Michael A. Gordon, CPA, LLC

"Not Your Basic Bean Counter"

290 S. 4th Street, Coos Bay, Oregon 97420 541-269-1272

WARNING: Not updated for any new tax laws since 2015.

RENTAL REAL ESTATE ACTIVITY BINDER

TABLE OF CONTENTS

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Tab #1

Checklist & Conceptual Framework

Michael A. Gordon, CPA, LLC
RENTAL REAL ESTATE -PASSIVE ACTIVITY RULES
Conceptual Framework

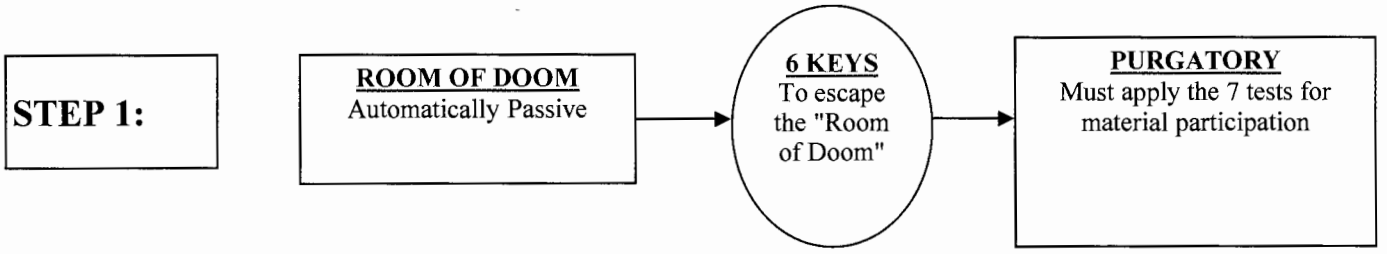
Rental activities, by statute, are automatically passive...period. There are only 2 ways that a rental activiy can get out of the "automatic" passive taint.

First way out of the "automatic" passive taint: **This is called the Real Estate Professional (REP) designation. A client that meets the REP rules can treat rental real estate activities as nonpassive activities.**

If this is the direction we want to go, then refer to Tab 8 of this binder and discuss with MAG. We will probably need to meet with the cient and document our conclusion.

Second way out of the "automatic" passive taint: **The 6 exceptions. These are found at IRS Reg. Section 1.469-1T(e)(3)(ii). These are, typically, tool rentals, hotels, b&b's, golf courses, and hospitals. If a client meets one of these 6 exceptions (which will be rare), it means that they are not considered "automatically" passive. They must, then, meet one of the 7 tests for material participation...or else they are still passive.**

The following pictorial/diagram illustrates the process we will need to go through. For documentation purposes you will need to fill out one of our "flowcharts" for each activity. These flowcharts should be in your *Rental Real Estate Activity* binders.



STEP 2:

THE 3 COPS (The 3 Recharacterization Rules).....these TRUMP rules above!!
Cop #1: The self-rental rule (Income is reclassed as non-passive....loss stays passive)
Cop #2: The ground rents rule (If < 30% of basis is subject to dep'n, income is non-passive)
Cop #3: Property rented incidental to a development activity

Conceptually, completing Step 1 will bring you to an "tentative" conclusion regarding whether or not this is a passive activity. However, once that "tentative" conclusion has been reached, we must then look at the 3 recharacterization rules (the 3 cops, as I refer to them) to see if they overrule our "tentative" conclusion. The 3 recharacterization rules, if applicable, TRUMP whatever we concluded in Step 1.

Michael A. Gordon, CPA, LLC
1040 PREPARER CHECKLIST FOR 2014 RETURNS
RENTAL REAL ESTATE - GENERAL & ADMIN ISSUES

CLIENT NAME:	*Prepared by:*
	Date:

		Y	N	N/A	*Comments*
1	**For NEW rentals**				
	• Use the Rental Setup excel worksheet (p:/Blankforms/Tax Worksheets)				
2	**Issue re: holding each rental in a separate LLC**				
	• If possible, ascertain if each rental is held in a separate LLC…indicate in comments area.				
	• If can't tell, or not sure, check front of Lead Sheet to print out our template LLC letter to send to client regarding this issue.				
3	**Depreciation Issues**				
	• Remember, no §179 on assets used in a rental activity.				
	• Don't forget 50% bonus dep'n is still available for qualifying assets placed in service by 12/31/14. Did you consider electing out of bonus depreciation if it is not advantageous to the client?				
	• **EXTENDER BILL - QUALIFIED REAL ESTATE** The 2 major provisions for "qualified real property" that applied for 2012 & 2013 were extended to include tax years beginning in 2014. They are 15 year useful life and the availability of IRC 179 (up to a maximum of $250,000).				
4	**Sale of assets and activities…**				
	• If a loss, was the sale to a related party?				
	• §1231 gain - any §1231 losses in the past 5 years?				
	• Current yr Installment Sale - consider electing out, discuss and document.				
	- Did you split Land & Building into two separate installment sales?				
	• Consider whether the gain/loss might be "passive".				
	• Was the rental previously used as a residence? If so, attach Sale of Residence checklist.				
	• §1031 exchange - did you use our Excel worksheet to calculate any recognized gain & basis in new asset?				
5	**Refinancing activities**				
	• Get all closing docs				
	• Obtain info on how proceeds were used.				
	• If needed, prepare Excel spreadsheet showing interest tracing allocations.				
6	Property taxes been paid by the lessee? Amount s/b included in rent income and deducted by taxpayer. GOAL: Want to see "property taxes" on Sch E.				
7	**Out-of-state rentals**				
	• Are there any out-of-state rentals?				
	• If YES, pull the filing requirements for that state and discuss with MAG.				
8	**Have you filled out a FLOWCHART for each rental activity?**				

Tab #2

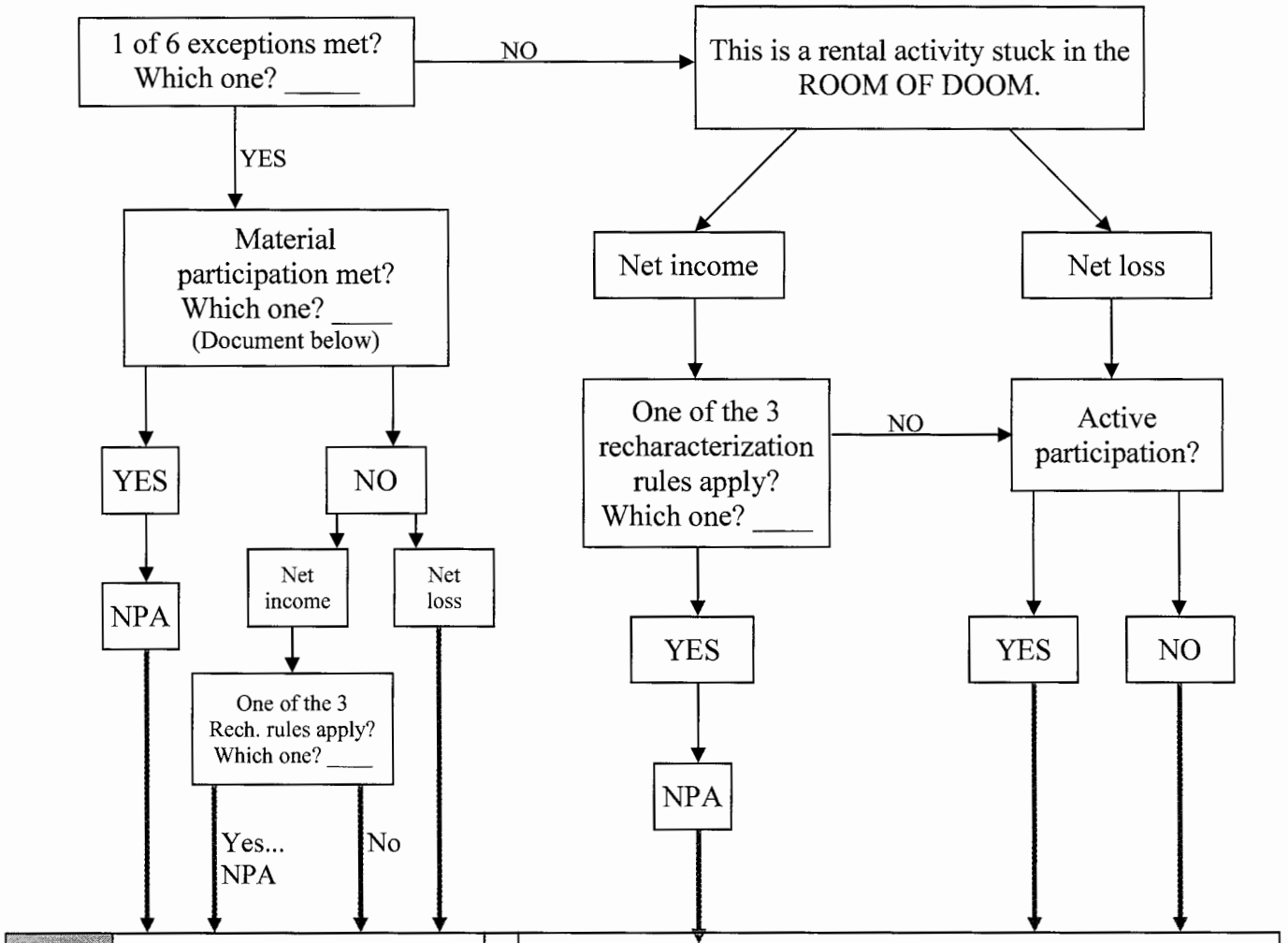
Flowchart

Michael A. Gordon, CPA, LLC
Flowchart for Rental Activities

Client Name: _____

Activity: _____

For Year: _____ Prepared By: _____



Form 8582 Report-ing	**Not on F8582**	**F8582 Pg. 2 W3**		**Not on F8582**	**F8582 Pg. 2 W1**	**F8582 Pg. 2 W3**

Subject to SE?	Almost always YES. But could be NO if Reg. ¶1.1402(a)(4)(c) is properly applied…see Example 3 in SE section.		NO….Generally, not subject to SE But watch out for Reg. Section 1.1402(a)-(4)(c)….this is cited in PPC's 1040 Deskbook, Key Issue 16E, the *preparation pointer* just after the 6 exceptions. Also see discussion in SE section.

What documentation exists to verify that client met the material participation standard? Discuss below.

_____

_____

_____

_____

Tab #3

Applying the SE rules

Applying the SE rules to rentals—General Discussion

The SE tax rules have their own rules and exceptions for real estate that are independent of the passive activity rules. The passive activity rules are found in IRC 469 (and the regs thereunder) while the SE tax rules are found in IRC 1402 (and the regs thereunder).

Thus, any conclusion about how an activity is classified under the passive activity rules has no bearing on its SE treatment.

Generally, real estate rental income is exempt from SE tax. This is stated in Reg. Sec. 1.1402(a)-4(a). However, in this same reg. there is an exception that subjects real estate rental income received by an individual in the course of his/her trade or business as a "real estate dealer" to SE tax.

If the Reg. Sec. quoted above were all we had, we would conclude that the only real estate rental income subject to SE tax would be if our client was a "real estate dealer". Thus, for example, a hotel or B&B would not be subject to SE tax since they are clearly not considered a "real estate dealer"...even though we would be reporting the activity on a Schedule C.

So why is it that we subject our hotel and B&B clients to SE tax? Is it only because it is reported on a Schedule C? The answer is NO. The answer is stated in Reg. Sec. 1.1402(a)-4(c) which lays out the "services rendered for occupants" concept.

Services rendered for occupants

The regulation says that "services are considered rendered to the occupant if they are primarily for his convenience and are *other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only*". So, if the services rendered meet this definition, then the rental income is subject to SE tax. If the services are "*merely those that are usually or customarily rendered*", then the rental income is NOT subject to SE tax. Bifurcation may be necessary in certain situations.

