IRS will claim that the taxpayer is a real estate dealer.

As a hypothetical example, suppose that an individual owns 10 residential rental properties, and during the year, those rental properties resulted in a $100,000 net loss in the aggregate. The individual satisfies the requirements for being a real estate professional, and has records to prove over 750 hours of material participation. On the return, the individual made the election to treat all interests in rental real estate as a single rental activity. The individual sold two of the rental properties during the year, and reported the sales on Form 4797 as sales of property used in a trade or business. The sales resulted in a $240,000 gain which was taxed partly at a 25% rate (unrecaptured section 1250 gain) and partly at a 15% rate (capital gain).

It would be worthwhile for the IRS to audit this tax return. If the IRS were to determine that the individual did not qualify as a real estate professional, or that the individual's records to prove over 750 hours of material participation were somehow inadequate, then none of the $100,000 in rental losses would be allowable.[39]

Alternately, the IRS might determine that the taxpayer is a real estate dealer, and that the rental properties were held primarily for sale.[40] As a result, although the IRS would allow the $100,000 in rental losses, the $240,000 in gains on sales of the two rental properties would be taxed at ordinary income rates (rather than capital gain rates), and self-employment tax would be imposed on these gains as income from a business.

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.[41]

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.[42] 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.[43]

IRS regulations outline the general rules for grouping trade or business activities and grouping rental activities.[44] 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.[45]

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." Whether the activities constitute an "appropriate economic unit" depends upon all the relevant facts and circumstances.[47] 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.[48]

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.[49] The term "insubstantial" refers to factors more than just the gross income from the activity.[50]

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.[51]

Conclusion

By now, you are probably scratching your head over these rules. That's certainly understandable. The rules in the Code are complicated enough, and the IRS's regulations don't help to clarify them; in fact they make the rules even more complex. 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 the effect of 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 of at least 750 hours of 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., May 29, 1986).
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), p. 91, 92.
5 H. Rept. No. 103-11, H.R. 2141 (103rd Cong., 1st Sess., May 18, 1993).
6 IRC §469(c)(1).
7 IRC §469(d)(1).
8 IRC §§469(c)(2) and (4).
9 IRC §469(i)(2).
10 IRC §469(i)(3)(A).
11 IRC §469(c)(7).
12 Treas. Reg. §1.469-9(e)(1).
13 IRC §469(c)(7)(B).
14 Treas. Reg. §1.469-9(b)(4).
15 Temp. Reg. §1.469-5T(f)(2)(ii)(A). See also *Lapid v. Commissioner*, T.C. Memo. 2004-222 (taxpayer's review of financial statements and operation reports of hotel condominiums could not be counted towards material par-

ticipation requirement because they were activities of an investor).

16 IRC §469(c)(7)(C).

17 IRC §469(h)(1).

18 IRC §469(h)(5).

19 See IRC §469(c)(7)(A) and Treas. Reg. §1.469-9(e)(1).

20 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).

21 See D'Avanzo v. United States, 67 Fed.Cl. 39 (Ct.Fed.Cls. 2005), aff'd per curiam 2007 TNT 26-6 (Fed. Cir. 2007).

22 Temp. Reg. §1.469-5T(a)(1).

23 Temp. Reg. §1.469-5T(a)(2). See also *Misko v. Commissioner*, T.C. Memo. 2005-166 (attorney who leased office equipment to his wholly owned C corporation was the only person who participated in the leasing activity).

24 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).

25 Temp. Reg. §1.469-5T(a)(4).

26 Temp. Reg. §1.469-5T(a)(5).

27 Temp. Reg. §1.469-5T(a)(6).

28 Temp. Reg. §1.469-5T(a)(7).

29 Temp. Reg. §1.469-5T(f)(4).

30 Id.

31 See *D'Avanzo v. United States*, supra; *Lee v. Commissione*r, T.C. Memo. 2006-193; *Fowler v. Commissioner*, T.C. Memo. 2002-223; *Shaw v. Commissioner*, T.C. Memo. 2002-35; and *Mowafi v. Commissioner*, T.C. Memo. 2001-161.

32 See, e.g., *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, T.C. Memo. 1993-578.

33 IRC §469(h)(2).

34 Temp. Reg. §1.469-5T(e)(2).

35 Treas. Reg. §1.469-9(f)(1).

36 Treas. Reg. §1.469-9(f)(2).

37 Treas. Reg. §1.469-9(f)(1) and Temp. Reg. §1.469-5T(e)(2).

38 Gregg v. United States, 186 F.Supp.2d 1123 (Dist. Ore. 2000).

39 The $25,000 allowance for rental losses would not be allowable since modified adjusted gross income exceeds $150,000.

40 For a discussion of who is a real estate dealer and whether real estate is held primarily for sale, see David M. Fogel, "Real Estate Dealers: Capital Gain or Ordinary Income?" California Enrolled Agent, May/June 2004, p.11.

41 Treas. Reg. §1.469-9(e)(3).

42 Id.

43 Id.

44 Treas. Regs. §§1.469-4(c) through (f).

45 Treas. Reg. §1.469-4(e).

46 Treas. Reg. §1.469-4(c)(1).

47 Treas. Reg. §1.469-4(c)(2).

48 Id.

49 Treas. Reg. §1.469-4(d)(1)(i).

50 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."

51 Treas. Reg. §1.469-9(b)(3).