Services that fit the definition of "*merely those that are usually or customarily rendered*" include furnishing heat & light, cleaning public entrances, exits stairways and lobbies, or collecting trash.

So, an example of services that would be considered "*primarily for his convenience*" would be maid services, according to the regulation (it's the only example given in the regulation).

Rev. Rul. 57-108

This revenue ruling is one of the only places we can see a real example. Here we have a taxpayer who rents beach houses and provides linens, tableware, swimming instructions, message and mail delivery, etc. In some cases, but not all cases, maid service was provided as well. The IRS found that these services were enough to cause the activity to be subject to SE tax.

More examples

On the next page are several examples that will attempt to apply the passive activity rules and the SE rules and show how they are separate and can have very different results than what might be expected.

Applying the SE rules to rentals—Examples

Example 1

NOT a "rental activity"....NOT subject to SE tax

Mike owns a condo in Portland. He and his wife vacation there on and off for a total of 24 days in 2011. When not there, a leasing company rents it out to various people. The average period of use was 6 days. No services were provided other than utilities, cleaning of public areas and trash collection.

Passive activity rules:

This activity meets one of the 6 exceptions (exception #1) and is, therefore, not considered a "rental activity" for purposes of the passive activity rules. Therefore, it must go to the 7 tests for material participation to determine if it is a passive activity or not. If they materially participate, then the income or loss is non-passive. If they do not materially participate the income or loss is passive. Note, however, that a loss here would not be eligible for the special $25,000 allowance for "active participation" since the activity is not considered a "rental activity".

SE tax rules:

Irrespective of the passive activity rules above, any income will be exempt from SE tax since no services *other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only* were provided to the occupants.

Reporting the activity:

Either way, we would report this on a Schedule E.

Example 2

NOT a "rental activity"....SUBJECT to SE tax

Same facts as in Example 1, except the leasing company also provided maid services to every occupant.

Passive activity rules:

The analysis here remains the same as above in Example 1.

SE tax rules:

Here's where we get a different result, according to the regulation. Since maid services constitute services that are "*considered rendered to the occupant primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only",* income will be subject to SE tax.

Reporting the activity:

We would still report this on a Schedule E....some PPC authors (in a TAM from 2003) might argue that this should be reported on a Schedule C.

Example 3, on the next page, will show how and where and why a bifurcation may be necessary.

Mike owns one apartment building. He is not a real estate dealer. The building has 4 apartments.

Apartments 1 & 2

These renters paid Mike $20,000 rent in 2011. No services are rendered to the renters other than trash collection and periodic cleaning of the parking area. He had the same renters all year.

Apartments 3 &4

These renters paid Mike $36,000 rent in 2011. These are rented for a higher dollar amount because Mike provides services rendered to the occupants (eg. maid services).

Expenses for 2011

2011 property taxes and interest totaled $30,000. Mike had to pay $6,000 for the maid services he provided to the occupants of units 3 and 4.

Passive activity rules:

This activity does NOT meet one of the 6 exceptions and is, therefore, a "rental activity".

SE tax rules:

Here we have the need for bifurcation. The income from units 1 & 2 are clearly NOT subject to SE tax. However, the income from units 3 & 4 clearly ARE subject to SE tax.

To get the right numbers, it helps to envision a Schedule E with 2 columns...column 1 for units 1 & 2, and column 2 for units # 3 & 4.

The $30,000 of taxes and interest will get allocated 50% to column 1 and 50% to column 2 (we are assuming that this is a reasonable allocation based on square footage). The $6,000 direct expenses will be allocated 100% to column 2.

So, column 1 will show a net income of $5,000 ($20,000 income less the $15,000 of allocated taxes and interest). That income will be passive, based on the analysis above, and will NOT be subject to SE tax.

Column 2 will show a net income of $15,000 ($36,000 income less the $15,000 of allocated taxes and interest *and* the $6,000 of direct expenses). That income will also be passive, based on the analysis above, but WILL be subject to SE tax. ***Interesting side note: if this showed a loss, would it be available to offset SE income reported elsewhere in the return?***

Reporting the activity:

You can see that my analysis above, under the *SE tax rules*, has everything reported on one Schedule E with 2 columns. A similar example with the same numbers was discussed in a 2003 TAM from PPC. In that TAM, the author specified that units 1&2 should be reported on Schedule E, while units 3 & 4 should be reported on a Schedule C.

Example 4	*SE tax as it relates to "vacation homes"*

Assume the same facts as in Example 1 except that Mike and his family used the condo for a total of 28 days in 2011. Remember the vacation home rules found in IRC Sec. 280A.....Mike's condo will be considered a "vacation home" under the IRC Sec. 280A rules if personal use exceeds the "greater of 14 days or 10% of the rental days". In this case, assume it was rented for a total of 245 days.

10% of 245 days is 24.5 days. Since personal use was 28 days, and that exceeds the 10% rule, Mike's condo is considered (for 2011) a "vacation home" and the rules under IRC Sec. 280A apply.

Keep in mind that the rules under IRC Sec. 280A outline what is deductible and the bifurcation process. However, it does NOT have any bearing on whether or not the income/loss is subject to SE tax. Again, the SE issue is entirely separate and governed solely by IRC Sec. 1402 and the regs thereunder. Thus, classification as a "vacation home" should not automatically result in any particular SE treatment.

So, we must apply the same rules as we have already been dealing with (in the prior examples) to determine if a vacation home activity might be subject to SE tax. In other words we need to determine whether or not Mike furnishes services to the occupants in addition to those "customarily furnished in connection with renting space". If not, then the rental income/loss is NOT subject to SE tax. If yes, then the income/loss is subject to SE tax, but only if it rises to the level of a trade or business. To be engaged in a trade or business, Mike generally must be involved in the activity with continuity and regularity.

Another practical application:

Many taxpayers will rent their vacation home out only once a year for a short time. For example, Mike might rent his condo out for 3-4 weeks each summer and then use it personally for the rest of the year. Here, even though the "vacation home" rules will apply, it should be arguable that the SE tax is not applicable because the activity is not continuous....so, it is not a trade or business.

Tab #4

The 6 Exceptions

Six Exceptions to Treatment as Rental Activities

Temp. Reg. 1.469-1T(e)(3)(ii) provides six exceptions whereby the following activities are not categorized as rental activities for PAL purposes even though gross income is received for the use of the property:

1. Average period of customer use or rental is seven days or less (e.g., a vacation condo or motel).

2. Average period of customer use is 30 days or less, and significant personal services are provided (e.g., dude ranch, hotel or other temporary lodging where housekeeping and/or other valet services are provided). Significant personal services are defined only as services performed by individuals using a *relevant facts and circumstances test.* Services provided along with the use of realty, such as cleaning and maintenance of common areas, routine repairs, trash collection, providing of security, etc., are not considered significant personal services. Neither is travel between the owner's home and rental properties to inspect and maintain units or to attend condominium association meetings (*Sweet*). In *Hairston*, the taxpayer argued that equipment owned personally and leased to a controlled S corporation (which leased it to third parties for an average rental period of 30 days or less) qualified for this exclusion from the definition of rental activity. The court determined that the lease to the S corporation was long-term because the S corporation had access to the equipment for an indefinite period. The end-user's lease term was irrelevant.

3. Extraordinary personal services are provided by or on behalf of the owner, without regard to the average period of customer use. The services must be performed by individuals, and the use of the property by customers is incidental to their receipt of such services, such as with a hospital or a boarding school's dormitories (*Assaf*).

4. Rental of the property is incidental to a non-rental activity of the taxpayer. This exception applies when property is held for investment or business use and the gross rental income from the property for the year is less than 2% of the lesser of the unadjusted basis of the property or its FMV. If the property is used in a trade or business activity, the taxpayer must also own an interest in the activity during the year and have used the property predominantly

in the trade or business activity during the year or during at least two of the preceding five tax years. **(See Example below)**

5. Taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers (e.g., a golf course).

6. Taxpayer, in his or her capacity as an owner, provides the property for use in an activity conducted by a partnership, S corporation, or a joint venture in which he or she owns an interest, and the activity is not a rental activity. Thus, if a partner, for example, contributes the use of property to a partnership, none of his or her distributive share of the partnership's income is rental income, unless the partnership is engaged in a rental activity. Whether property is provided in the taxpayer's capacity as an owner is determined based on all the facts and circumstances. In Ltr. Rul. 9722007, the IRS found that owners who formally leased property to their S corporation were engaged in a rental activity rather than in providing property to the S corporation in their capacity as owners. Unfortunately, the ruling does not explain what criteria must be present for a formal lease to exist.

EXAMPLE: Lease of land incidental to nonrental activity (Exception #4 above)

Last year Mike paid $200,000 for 500 acres of unimproved land in a rural area. He anticipates that in the next five years the value of the property will appreciate significantly, at which point he plans to sell the land. In the interim, Mike agrees to lease the land to a neighboring rancher for $3,500 a year. Because the rental of the land is incidental to Mike's primary purpose of holding for appreciation, and the income he receives is less than 2% of the property's unadjusted basis, the income is not considered to be from a rental activity.

Tab #5

7 tests for "material participation"

Tests for Determining Material Participation

Material participation occurs when the taxpayer's involvement in the trade or business (or rental real estate activity for real estate professionals) is regular, continuous, and substantial [**IRC Sec. 469(h)(1)**]. **Reg. 1.469-5** and **Temp. Reg. 1.469-5T** establish guidelines to determine material participation. Any work an individual performs in an activity in which he or she owns an interest (when the work is done) generally is considered participation. However, not all participation is considered material; see the discussion of "Nonqualifying Participation" later in this key issue. An individual materially participates in an activity if *any one* of the following tests is met:

1. *More Than 500 Hours Test.* The taxpayer participates in the activity for more than 500 hours during the year.

2. *Substantially All Participation Test.* The taxpayer's participation in the activity constitutes substantially all of the participation by all individuals (including nonowners) in the activity for the year.

3. *More Than 100 Hours Test.* The taxpayer's participation is more than 100 hours during the year, and no other individual (including nonowners) participates more hours than the taxpayer.

4. *Significant Participation Activity (SPA) Test.* The activity is a significant participation activity in which the taxpayer participates for more than 100 hours during the year and the taxpayer's 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) that the taxpayer participates in for more than 100 hours during the year but does not materially participate (under any of the material participation tests other than this test).]

5. *Prior-year Material Participation Test.* The taxpayer materially participated in the activity for any five tax years (whether or not consecutive) during the 10 immediately preceding tax years.

6. *Personal Service Activity Test.* For a personal service activity, the taxpayer materially participated for any three tax years (whether or not consecutive) preceding the current tax year. (Personal service includes the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.)

7. *Facts and Circumstance Test.* Based on all the facts and circumstances, the taxpayer participates on a regular, continuous, and substantial basis during the year [**Temp. Reg. 1.469-5T(a)(7)**]. Future regulations are to provide further guidance for this test. However, temporary regulations indicate that if an individual participates in an activity for 100 hours or less during the year, this "facts and circumstances" test is not available. Participating in the management of an activity is not considered for this test if (a) any person (other than the taxpayer) received compensation for performing services in the management of the activity, or (b) any individual spent more hours during the tax year performing management services than the taxpayer (whether or not the individual was compensated for the management services).

In applying the material participation rules, the following should be considered:

1. Limited partners *generally* are not considered to materially participate in activities of the limited partnership. Instead of the availability of all seven tests to determine material participation, a limited partner must pass either the first, fifth, or sixth test [**Temp. Reg. 1.469-5T(e)(2)**].

2. Unlike limited partners (see #1 above), LLC members are not limited to 3 of the 7 tests. A 2009 Tax Court case, Garnett v. Comm., TC No. 19 (06/30/2009), made it clear that LLC members can avail themselves of all 7 tests.

3. If a taxpayer's spouse materially participates in an activity, the taxpayer is also considered to materially participate, even if the spouse does not own any interest in the activity, or file a joint return with the taxpayer [**IRC Sec. 469(h)(5)**].

Reg §1.469-5T. Material participation (temporary).

Effective: The final regulations under §§1.469-0, 1.469.1, 1.469-2, 1.469-3 and 1.469-5, the addition of §§1.469-6 through 1.469-10, the removal of §§1.469-0T and 1.469.6T through 1.469.11T, and the amendments to §§1.469-1T, 1.469-2T, 1.469-3T and 1.469-5T are effective for taxable years ending after May 10, 1992.

(a) In general. Except as provided in paragraphs (e) and (h)(2) of this section, an individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if—

(1) The individual participates in the activity for more than 500 hours during such year.

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

(4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year.

(b) Facts and circumstances.

(1) In general. [Reserved]

(2) Certain participation insufficient to constitute material participation under this paragraph (b).

(i) Participation satisfying standards not contained in section 469. Except as provided in section 469(h)(3) and paragraph (h)(2) of this section (relating to certain retired individuals and surviving spouses in the case of farming activities), the fact that an individual satisfies the requirements of any participation standard (whether or not referred to as "material participation") under any provision (including sections 1402 and 2032A and the regulations thereunder) other than section 469 and the regulations thereunder shall not be taken into account in determining whether such individual materially participates in any activity for any taxable year for purposes of section 469 and the regulations thereunder.

(ii) Certain management activities. An individual's services performed in the management of an activity shall not be taken into account in determining whether such individual is treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section unless, for such taxable year—

(A) No person (other than such individual) who performs services in connection with the management of the activity receives compensation described in section 911(d)(2)(A) in consideration for such services; and

(B) No individual performs services in connection with the management of the activity that exceed (by hours) the amount of such services performed by such individual.

(iii) Participation less than 100 hours. If an individual participates in an activity for 100 hours or less during the taxable year, such individual shall not be treated as materially participating in such activity for the taxable year under paragraph (a)(7) of this section.

(c) Significant participation activity.

(1) In general. For purposes of paragraph (a)(4) of this section, an activity is a significant participation activity of an individual if and only if such activity—

(i) Is a trade or business activity (within the meaning of §1.469-1T(e)(2)) in which the individual significantly participates for the taxable year; and

(ii) Would be an activity in which the individual does not materially participate for the taxable year if material participation for such year were determined without regard to paragraph (a)(4) of this section.

(2) Significant participation. An individual is treated as significantly participating in an activity for a taxable year if and only if the individual participates in the activity for more than 100 hours during such year.

(d) Personal service activity. An activity constitutes a personal service activity for purposes of paragraph (a)(6) of this section if such activity involves the performance of personal services in—

(1) The fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; or

(2) Any other trade or business in which capital is not a material income-producing factor.

(e) Treatment of limited partners.

(1) General rule. Except as otherwise provided in this paragraph (e), an individual shall not be treated as materially participating in any activity of a limited partnership for purposes of applying section 469 and the regulations thereunder to—

(i) The individual's share of any income, gain, loss, deduction, or credit from such activity that is attributable to a limited partnership interest in the partnership; and

(ii) Any gain or loss from such activity recognized upon a sale or exchange of such an interest.

(2) Exceptions. Paragraph (e)(1) of this section shall not apply to an individual's share of income, gain, loss, deduction, and credit for a taxable year from any activity in which the

individual would be treated as materially participating for the taxable year under paragraph (a)(1), (5), or (6) of this section if the individual were not a limited partner for such taxable year.

(3) Limited partnership interest.

(i) In general. Except as provided in paragraph (e)(3)(ii) of this section, for purposes of section 469(h)(2) and this paragraph (e), a partnership interest shall be treated as a limited partnership interest if—

(A) Such interest is designated a limited partnership interest in the limited partnership agreement or the certificate of limited partnership, without regard to whether the liability of the holder of such interest for obligations of the partnership is limited under the applicable State law; or

(B) The liability of the holder of such interest for obligations of the partnership is limited, under the law of the State in which the partnership is organized, to a determinable fixed amount (for example, the sum of the holder's capital contributions to the partnership and contractual obligations to make additional capital contributions to the partnership).

(ii) Limited partner holding general partner interest. A partnership interest of an individual shall not be treated as a limited partnership interest for the individual's taxable year if the individual is a general partner in the partnership at all times during the partnership's taxable year ending with or within the individual's taxable year (or the portion of the partnership's taxable year during which the individual (directly or indirectly) owns such limited partnership interest).

(f) Participation.

(1) [Reserved] See §1.469-5(f)(1) for rules relating to this paragraph.

(2) Exceptions.

(i) Certain work not customarily done by owners. Work done in connection with an activity shall not be treated as participation in the activity for purposes of this section if—

(A) Such work is not of a type that is customarily done by an owner of such an activity; and

(B) One of the principal purposes for the performance of such work is to avoid the disallowance, under section 469 and the regulations thereunder, of any loss or credit from such activity.

(ii) Participation as an investor.

(A) In general. Work done by an individual in the individual's capacity as an investor in an activity shall not be treated as participation in the activity for purposes of this section unless the individual is directly involved in the day-to-day management or operations of the activity.

(B) Work done in individual's capacity as an investor. For purposes of this paragraph (f)(2)(ii), work done by an individual in the individual's capacity as an investor in an activity includes—

(1) Studying and reviewing financial statements or reports on operations of the activity;

(2) Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use; and

(3) Monitoring the finances or operations of the activity in a non-managerial capacity.

(3) Participation of spouse. In the case of any person who is a married individual (within the meaning of section 7703) for the taxable year, any participation by such person's spouse in the activity during the taxable year (without regard to whether the spouse owns an interest in the activity and without regard to whether the spouses file a joint return for the taxable year) shall be treated, for purposes of applying section 469 and the regulations thereunder to such person, as participation by such person in the activity during the taxable year.

(4) Methods of proof. The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar

documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to 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.

(g) Material participation of trusts and estates. [Reserved]

(h) Miscellaneous rules.

(1) Participation of corporations. For rules relating to the participation in an activity of a personal service corporation (within the meaning of §1.469-1T(g)(2)(i)) or a closely held corporation (within the meaning of §1.469-1T(g)(2)(ii)), see §1.469-1T(g)(3).

(2) Treatment of certain retired farmers and surviving spouses of retired or disabled farmers. An individual shall be treated as materially participating for a taxable year in any trade or business activity of farming if paragraph (4) or (5) of section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity had the individual died during such taxable year.

(3) Coordination with rules governing the treatment of passthrough entities. [Reserved] See §1.469-5(h)(3) for rules relating to this paragraph.

(i) [Reserved]

(j) Material participation for preceding taxable years. [Reserved] See §1.469-5(j) for rules relating to this paragraph.

(k) Examples. The following examples illustrate the application of this section:

Example (1). A, a calendar year individual, owns all of the stock of X, a C corporation. X is the general partner, and A is the limited partner, in P, a calendar year partnership. P has a single activity, a restaurant, which is a trade or business activity (within the meaning of §1.469-1T(e)(2)). During the taxable year, A works for an average of 30 hours per week in connection with P's restaurant activity. Under paragraphs (a)(1) and (e)(2) of this section, A is treated as materially participating in the activity for the taxable year because A participates in the restaurant activity

during such year for more than 500 hours. In addition, under §1.469-1T(g)(3)(i), A's participation will cause X to be treated as materially participating in the restaurant activity.

Example (2). The facts are the same as in example (1), except that the partnership agreement provides that P's restaurant activity is to be managed by X, and A's work in the activity is performed pursuant to an employment contract between A and X. Under paragraph (f)(1) of this section, work done by A in connection with the activity in any capacity is treated as participation in the activity by A. Accordingly, the conclusion is the same as in example (1). The conclusion would be the same if A owned no stock in X at any time, although in that case A's participation would not be taken into account in determining whether X materially participates in the restaurant activity.

Example (3). B, an individual, is employed full-time as a carpenter. B also owns an interest in a partnership which is engaged in a van conversion activity, which is a trade or business activity (within the meaning of §1.469-1T(e)(2)). B and C, the other partner, are the only participants in the activity for the taxable year. The activity is conducted entirely on Saturdays. Each Saturday throughout the taxable year, B and C work for eight hours in the activity. Although B does not participate in the activity for more than 500 hours during the taxable year, under paragraph (a)(3) of this section, B is treated for such year as materially participating in the activity because B participates in the activity for more than 100 hours during the taxable year, and B's participation in the activity for such year is not less than the participation of any other person in the activity for such year.

Example (4). C, an individual, is employed full-time as an accountant. C also owns interests in a restaurant and a shoe store. The restaurant and shoe store are trade or business activities (within the meaning of §1.469-1T(e)(2)) that are treated as separate activities under the rules to be contained in §1.469-4T. Each activity has several full-time employees. During the taxable year, C works in the restaurant activity for 400 hours and in the shoe store activity for 150 hours. Under paragraph (c) of this section, both the restaurant and shoe store activities are significant participation activities of C for the taxable year. Accordingly, since C's aggregate participation in the restaurant and shoe store activities during the taxable year exceeds 500 hours, C is treated under paragraph (a)(4) of this section as materially participating in both activities.

Example (5). [Reserved] See §1.469-5(k) Example 5 for this example.

Example (6). The facts are the same as in example (5), except that D does not acquire any stock in the S corporation until 1994. Under paragraph (f)(1) of this section, D is not treated as participating in the activity for any taxable year prior to 1994 because D does not own an interest in the activity for any such taxable year. Accordingly, D materially participates in the activity for only one taxable year prior to 1995, and D is not treated under paragraph (a)(5) of this section as materially participating in the activity for 1995 or subsequent taxable years.

Example (7). (i) E, a married individual filing a separate return for the taxable year, is employed full-time as an attorney. E also owns an interest in a professional football team that is a trade or business activity (within the meaning of §1.469-1T(e)(2)). E does no work in connection with this activity. E anticipates that, for the taxable year, E's deductions from the activity will exceed E's gross income from the activity and that, if E does not materially participate in the activity for the taxable year, part or all of F's passive activity loss for the taxable year will be disallowed under §1.469-1T(a)(1)(i). Accordingly, E pays E's spouse to work as an office receptionist in connection with the activity for an average of 15 hours per week during the taxable year.

(ii) Under paragraph (f)(3) of this section, any participation in the activity by E's spouse is treated as participation in the activity by E. However, under paragraph (f)(2)(i) of this section, the work done by E's spouse is not treated as participation in the activity because work as an office receptionist is not work of a type customarily done by an owner of a football team, and one of E's principal purposes for paying E's spouse to do this work is to avoid the disallowance under §1.469-1T(a)(1)(i) of E's passive activity loss. Accordingly, E is not treated as participating in the activity for the taxable year.

Example (8). (i) F, an individual, owns an interest in a partnership that feeds and sells cattle. The general partner of the partnership periodically mails F a letter setting forth certain proposed actions and decisions with respect to the cattle-feeding operation. Such actions and decisions include, for example, what kind of feed to purchase, how much to purchase, and when to purchase it, how often to feed cattle, and when to sell cattle. The letters explain the proposed actions and decisions, emphasize that taking or not taking a particular action or decision is solely within the discretion of F and other partners, and ask F to indicate a decision with respect to each proposed action by answering certain questions. The general partner receives a fee that constitutes earned income (within the meaning of section 911(d)(2)(A)) for managing the cattle-feeding operation. F is not

treated as materially participating in the cattle-feeding operation under paragraph (a)(1) through (6) of this section.

(ii) F's only participation in the cattle-feeding operation is to make certain managerial decisions. Under paragraph (b)(2)(ii) of this section, such management services are not taken into account in determining whether the taxpayer is treated as materially participating in the activity for a taxable year under paragraph (a)(7) of this section if any other person performs services in connection with the management of the activity and receives compensation described in section 911(d)(2)(A) for such services. Therefore, F is not treated as materially participating for the taxable year in the cattle-feeding operation.

Tab #6

The 3 recharacterization rules

3 Recharacterization Rules

#1-Self Rental Rule — Actual Reg. 1.469-2(f)(6)

(6) Property rented to a nonpassive activity. An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from that item of property is treated as not from a passive activity if the property—

(i) Is rented for use in a trade or business activity (within the meaning of paragraph (e)(2) of this section) in which the taxpayer materially participates (within the meaning of §1.469-5T) for the taxable year; and

(ii) Is not described in §1.469-2T(f)(5).

#2-Ground Rents Rule — Actual Reg. 1.469-2T(f)(3)

(3) Rental of nondepreciable property. If less than 30 percent of the unadjusted basis of the property used or held for use by customers in a rental activity (within the meaning of §1.469-1T(e)(3)) during the taxable year is subject to the allowance for depreciation under section 167, an amount of the taxpayer's gross income from the activity equal to the taxpayer's net passive income from the activity shall be treated as not from a passive activity. For purposes of this paragraph (f)(3), the term "unadjusted basis" means adjusted basis determined without regard to any adjustment described in section 1016 that decreases basis. The following example illustrates the application of this paragraph (f)(3):

Example. C is a limited partner in a partnership. The partnership acquires vacant land for $300,000, constructs improvements on the land at a cost of $100,000, and leases the land and improvements to a tenant. The partnership then sells the land and improvements for $600,000, thereby realizing a gain on the disposition. The unadjusted basis of the improvements ($100,000) equals 25 percent of the unadjusted basis of all property ($400,000) used in the rental activity. Therefore, under this paragraph (f)(3), an amount of C's gross income from the activity equal to the net passive income from the activity (which is computed by taking into account the gain from the disposition, including gain allocable to the improvements) is treated as not from a passive activity

#3-Property Rented Incidental to a Development Activity — Actual Reg. 1.469-2(f)(5)

(5) Net income from certain property rented incidental to development activity.

(i) In general. An amount of the taxpayer's gross rental activity income for the taxable year from an item of property equal to the net rental activity income for the year from the item of property shall be treated as not from a passive activity if—

(A) Any gain from the sale, exchange, or other disposition of the item of property is included in the taxpayer's income for the taxable year;

(B) The taxpayer's use of the item of property in an activity involving the rental of the property commenced less than 12 months before the date of the disposition (within the meaning of paragraph (c)(2)(iii)(B) of this section) of such property; and

(C) The taxpayer materially participated (within the meaning of §1.469-5T) or significantly participated (within the meaning of §1.469- 5T(c)(2)) for any taxable year in an activity that involved for such year the performance of services for the purpose of enhancing the value of such item of property (or any other item of property if the basis of the item of property that is sold, exchanged, or otherwise disposed of is determined in whole or in part by reference to the basis of such other item of property).

(ii) Commencement of use.

(A) In general. For purposes of paragraph (f)(5)(i)(B) of this section, a taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which—

(1) The taxpayer owns an interest in the property;

(2) Substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental); and

(3) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) Value-enhancing services. For purposes of this paragraph (f)(5)(ii), the term value-enhancing services means the services described in paragraphs (f)(5) (i)(C) and (iii) of this section, except that the term does not include lease-up. Thus, in cases in which this paragraph (f)(5) applies solely because substantial lease-up remains to be performed (see paragraph (f)(5)(iii)(C) of this section), the twelve month period described in paragraph (f)(5)(i)(B) of this section will begin when the taxpayer acquires an interest in the property if substantially all of the property is held out for rent and is in a state of readiness for rental on that date.

(iii) Services performed for the purpose of enhancing the value of property. For purposes of paragraph (f)(5)(i)(C) of this section, services that are treated as performed for the purpose of enhancing the value of an item of property include but are not limited to—

(A) Construction;

(B) Renovation; and

(C) Lease-up (unless more than 50 percent of the property is leased on the date that the taxpayer acquires an interest in the property).

(iv) Examples. The following examples illustrate the application of this paragraph (f)(5):

Example (1). (i) A, a calendar year individual, is a partner in P, a calendar year partnership, which develops real estate. In 1993, P acquires an interest in undeveloped land and arranges for the financing and construction of an office building on the land.

Construction is completed in February 1995, and substantially all of the building is either rented or held out for rent and in a state of readiness for rental beginning on March 1, 1995. Twenty percent of the building is leased as of March 1, 1995.

(ii) P rents the building (or holds it out for rent) for the remainder of 1995 and all of 1996, and sells the building on February 1, 1997, pursuant to a contract entered into on January 15, 1996. P did not hold the building (or any other buildings) for sale to customers in the ordinary course of P's trade or business (see paragraph (c)(2)(v) of this section). A's distributive share of P's taxable losses from the rental of the building is $50,000 for 1995 and $30,000 for 1996. All of A's losses from the rental of the building are disallowed under 1.469-1(a)(1)(i) (relating to the disallowance of the passive activity loss for the taxable year). A's distributive share of P's gain from the sale of the building is $150,000. A has no other gross income or deductions from the activity of renting the building.

(iii) The real estate development activity that A holds through P in 1993, 1994, and 1995 involves the performance of services (e.g., construction) for the purpose of enhancing the value of the building. Accordingly, an amount equal to A's net rental activity income from the building may be treated as gross income that is not from a passive activity if A's use of the building in an activity involving the rental of the building commenced less that 12 months before the date of the disposition of the building. In this case, the date of the disposition of the building is January 15, 1996, the date of the binding contract for its sale.

(iv) (A) A taxpayer's use of an item of property in an activity involving the rental of the property commences on the first date on which—

(1) The taxpayer owns an interest in the item of property;

(2) Substantially all of the property is rented (or is held out for rent and is in a state of readiness for rental); and

(3) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) In this case, A's use of the building in an activity involving the rental of the building commenced on March 1, 1995, less than 12 months before January 15, 1996, the date of disposition. Accordingly, if A materially (or significantly) participated in the real estate development activity in 1993, 1994, or 1995 (without regard to whether A materially participated in the activity in more than one of those years), an amount of A's gross rental activity income from the building for 1997 equal to A's net rental activity income from the building for 1997 is treated under this paragraph (f)(5) as gross income that is not from a passive activity. Under paragraph (f)(9)(iv) of this section, A's net rental activity income from the building for 1997 is $70,000 ($150,000 distributive share of gain from the disposition of the building minus $80,000 of reasonably allocable passive activity deductions).

Example (2). (i) X, a calendar year taxpayer subject to section 469, acquires a building on February 1, 1994, when the building is 25 percent leased. During 1994, X rents the building (or holds it out for rent) and materially participates in an activity that involves the lease-up of the building. X's activities do not otherwise involve the performance of construction or other services for the purpose of enhancing the value of the building, and X does not hold the building (or any other building) for sale to customers in the ordinary course of X's trade or business. X sells the building on December 1, 1994.

(ii) (A) Under paragraph (f)(5)(iii)(C) of this section, lease-up is considered a service performed for the purpose of enhancing the value of property unless more than 50 percent of the property is leased on the date the taxpayer acquires an interest in the property. Under paragraph (f)(5)(ii)(B) of this section, however, lease-up is not considered a value-enhancing service for purposes of determining when the taxpayer commences using an item of property in an activity involving the rental of the property. Accordingly, X's acquisition of the building constitutes a commencement of X's use of the building in a rental activity, because February 1, 1994, is the first date on which—

(1) The taxpayer owns an interest in the item of property;

(2) Substantially all of the property is held out for rent; and

(3) No significant value-enhancing services (within the meaning of paragraph (f)(5)(ii)(B) of this section) remain to be performed.

(B) In this case, X disposes of the property within 12 months of the date X commenced using the building in a rental activity. Accordingly, an amount of X's gross rental activity income for 1994 equal to X's net rental activity income from the building for 1994 is treated under this paragraph (f)(5) as gain that is not from a passive activity.

Example (3). The facts are the same as in Example 2, except that at the time X acquires the building it is 60 percent leased. Under paragraph (f)(5)(iii)(C) of this section, lease-up is not considered a service performed for the purpose of enhancing the value of property if more than 50 percent of the property is leased on the date the taxpayer acquires an interest in the property. Therefore, additional lease-up performed by X is not taken into account under this paragraph (f)(5). Since X's activities do not otherwise involve the performance of services for the purpose of enhancing the value of the building, none of X's gross rental activity income from the building will be treated as income that is not from a passive activity under this paragraph (f)(5).

General Treatment of Self-rented Property

The self-rented property regulations prohibit using net income from the rental of property to offset other passive losses if the property is rented for use in a trade or business in which the taxpayer materially participates (other than certain development activities) [**Reg. 1.469-2(f)(6)**]. However, rental income pursuant to a written, binding contract entered into before February 19, 1988, is not subject to the income recharacterization rules [**Reg. 1.469-11(c)(1)(ii)**]. See *Kucera* for more on a written binding contract.

Caution: These rules recharacterizing passive income into nonpassive income apply only if the rental activity generates net income. If the rental activity produces a loss, it retains its passive character.

Example: Robin is an investor in a limited partnership that has produced annual losses averaging $10,000 over the past few years; he does not have passive income to offset these losses. Robin materially participates and is sole shareholder in his trucking business, which is an S corporation. He is considering personally purchasing a building to house and repair trucks. Robin would then rent this property to his trucking business for use as an additional shop, thereby creating (he hopes) passive income on his Form 1040 which can offset the passive loss from the limited partnership.

Robin's idea to generate passive income would not work. A taxpayer involved in renting property to a trade or business in which he owns an interest and materially participates must recharacterize the net rental income from the property to nonpassive status. Thus, Robin's net passive rental income would be zero and the passive losses from the limited partnership would continue to be suspended under the PAL rules.

Caution: Recharacterization cannot be avoided by combining a self-rental activity generating income with other rental activities that generate passive losses as a single economic unit. The self-rental activity generating net income must be removed from the passive loss calculation before any grouping is considered (*Carlos*).

Note: Self-rented property is treated as a nonpassive activity if it produces net income but a passive activity if a net loss results. Thus, a taxpayer could end up with a suspended passive loss for the activity if it produces a net loss over a period of years. Under the former passive activity rules, however, an activity with suspended passive losses that later is treated as a nonpassive activity can utilize the suspended losses against the activity's nonpassive net income [**IRC Sec. 469(f)(1)**]. In other words, the recharacterization rules only prevent taxpayers from using income from self-rented property to absorb losses from other passive activities. It does not prevent taxpayers from offsetting income and losses from such property against each other, regardless of when generated.

Planning Tip: Taxpayers can minimize the effect of not being able to offset income of self-rental property with other passive loss property by identifying opportunities to minimize the losses generated by the passive activities, for example reducing debt that generates interest deductions, increasing rents that

affect revenue, etc. Additionally, taxpayers could group the self-rental entity with a business activity if there is identical ownership and if the taxpayer participates in the business activity, or if the rental activity is insubstantial in relation to the business activity [**Reg. 1.469-4(d)(1)**]. (See Examples **16A-3** and **16A-4**.) Once grouped, if the owner materially participates in the business, the rental activity is no longer treated as passive. However, the taxpayer must meet the material participation requirements for each taxable year.

Rental to C Corporations

When **Reg. 1.469-2(f)(6)** was first issued and for several years thereafter, it was unclear whether leasing property to a C corporation in which the taxpayer materially participated was subject to the recharacterization rule. However, final regulations in **Reg. 1.469-4** state that a taxpayer's activities subject to **IRC Sec. 469** include those conducted through a C corporation. Several decisions have specifically upheld the application of this regulation to a lease arrangement involving a C corporation as tenant [***Connor*** and ***Krukowski*** (affirmed by the 7th Circuit); ***Sidell*** (affirmed by the 1st Circuit); ***Schwalbach***, ***Shaw***, and ***Beecher*** (affirmed by the 9th Circuit); ***Senra***]. Accordingly, an individual who owns property that is leased to any entity (whether a partnership, S corporation, or C corporation) in which that individual materially participates will find that the net rental income is recharacterized as nonpassive income.

According to the IRS Passive Activity Audit Guide, net rental income from a closely held C corporation is subject to recharacterization as nonpassive income. Thus, the IRS has directed its examiners to look for these rental arrangements during audits and review them for proper application of the recharacterization rules.

#2-Ground Rents Rule — Analysis

Net income from rental property is not considered passive if less than 30% of the unadjusted basis of the property is depreciable [**Temp. Reg. 1.469-2T(f)(3)**]. Instead, it is considered portfolio income.

Caution: This rule recharacterizing passive income into portfolio income applies only if net income occurs. If the activity produces a loss, it retains its passive character.

Example: Bill purchased a vacant lot for $40,000 and constructed a storage shed on it for $10,000. During the current year, Bill leased the property to a trucking company to park its trailers and use the shed for storage. Bill had net income from the rental property of $3,000. Since this was a rental activity, Bill assumed the $3,000 was passive income that could be offset by passive losses from limited partner interests he owns.

Since less than 30% of the unadjusted basis of the property is depreciable ($10,000/$50,000 = 20%), the activity's net income is treated as portfolio income. Therefore, Bill cannot offset this income with passive losses.

Preparation Pointer: Bill must report the net rental income on Schedule E; the recharacterization rule prevents using the $3,000 net income on Form 8582 to compute allowable passive activity losses. But, rentals of nondepreciable property characterized as portfolio income may allow the taxpayer to claim additional investment interest expense deductions, since investment interest is deductible to the extent of net investment income (which includes portfolio income) [**Reg. 1.469-2(f)(10)**].

If real property is subject to recharacterization in the year it is sold, gain from the disposal is also subject to recharacterization. For the recharacterization rule to apply, the activity must be treated as a rental activity under the Section 469 rules. If one of the rental exceptions applies the activity is not subject to this recharacterization rule; instead, the passive or nonpassive nature of the activity depends on the taxpayer's participation.

#3-Property Rented Incidental to a Development Activity — Analysis

Property Rented Incidental to a Development Activity

Another recharacterization rule applies to income from property rented incidental to a development activity. Rental of property by a developer for less than 12 months is recharacterized from passive income to business income for purposes of the passive activity loss rules [**Reg. 1.469-2(f)(5)**]. Losses are not affected by the recharacterization rule.

Tab #7

The "active participation" rules

$25,000 offset for rental real estate activities....IRC 469(i)
Active Participation....469(i)(6)

SNAPSHOP SUMMARY – ACTIVE PARTICIPATION

1. Active rental real estate losses of up to $25,000 may be deducted in full by anyone who has modified adjusted gross income less than $100,000 (and after ignoring a list of various deductions).
2. It is phased out at the rate of $.50 for every dollar above the $100,000 threshold. So, it completely phases out at MAGI of $150,000.
3. It is not available to taxpayers filing MFS who live together at any time during the year (IRC Sec. 469(i)).
4. Active Participation – what it is
   a. Much less stringent than the material participation rules.
   b. There are no specific hour requirements, like under the material participation rules.
   c. Taxpayers are deemed to be actively participating as long as they participate in management decisions in a bona fide sense. The must exercise independent judgment and not simply ratify the actions of a manager/management company.
   d. Participation of the spouse may be counted in meeting the standard. IRC Sec. 469(D).
5. Active Participation – what it is NOT
   a. Limited partners, statutorily, do not meet the active participation standard. IRC Sec. 469(6)(C).
   b. Anyone owning less than a 10% ownership in the activity at any time during the year does not meet the active participation standard. IRC Sec. 469(6)(A).
   c. Active participation is not met if losses are from an entity under a net lease. This is not defined in IRC Sec. 469. However, according to the IRS Passive Activity Audit Guide, a net lease is a lease arrangement where the tenant pays most or all of the expenses. Drawing from the definition found in pre-1986 law concerning investment interest, the Guide states that a net lease exists when (1) deductions (other than interest, taxes, and depreciation) are less than 15% of gross rents, or (2) the lessor is guaranteed a specific return or against loss of income.
   d. Some vacation rentals have an average period of customer use which is 7 days or less, which means they pass one of the 6 exceptions and are, thus, NOT a rental activity. This means no $25,000 allowance!

$25,000 Rental Real Estate Exception

A special favorable exception for rental real estate activities may allow the first $25,000 of net passive losses from such activities to be deducted against the taxpayer's nonpassive income when the taxpayer actively participates in the activity [**IRC Sec. 469(i)**]. When married taxpayers file separately, the allowance is $12,500 per taxpayer if the couple lived apart for the entire year; otherwise, the allowance is zero if they did live together during the year.

The $25,000 allowance is phased out for taxpayers with higher AGIs. The amount is reduced by 50% of the amount by which the taxpayer's modified AGI exceeds $100,000 ($50,000 for married taxpayers filing separately). Accordingly, as a taxpayer's modified AGI increases from $100,000 to $150,000, the $25,000 allowance decreases from $25,000 to zero.

Active Participation Requirement. To qualify for the $25,000 allowance, the taxpayer must *actively participate* in the rental activity during the tax year the loss is incurred. The taxpayer must also have at least a 10% (by value) ownership interest in the activity at all times during the tax year, and this interest may generally not be that of a limited partner [**IRC Sec. 469(i)(6)(A)**].

The active participation standards are much less stringent than the material participation standards. Active participation does *not* require regular, continuous, and substantial involvement in the operations. Instead, the taxpayer must participate in a significant way, such as making management decisions or arranging for others to perform services (e.g., repairs) for the rental activity. Management activity qualifying under the active participation test includes approving new tenants, setting rental policies and terms, and approving capital expenditure or repair decisions (***Madler***).

Example: Active participation: managing the property.
Dean lives in New York but owns a rental property in Chicago. He receives all rent through the mail and has not been to Chicago to see the rental property for more than a year. If problems occur or repairs are needed, he hires someone in Chicago to perform the work. Dean continues to set the policy on rentals and approves tenants when vacancies occur. Because Dean owns at least 10% of the rental activity, makes all management decisions, and provides for others to perform services for the property in his absence, he actively participates even though he does not visit the property.

Example: Active participation: silent partner fails the test.
Dave and Kevin are equal shareholders in an S corporation that owns an apartment building in Minneapolis. Dave lives in Minneapolis; Kevin lives in Los Angeles. Dave makes all management decisions for the rental property. He inspects it on a regular basis and collects all rent. Kevin has had no involvement whatsoever with the property since he invested in it several years ago. Both Dave and Kevin meet the ownership test under **IRC Sec. 469(i)(6)**. However, since Kevin has had no contact with the property and makes no management decisions, he does not actively participate in the property. Dave actively participates in the property as he makes all management decisions. Consequently, Dave can deduct up to $25,000 of his share of S corporation losses against his nonpassive income, but Kevin's S corporation losses are considered passive.

Example: $25,000 rental loss allowance phase-out.
Ted acquired an apartment building in the current year. Because of vacancies during remodeling, he incurred a $35,000 loss in the current year. Ted is not a real estate professional and has no other passive activities. He actively participates in operating the building. His current year income before any passive loss limitation consists of the following:

Form W-2 wages	$ 20,000
Schedule C proprietorship	100,000
Schedule E rental loss	(35,000)
IRA deduction	(2,000)
SE tax deduction	(5,825)
Tentative AGI	$ 77,175

The $25,000 rental realty loss allowance is reduced by 50% of the amount by which modified AGI exceeds $100,000. Modified AGI (MAGI) is AGI computed without regard to any (1) passive loss deductions, (2) IRA deductions, (3) taxable social security and railroad retirement benefits, (4) income exclusion for interest on U.S. Series EE or I bonds used for higher education, (5) income exclusion for employer-provided adoption assistance, (6) deduction for interest on higher education loans, (7) deduction for qualified tuition and related expenses, (8) the Section 199 domestic production activities deduction, or (9) rental real estate losses considered nonpassive because the taxpayer is a real estate professional who materially participates in the activity [**IRC Sec. 469(i)(3)(F)**].

Preparation Pointer: The IRS instructions for Form 8582, Part II, line 7 (regarding the definition of "modified AGI") state that modified AGI is also computed without regard to the deduction allowed under **IRC Sec. 164(f)** for half of the SE tax, thus reducing the amount of loss allowed for taxpayers with modified AGIs in the phase-out range. However, this position has no support in the Code or regulations. It is possible that with a certain set of facts (i.e., the taxpayer has AGI in the phase-out range, a passive rental loss, a passive income activity subject to SE tax, or a passive loss activity subject to SE tax but with a loss less than the SE income from the other activity), the computation of a taxpayer's modified AGI may become a circular equation, and thus the IRS method is required to compute modified AGI. For most taxpayers, however, this will not be the case. In the authors' opinion, the deduction for SE tax should be allowed in computing modified AGI since there is no authority for the IRS position. Practitioners using tax preparation software should determine how the software is calculating modified AGI and consider overriding the computation if necessary (with the client's concurrence), after full discussion with the client about possible increased audit risk.

Ted's current year modified AGI is computed as follows:

	Based on the IRS Instructions	**Based on IRC Sec. 469(i)(3)(F)**
Tentative AGI	$ 77,175	$ 77,175
Addback:		
IRA deduction	2,000	2,000
Passive rental loss	35,000	35,000
SE tax deduction	5,825	—
Modified AGI	$ 120,000	$ 114,175
Allowable rental loss:		
[$25,000 – 50% ($120,000 – $100,000)]	$ 15,000	
[$25,000 – 50% ($114,175 – $100,000)]		$ 17,913

Following the IRS instructions requires Ted to defer an additional $2,913 ($17,913 – $15,000) of his rental loss (i.e., 50% of his $5,825 SE tax deduction).

Planning Tip: When a taxpayer's modified AGI is between $100,000 and $150,000 and the $25,000 allowance is limited, consider ways to reduce modified AGI. Depreciation methods, the Section 179 deduction, a Keogh, SEP, or SIMPLE IRA plan contribution, certain accounting method elections, and a health savings account contribution are examples of strategies to consider.

Net Lease Property. Typically, it will be difficult for taxpayers to demonstrate active participation in a net lease property, since such an arrangement transfers the operating expenses (and thus any related work) from the owner to the tenant. The owner's only obligation is usually to pay the interest and taxes on the property.

The term *net lease* is not defined under **IRC Sec. 469**. However, according to the IRS Passive Activity Audit Guide, a net lease is a lease arrangement where the tenant pays most or all of the expenses. Drawing from the definition found in pre-1986 law concerning investment interest, the Guide states that a net lease exists when (1) deductions (other than interest, taxes, and depreciation) are less than 15% of gross rents, or (2) the lessor is guaranteed a specific return or against loss of income. A net lease rental activity in which the taxpayer cannot establish active participation is detrimental when the activity incurs a net loss (the loss is not eligible for the $25,000 loss allowance). However, if the activity generates net income (which is often the case in net lease arrangements), net lease classification may be beneficial. The income from the net lease property can be used to offset other passive losses without affecting a taxpayer's use of the $25,000 rental loss allowance on other qualifying properties. But, because a net lease is a rental subject to the passive loss rules, it is not considered investment property for the limitation on investment interest expense [S. Rept. No. 99-841 (PL 99-514), p. II-154].

Observation: The IRS Passive Activity Audit Guide directs auditors to look for Schedule E rental activities with no deduction other than interest or taxes, or few other expenses—indicators that the property may be net leased, and thus potentially failing the active participation test. The Audit Guide is for internal training purposes only and its contents cannot be relied on or cited as authority for setting or sustaining a technical position. Nevertheless, the Guide is indicative of the IRS position on passive activity issues.

Example: Net lease property.
George leases an office building to an unrelated tenant. Under the lease arrangement, the tenant must pay the operating costs of the building. George is not involved in approving capital expenditure or repair decisions, although he did approve the tenant and negotiate the rental terms.

This is a rental activity because none of the exceptions to the rental activity definition (see discussion earlier in this key issue) apply. During the year, the only expenses George incurred were for interest, taxes, and depreciation. If this is a net lease arrangement, George will have a

difficult time establishing that he actively participates in the activity [S. Rept. No. 99-33 (PL 99-515), p. 738].

Since George's deductions (other than interest, taxes, and depreciation—the only deductions he has) are less than 15% of gross rents, this could be considered a net lease arrangement. Therefore, George may not be able to establish active participation and thus may not be eligible for the $25,000 rental realty allowance. However, he probably can pass the test if he can arrange with the tenant to take a more active role in making capital expenditure and repair decisions, even though he does not pay for these costs.

IRS Code Section 469(i)

(i) $25,000 offset for rental real estate activities.

(1) n general.

In the case of any natural person, **subsection (a)** shall not apply to that portion of the passive activity loss or the deduction equivalent (within the meaning of **subsection (j)(5)**) of the passive activity credit for any taxable year which is attributable to all rental real estate activities with respect to which such individual actively participated in such taxable year (and if any portion of such loss or credit arose in another taxable year, in such other taxable year).

(2) Dollar limitation.

The aggregate amount to which **paragraph (1)** applies for any taxable year shall not exceed $25,000.

(3) Phase-out of exemption.

(A) In general. In the case of any taxpayer, the $25,000 amount under **paragraph (2)** shall be reduced (but not below zero) by 50 percent of the amount by which the adjusted gross income of the taxpayer for the taxable year exceeds $100,000.

(B) Special phase-out of rehabilitation credit. In the case of any portion of the passive activity credit for any taxable year which is attributable to the rehabilitation credit determined under **section 47** , **subparagraph (A)** shall be applied by substituting "$200,000" for "$100,000".

(C) Exception for commercial revitalization deduction. Subparagraph (A) shall not apply to any portion of the passive activity loss for any taxable year which is attributable to the commercial revitalization deduction under section 1400I.

(D) Exception for low-income housing credit. **Subparagraph (A)** shall not apply to any portion of the passive activity credit for any taxable year which is attributable to any credit determined under **section 42** .

(E) Ordering rules to reflect exceptions and separate phase-outs. If **subparagraph (B)** , **(C)** , or **(D)** applies for a taxable year, **paragraph (1)** shall be applied—

(i) first to the portion of the passive activity loss to which subparagraph (C) does not apply,

(ii) second to the portion of such loss to which **subparagraph (C)** applies,

(iii) third to the portion of the passive activity credit to which **subparagraph (B)** or **(D)** does not apply,

(iv) fourth to the portion of such credit to which **subparagraph (B)** applies, and

(v) then to the portion of such credit to which **subparagraph (D)** applies.

Caution: Code Sec. 469(i)(3)(F), following, was amended by P.L. 107-16, EGTRRA. These provisions generally sunset for tax years beginning after 12/31/2012. For specific sunset provisions, see Sec. 901, P.L. 107-16 (as amended) reproduced in history notes for this Code Sec.

(F) Adjusted gross income. For purposes of **this paragraph** , adjusted gross income shall be determined without regard to—

(i) any amount includible in gross income under **section 86** ,

(ii) the amounts excludable from gross income under **sections 135** and **137** ,

(iii) the amounts allowable as a deduction under **sections 199** , **219** , **221**, and **222**, and

(iv) any passive activity loss or any loss allowable by reason of **subsection (c)(7)** .

(4) Special rule for estates.

(A) In general. In the case of taxable years of an estate ending less than 2 years after the date of the death of the decedent, **this subsection** shall apply to all rental real estate activities with respect to which such decedent actively participated before his death.

(B) Reduction for surviving spouse's exemption. For purposes of **subparagraph (A)** , the $25,000 amount under **paragraph (2)** shall be reduced by the amount of the exemption under **paragraph (1)** (without regard to **paragraph (3)**) allowable to the surviving spouse of the decedent for the taxable year ending with or within the taxable year of the estate.

(5) Married individuals filing separately.

(A) In general. Except as provided in **subparagraph (B)** , in the case of any married individual filing a separate return, **this subsection** shall be applied by substituting—

(i) "$12,500" for "$25,000" each place it appears,

(ii) "$50,000" for "$100,000" in **paragraph (3)(A)** , and

(iii) "$100,000" for "$200,000" in **paragraph (3)(B)** .

(B) Taxpayers not living apart. **This subsection** shall not apply to a taxpayer who—

(i) is a married individual filing a separate return for any taxable year, and

(ii) does not live apart from his spouse at all times during such taxable year.

(6) Active participation.

(A) In general. An individual shall not be treated as actively participating with respect to any interest in any rental real estate activity for any period if, at any time during such period, such interest (including any interest of the spouse of the individual) is less than 10 percent (by value) of all interests in such activity.

(B) No participation requirement for low-income housing, rehabilitation credit, or commercial revitalization deduction. **Paragraphs (1)** and **(4)(A)** shall be applied without regard to the active participation requirement in the case of—

(i) any credit determined under **section 42** for any taxable year,

(ii) any rehabilitation credit determined under **section 47** , or

(iii) any deduction under section 1400I (relating to commercial revitalization deduction).

(C) Interest as a limited partner. Except as provided in regulations, no interest as a limited partner in a limited partnership shall be treated as an interest with respect to which the taxpayer actively participates.

(D) Participation by spouse. In determining whether a taxpayer actively participates, the participation of the spouse of the taxpayer shall be taken into account.

Tab #8

Real Estate Professional

Tax Action Memo®

TAM-1424
July 13, 2010

Election Statement Required to Aggregate Rentals and Thereby Escape PAL Rules

Type of Clients: Individuals who own rental real estate **Situation:** In general, the PAL rules limit current tax deductions for rental real estate losses. **Deadline:** Before year-end	**Tax Action Required:** Read this release to get up to speed on how the real estate professional exception to the PAL rules works, then get with affected clients to help them lock in eligibility.

Background

In general, an individual's rental real estate activities automatically fall under the dreaded passive activity loss (PAL) rules. For most folks, the only escape hatch is the well-known $25,000 exception for small landlords. [See IRC Sec. 469(i).] However, the small landlord exception is phased out for higher-income taxpayers, and many clients are ineligible. Rats!

Fortunately, individuals who devote significant time to real estate endeavors may qualify for another exception that allows them to treat some or all of their rental real estate losses as *nonpassive* losses. [See IRC Sec. 469(c)(7).] We will call taxpayers who are eligible for this exception *real estate professionals.* These folks can currently deduct their nonpassive rental real estate losses against income from all other sources (salary, self-employment income, capital gains, dividends, interest, alimony, and so on), assuming no other tax-law limitation (such as the Section 465 at-risk rules) prevents that favorable outcome. Great! But there are details that must be respected.

The rest of this release is a primer on how the real estate professional exception to the PAL rules works. Please pay special attention to what we say about how to make (and how *not* to make) the special aggregation election that might be needed to ensure your client's eligibility for the exception. Please also focus on what your client can do with his or her time between now and year-end to lock in eligibility.

Four Steps to Determine Client's Eligibility for the Real Estate Professional Exception

Use the following four steps to determine if your client qualifies—or could qualify by taking action between now and year-end—for relief from the PAL rules under the real estate professional exception.

1. Evaluate each real property trade or business activity (including rental real estate) to determine if the client materially participates in that activity. For this purpose, real property trades or businesses include any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trades or businesses. [See IRC Sec. 469(c)(7)(C) and Reg. 1.469-9(b)(2).]

2. Determine if the client has made a substantial enough time commitment to real property trades or businesses in which he or she materially participates to be considered a real estate professional. If not, the client may be able to devote more time between now and year-end to get over the hump.

3. If the client fails to clear both of the above hurdles, he or she will not be considered a real estate professional and will therefore be ineligible for the real estate professional exception. So the third step is to "try again" (if necessary) by electing to aggregate all of the client's rental real estate activities into a single unit for purposes of passing the material participation and substantial time commitment tests. For this purpose, rental real estate interests *cannot* be combined with other activities such as real estate development. It's important to remember that failing to make the aggregation election for one tax year does not preclude making the election in a later year. [See Reg. 1.469-9(g).]

   Note: If the client can clear the first two hurdles without having to make the election to aggregate rental real estate activities, that's great. Skip Step 3, and proceed directly to Step 4.

4. Exclude from the PAL rules each rental real estate activity for which the material participation test is passed. Rental real estate activities in which the client fails to materially participate continue to be subject to the PAL rules.

This all sounds pretty easy, but it's not really that simple. Please keep reading for the nitty gritty details.

Step 1: Pass Material Participation Test

To have any hope of qualifying for relief from the PAL rules under the real estate professional exception, the client must first meet the material participation standard for one or more trades or businesses within the broad overall category of real property trades or businesses. This means passing one or more of the following material participation tests listed in Temp. Reg. 1.469-5T(a):

1. *More Than 500 Hours Test.* The taxpayer participates in the activity for more than 500 hours during the tax year in question.

2. *Substantially All Participation Test.* The taxpayer's participation in the activity for the year constitutes substantially all the participation by all individuals (including those who are not owners of interests in the activity).

3. *More Than 100 Hours Test.* The taxpayer participates in the activity for more than 100 hours during the year in question, and no other individual participates more than the taxpayer.

4. *Significant Participation Activity (SPA) Test.* The activity is a SPA (a term of art under Temp. Reg. 1.469-5T) in which the taxpayer participates for more than 100 hours during the year, and the taxpayer's total participation in all SPAs during the year exceeds 500 hours.

5. *Prior-year Material Participation Test.* The taxpayer materially participated in the activity for any five of the ten immediately preceding years.

6. *Personal Service Activity Test.* The activity is a personal service activity, and the taxpayer materially participated in the activity for any three years before the year in question.

7. *Facts and Circumstances Test.* Consideration of relevant facts and circumstances indicate the taxpayer materially participated in the activity on a regular, continuous, and substantial basis.

Generally, tests 1, 2, and 3 are the easiest to pass. For purposes of passing any of these material participation tests, married individuals can count participation by their spouses, whether or not a joint return is filed. [See IRC Sec. 469(h)(5) and Temp. Reg. 1.469-5T(f)(3).] Also, each interest in rental real estate is

treated as a *separate* activity unless the taxpayer elects to aggregate all rental real estate interests into a single activity (more on that later) [See Reg. 1.469-9(e).]

Example 1: Passing the material participation test.

Will and Jen are married. During 2010, they both work as self-employed real estate brokers. During the year, Will works full-time (1,800 hours), and Jen works part-time (550 hours). They also spend 75 hours each (combined total of 150 hours) on a rental property they own. Assume their work comprises most of the work done on that property. Under these facts, Will and Jen materially participate in both the brokerage activity (under the 500-hour test) and the rental real estate activity (under the 100-hour test) for 2010.

Step 2: Meet Time Commitment Thresholds

To clear this second hurdle, the client must meet the tax-law definition of a real estate professional by showing that:

1. *More than* 50% of his or her personal services during the tax year were performed in real property trades or businesses in which he or she materially participates, and

2. *More than* 750 hours of personal services were performed in real property trades or businesses in which he or she materially participates.

Personal services in real property trades or businesses means any work (other than in the capacity as an investor) in those activities *including* management work connected with rental real estate activities. [See Reg. 1.469-9(b)(4) and (e)(3)(ii).] However, personal services performed as an employee only count as personal services performed in a real property trade or business when the employee is also a more-than-5% owner of the employer. [See Reg. 1.469-9(c)(5).]

So, to qualify for the real estate professional exception, the client must spend the majority of his or her working hours in real property trades or businesses in which he or she has a more-than-5% ownership interest (to meet the 50% rule), *and* the client must be more than just a "dabbler" in real estate (to meet the 750-hour rule). For example, a client who renders 2,000 hours of personal services in all types of activities during the year must spend more than 1,000 hours in real property trades or businesses. A client who renders only 700 hours of personal services of all kinds during the year cannot qualify under any circumstances.

For married joint-filing couples, one (or both) of the spouses must *individually* meet both the 50% and 750-hour rules. [See IRC Sec. 469(c)(7)(B) and Reg. 1.469-9(c)(4).] Put another way, time spent by spouses cannot be combined to pass the 50% test or the 750-hour test (even though time spent by spouses *can* be combined to meet the material participation standard for purposes of Step 1).

Observation: For individuals with full-time jobs outside real estate, the 50% rule is just as likely to cause problems as the 750-hour rule. However, in cases where the first spouse works full-time outside real estate and the second spouse doesn't, it may be possible to structure the second spouse's time to pass both the 50% test and the 750-hour test. In fact, it may even be possible to arrange for this to happen between now and year-end. Remember: when one spouse manages to pass both the 50% and 750-hour tests, both spouses are considered to pass, provided a joint return is filed. (See Examples 3 and 4.)

Example 2: Passing the 50% and 750-hour tests.

Assume the same facts as in Example 1. Will separately meets the time commitment thresholds for real property trades or businesses in which he materially participates. Jen does not, because she spends less than 750 hours in real estate trades or businesses in which she materially participates (she has only 625

hours). However, since Will and Jen file jointly, Will's participation qualifies them for the beneficial real estate professional exception. Good!

Example 3: Material participation alone isn't enough.

During 2010, Julio spends 1,500 hours in his law practice, 500 hours as an employee of his real estate brokerage business (he owns 25% of the firm), and 75 hours on a rental property which he owns. His wife Anna spends 600 hours as an employee of the same brokerage business and 125 hours on the rental property. Assume their work comprises most of the work done on the rental property during the year. Julio and Anna file jointly. Under these facts, they materially participate in both the brokerage and rental real estate activities. However, since neither spouse passes the 750-hour test, the real estate professional exception is unavailable.

But if Anna could manage to spend 626 hours in the brokerage business (just 26 more hours between now and year-end), she would qualify as a real estate professional. Why? Because she would then have 751 hours in real estate trades or businesses in which she materially participates (626 from the brokerage plus 125 from the rental property), and that would represent 100% of her personal-service hours for the year. The couple's rental real estate activity would then be classified as nonpassive—which is the whole idea here. This is the sort of thing we mean by year-round tax planning!

Example 4: Passing all the tests.

Same basic facts as Example 3, but now assume that Julio spends 1,500 hours in his law practice, 100 hours in the real estate brokerage business, and 60 hours each on three rental properties which he owns. Anna spends 600 hours in the brokerage business, and she also spends 60 hours on each of the three rental properties. Assume the couple's work on the rental properties comprises most of the work done on each of them during the year. Under these facts, the couple materially participates in the brokerage business (under the 500-hour rule) and in all three of the rental activities (under the 100-hour rule). Anna passes the 50% and 750-hour tests, because she spends 100% of her personal service hours in real estate and those hours add up to 780 (600 + 60 + 60 + 60). Thanks to the real estate professional exception, the three rental properties are treated as three separate nonpassive activities. Great!

Step 3: If Necessary, Aggregate Rental Real Estate and Try Again

This step is best illustrated by yet another example.

Example 5: Electing to aggregate rentals.

Phil and Ashley are married and file jointly. During 2010, Phil spends 2,200 hours in his medical practice. The couple also owns interests in 26 rental real estate properties. Each spouse spends 10 hours managing each property (total of 260 hours for each spouse). In addition, Ashley spends 600 hours in her self-employed real estate brokerage business. Under these facts, Ashley materially participates in the brokerage business. However, since each rental real estate property is viewed separately for PAL purposes, the couple doesn't pass any of the material participation tests for any of them. So the real estate professional exception is unavailable to Phil and Ashley, and all their rental properties are subject to the dreaded PAL rules.

However, if Phil and Ashley elect to aggregate all their rental properties and treat them as a single unit, they can meet the material participation test (under the 500-hour rule) because they spend a combined 520 hours. As a result, Ashley will now pass the 50% and 750-hour tests. Why? Because she now spends a total of 860 hours in real estate trades or businesses in which she materially participates (600 hours from the brokerage business plus 260 from the aggregated rental properties), which represent 100% of her personal-service hours during the year. Now the couple can currently deduct all their rental real estate losses under the real estate professional exception. Wonderful!

Step 4: Exclude Rental Losses from PAL Rules

Assuming the client qualifies for the real estate professional exception, he or she must now identify the rental real estate activities in which he or she materially participates. He or she can then deduct the losses from those activities without regard to the dreaded PAL rules. However, any rental real estate activities in which the client *doesn't* materially participate will remain under the PAL rules.

As stated earlier, each interest in rental real estate is considered a separate activity *unless* the election is made to aggregate *all* rental real estate interests and treat them as a single activity. If the election is made, the combined interests are treated as a single activity for *all* purposes under the PAL rules. [See Reg. 1.469-9(e)(1).] In other words, the combined interests are treated as a single activity under the Section 469(g) complete-disposition rule and under the Section 469(f) rule for former passive activities.

Don't Overlook the Downside of the Aggregation Election

The biggest potential negative associated with making the aggregation election is the adverse impact it may have under the Section 469(g) complete-disposition rule. Specifically, all the suspended passive losses allocable to the electing taxpayer's now-aggregated rental real estate interests cannot be "freed up" under the complete disposition rule until after the taxpayer unloads substantially all of the interests. [See Reg. 1.469-4(g).] For this reason, when the client has significant suspended passive losses allocable to certain properties that are likely to be sold in the relatively near future, it may be prudent to defer making the aggregation election until after the sales are made.

Also, when one or more of the rental real estate interests is a limited partnership interest, making the election will subject the entire now-aggregated bunch of interests to the stricter material participation standards for limited partnership interests. However, this nasty little provision doesn't apply when the limited partnership interests generate less than 10% of the gross rental income from all of the client's rental real estate interests for the year. [See Reg. 1.469-9(f)(2).]

The aggregation election is also inadvisable when the client's rental real estate interests throw off overall passive income rather than losses. Passive income is always good, and combining the client's interests could result in the income becoming nonpassive. This may not do any harm, but it generally can't do any good either.

Finally, when the client's rental real estate interests throw off an overall passive loss which can be offset by passive income from other sources, there's no need to make the aggregation election.

Once made, the election applies to all future years in which the client qualifies as a real estate professional. The election is irrevocable unless there's a material change in the client's facts and circumstances. Becoming the victim of unintended or unfavorable tax outcomes as a result of making the election doesn't count as such a change. [See Reg. 1.469-9(g)(2).]

Bottom Line: The aggregation election makes sense only when it "converts" passive losses that would otherwise be suspended under the PAL rules into currently deductible nonpassive losses. Even then, the client must carefully consider any potential negative effects under the complete-disposition rule and/or the limited partnership rule.

How to Make the Aggregation Election

The election is made by including a statement in the original (not amended) return for a year in which the taxpayer is eligible for the real estate professional exception. As mentioned earlier, not making the election in one year in which the taxpayer is eligible does not preclude making the election in a later year. [See Reg. 1.469-9(g)(1).] The following statement will suffice:

> Taxpayer qualifies for relief from the passive activity loss limitation provisions under the special exception for taxpayers in real property businesses. Therefore, taxpayer hereby elects to treat all rental

real estate activities as a single (aggregated) activity pursuant to Section 469(c)(7)(A) and Reg. 1.469(g)(3).

How *NOT* to Make the Election

According to the Tax Court, the rental real estate aggregation election requires an affirmative tax return statement like the one we just provided. Simply aggregating income and expenses from several rental properties on the taxpayer's Schedule E will not do the trick. The Tax Court has reached this conclusion in three different decisions, two of which came out this year.

- In its 2000 *Kosonen* decision, the Tax Court stiffed a taxpayer who claimed he had effectively made the aggregation election by showing all his rental real estate losses as being currently deductible on Schedule E. The Tax Court concluded that an affirmative election statement was required to take advantage of the aggregation election privilege.

- In its 2010 *Trask* decision, the Tax Court opined that simply aggregating rental property income and expenses on Schedule E does not constitute a valid aggregation election. A tax return statement is required.

- In the even-more-recent 2010 *Shiekh* decision, the Tax Court again opined that aggregating rental property income and expenses on Schedule E does not amount to an election. A tax return statement is required.

Three strikes and you're out folks. Please keep the election statement requirement in mind at tax preparation time, because it's no use trying to buck the system here.

Note: As illustrated by Ltr. Rul. 200728016, the IRS may allow a late aggregation election, under Reg. 301.9100-3, when: (1) the taxpayer is able to show that he or she acted reasonably and in good faith and (2) granting an extension of time to make the missed election does not prejudice the government's interests. However, the taxpayer must request relief via the private letter ruling process, which is an expensive and uncertain drill. Better to simply get it right the first time by making the election in the original return for the year in question.

Conclusions

Taken together, the real estate professional exception and the rental real estate aggregation election can amount to a sweet tax-saving deal for clients who fit the profile. Of more importance at this very moment is the fact that some clients may be able to take action between now and year-end to qualify as real estate professionals for 2010. Then, if an aggregation election is necessary, don't fail to include the required *election statement* in the client's 2010 return. Ditto for 2009 returns that have not yet been filed.

One last thing: given the likelihood that tax rates will go up for higher-income clients in 2011 and beyond, don't reflexively make the aggregation election with 2010 returns (or with yet-to-be-filed 2009 returns) without due consideration. While making the election can accelerate deductible losses, that might not be advisable in all cases.

References:

IRC Sec. 469.
Kosonen, Matti, TC Memo 2000-107 (2000).
Trask, Donald, TC Memo 2010-78 (2010)
Shiekh, Anjum, TC Memo 2010-126 (2010).
Ltr. Rul. 200728016.

Subscriber Note: This *Tax Action Memo* was written by Tax Action Panel member William R. Bischoff, CPA of Colorado Springs, Colorado.

Key Issue 16H: Real Estate Professionals.

Real estate professionals may treat otherwise passive rental real estate activities as nonpassive if the taxpayer materially participates in the rental activity. Losses from such activities can be used to offset wages, interest, and other nonpassive income. This treatment is only available to eligible individual taxpayers and closely held C corporations who are considered to materially participate in the rental real estate activity. An individual is an eligible taxpayer for any tax year if [IRC Sec. 469(c)(7)(B)]:

1. more than 50% of personal services performed by the taxpayer in all trades or businesses during the tax 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 service during the tax year in real property trades or businesses in which the taxpayer materially participates. This criteria requires actual performance of services. The Tax Court disallowed a taxpayer's "on call" and "willing to work" hours to count towards this 750-hour requirement (*Moss*).

Both of these criteria require material participation (see later discussion).

Note: Hours spent managing short-term rental property (averaging less than seven days rental) does not qualify for the 750-hour test because short-term rental property is trade or business property (see Key Issue 16E) governed by material participation rules and not rental activity property for this test (*Bailey*).

Warning: Practitioners should be aware that the treatment of rental real estate income and loss as active rather than passive is not an election. There may be times when the treatment of rental real estate income and loss as active income is required. While treating rental activities as nonpassive is generally advantageous if the activity produces a loss, it may be a disadvantage if the activity generates income and the taxpayer has passive activity losses from other sources. Then, the rental activity's income cannot be offset by the passive losses.

Defining Real Property Trades or Businesses

A *real property trade or business* is broadly defined to include real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage [IRC Sec. 469(c)(7)(C)]. Reg. 1.469-9(d) provides that a facts and circumstances test applies in determining the taxpayer's real property trades and businesses and that any reasonable method may be used in applying that test.

To be eligible for these special rules, the taxpayer must materially participate in real property trades or businesses rather than participate in business activities involving real estate transactions. This suggests that the benefits of these rules may be unavailable to individuals who are only peripherally involved in real property trades and businesses.

Although real estate agents are engaged in regular sales of real property, most states prohibit them from acting as brokers without a license. Even after issuance of the regulations, it was unclear if the term *brokerage* in the Code's definition of eligible businesses limits eligibility to those who are licensed brokers or instead refers more broadly to the general activity of real estate sales. However, in the *Agarwal* case, the Tax Court held that a licensed real estate agent's activities counted towards satisfying the real estate professional's exception to the passive activity rules, even though the agent was not a broker under state law. The Court determined that under the Section 469 rules, the term *broker* has its common or ordinary meaning and includes any person whose activities include (1) selling, exchanging, purchasing, or leasing real property; (2) offering to do those activities; (3) negotiating the terms of a real estate contract; (4) listing real property for sale, lease, or exchange; or (5) procuring prospective sellers, purchasers, lessors, or lessees. Similar to the *Agarwal* case, in *Fitch* the taxpayer's spouse was a licensed real estate agent and qualified as a real estate professional after satisfying the two tests. Therefore, it appears real estate agents should

qualify for the benefits of IRC Sec. 469(c)(7) (assuming they satisfy the more-than-50% and more-than-750-hours tests).

If a taxpayer is trying to qualify as a real estate professional on the basis of a rental real estate business with multiple rental real estate interests and he has a job unrelated to those activities, which takes up a substantial amount of time, it may be impossible to qualify as a real estate professional without making the election to treat all rental real estate interests as a single activity (the election is explained later in this key issue). Because real estate trades or businesses that satisfy the real estate professional rules require the taxpayer to materially participate, the taxpayer must show material participation in each rental activity for that activity to help in satisfying the 50% and 750-hour requirements.

Example 16H-1: Defining real property trades or businesses.

Tom, a lawyer, spends 85% of his time working on real estate legal matters. His brother, Dick, spends 92% of his time in the real estate mortgage business. Both spend more than 750 hours in their respective businesses during the year. Each has several rental properties that have substantial losses each year. It appears that neither can treat the rental losses as nonpassive since neither is involved in a real property trade or business as defined by the Code, even though each spends a substantial amount of time dealing with real property (real estate legal and mortgage activities do not count as real estate trades or businesses). Taxpayers in businesses that fall into this category (which probably also includes real estate appraisers and inspectors) should be careful to document their participation and continue to monitor IRS activity in this area.

Observation: In its Passive Activity Audit Guide, the IRS uses the example of an attorney or accountant specializing in real estate as being someone who is *not* in a real estate trade or business. Although taxpayers and practitioners can make determinations of real property trades or businesses using any reasonable method of applying the facts and circumstances, it appears the IRS will disallow situations where the taxpayer is not directly involved with the real estate business.

Example 16H-2: Qualifying to treat rental real estate activities as nonpassive.

Biff is a general partner in Bluffview Partners and Mountainview Partners, two calendar-year partnerships formed to own and rent office buildings. He is the sole general partner in each of the partnerships and employs a small staff of legal, accounting, and maintenance personnel. Biff spends approximately 600 hours per year performing services for each of the partnerships (total of 1,200 hours); he performs no other personal services for any other business. Biff's share of each partnership's rental real estate losses for the year is $20,000 (total of $40,000).

More than 50% of the time Biff spends on all trade or business activities during the year is spent in real property trades or businesses in which he materially participates—in fact, 100% of his time is spent on those activities. Biff also spends more than 750 hours on real property trade or business activities in which he materially participates during the year. Biff is considered to materially participate in each of the two partnership activities under the 500-hour rule. (See discussion of material participation later in this key issue.) Therefore, Biff meets both the requirements for treating the $40,000 of partnership losses as currently deductible nonpassive losses.

Preparation Pointer: If income or loss is nonpassive, the taxpayer reports the net amount on Schedule E and does not report it on Form 8582. Also, the total net income or loss from all activities (reported anywhere on Form 1040) treated as nonpassive under these rules is reported on page 2 of Schedule E, line 43. No special forms or statements are necessary to take advantage of the special rule for rental real estate activities of real estate professionals. However, see "Election to Combine Rental Real Estate Activities" later in this key issue.

Material Participation by Real Estate Professionals

Material participation plays a role in two distinct aspects of the relief provision for real estate professionals. First, when determining whether a taxpayer qualifies as a real estate professional, only real property trades or businesses in which the taxpayer materially participates are counted for purposes of the 50% and 750-hour tests [IRC Sec. 469(c)(7)(B); Reg. 1.469-9(c)(3)]. Second, once it is determined that a taxpayer qualifies as a real estate professional, the nonpassive treatment is available only for *rental* real estate activities in which the real estate professional materially participates [Reg. 1.469-9(e)(1)]. Thus, a taxpayer must

pass *two* material participation hurdles before a rental activity receives nonpassive treatment.

The material participation standards under these special relief rules are the same as those otherwise applicable to passive activities [Reg. 1.469-9(b)(5)]. (See Key Issue 16B.) Thus, the taxpayer is considered to have materially participated in an activity if he meets one of the seven tests (or three tests for a limited partner interest) outlined in Key Issue 16B for that activity. A rental real estate activity may not be grouped with any nonrental real estate activity for purposes of determining material participation in that rental real estate activity [Reg. 1.469-9 (e)(3)]. When determining material participation in rental real estate activities, each interest of the taxpayer in a rental real estate activity is treated as a separate activity [IRC Sec. 469(c)(7)(A)(ii)]. (The taxpayer can elect to treat all interests in rental real estate activities as a single activity [Reg. 1.469-9(e)(1)]—see the discussion later in this key issue.)

Example 16H-3: Determining eligibility for real estate professional rules when nonrental real estate activities are involved.

Assume the same facts as in Example 16H-2, except (a) Mountainview was formed to develop and rent an office building, (b) Biff spent 460 hours on the development activity and 140 hours on the rental activity, and (c) Biff had an assistant who spent more hours than he did on each of the activities.

Biff cannot group Mountainview's development and rental real estate activities together because a rental real estate activity may not be grouped with a nonrental real estate activity under the material participation guidelines. Therefore, he fails to meet the material participation test for either activity. (See Key Issue 16B.) Thus, the 460 hours he spends on the development activity and the 140 hours he spends on the rental activity are not considered when determining whether he is an eligible real estate professional. Although he meets the material participation test for Bluffview's rental real estate activity, the 600 hours of material participation at Bluffview do not satisfy either the 50% or the 750-hour test. As a result, he fails to qualify as an eligible real estate professional and all of the partnership losses are passive.

Note: A rental real estate activity may be grouped with a business activity if the grouping constitutes an appropriate economic unit and (1) the rental activity is

insubstantial in relation to the business activity or (2) each owner in the business activity has the same proportionate ownership interest in the rental activity, in which case, the portion of the rental activity involving rental of items to the business activity may be grouped with the business activity. (See Key Issue 16A.) However, an activity so grouped is not considered a rental real estate activity for the real estate professional rules [Reg. 1.469-9(b)(3)].

Observation: It may be physically impossible for a real estate professional to materially participate in a property if that property has a separate manager. The real estate professional would fail the test of "being the only person involved" and also presumably would not have enough activity to meet the 500-hour material participation test.

Treatment of Services Performed by Spouse. For married couples, the 50% and 750-hour tests are satisfied only if one spouse individually satisfies the tests (or if both individually satisfy the tests). However, for determining material participation in an activity, the existing rules apply—allowing participation by one spouse to count as participation for the other spouse [IRC Sec. 469(h)(5); Reg. 1.469-9(c)(4)]. Therefore, a married couple is eligible to take advantage of the special rule for real estate professionals if, during the tax year, *either* spouse materially participates in the rental real estate activity, and one spouse performs more than 50% of his or her personal services and more than 750 hours in real estate trades or businesses in which he or she materially participates. This rule applies regardless of whether the spouses file a joint return [Reg. 1.469-9(c)(4)].

Example 16H-4: Determining eligibility when both spouses have real estate trade or business activities.

Adam and Ann are married and file a joint tax return for the year. Adam is a partner in two partnerships. He is a 50% partner in a CPA firm that accounts for about 75% of his total work hours (1,950 hours). He spends about 25% of his work hours (650 hours) performing services for Property Appreciation Partners (PAP), a general partnership in which he is a 50% partner (and in which he materially participates). PAP owns and operates residential rental real estate properties. Ann also operates two businesses. She is a 25% partner in an interior design firm that accounts for 50% of her work hours (550 hours) and a 50% partner in a property management firm (in which she materially participates) that

accounts for the other 50% of her time (550 hours). Can Adam and Ann treat their rental real estate losses from PAP as nonpassive because of their participation in real estate activities?

No. To take advantage of the special rule for reclassifying rental real estate income or loss as nonpassive, at least one spouse must meet the 50% and 750-hour tests individually. For the year, neither Ann nor Adam individually spends more than 50% of his or her total work hours and more than 750 hours on real estate trades or businesses in which he or she materially participates. Hours spent by each spouse on real estate trades or businesses cannot be combined to qualify for eligibility for the special rule.

Example 16H-5: Using material participation by a spouse to qualify for nonpassive loss treatment.

Ben and Beth are married and file a joint tax return for the year. Ben owns 75% of H&J Partners, a general partnership that brokers commercial real estate properties. Ben spends 70% of his working hours—about 700 hours per year—working for H&J. He also spends 210 hours per year performing services for the local Chamber of Commerce. Ben owns a 10% interest in Mansfield Apartments Partners (MAP), a general partnership owning and leasing residential apartments. He spends about 90 hours per year performing services for MAP. Beth works part-time—about 10 hours per week (520 hours per year) as an apartment manager for MAP (which also has full-time employees). During the year, Ben is allocated a rental loss from MAP of $15,000. Can Ben and Beth deduct the $15,000 loss from MAP as a nonpassive loss on their return?

Yes. The first step is to determine whether Ben is a real estate professional. He meets the test because he spends more than 50% of his total trade or business service hours and more than 750 hours working in real estate trades or businesses in which he materially participates. He works 700 hours in the brokerage business and 90 hours in the apartment business, for a total of 790 hours. He can include the 90 hours he spends working for MAP because, although he does not individually materially participate in the activity, he is deemed to materially participate (under the 500-hour rule) after considering the 520 hours his spouse, Beth, spends on the activity.

Next, to treat the MAP rental loss as nonpassive, Ben must materially participate in that activity. Again, Beth's participation can be considered

for this test, so Ben and Beth's combined participation in MAP is 610 (90 + 520) hours, which qualifies as material participation. Therefore, Ben and Beth can deduct the $15,000 loss as nonpassive on their tax return since Ben qualifies as a real estate professional and together they materially participate in MAP.

Special Rule for Employees

When applying the 50% and 750-hour tests, the personal services of an employee are not treated as performed in a real estate trade or business unless he has more than a 5% ownership (direct or indirect ownership under the attribution rules of IRC Sec. 318) interest in the employer [IRC Sec. 469(c)(7)(D)(ii); *Pungot*]. If an employee is not a 5% owner in the employer at all times during the tax year, only the personal services performed during the period of 5% ownership are considered [Reg. 1.469-9(c)(5)]. This provision apparently is designed to prevent employers in real estate trades or businesses from compensating employees with tax losses. An employee is considered a more-than-5% owner if he or she owns more than 5% of (1) a corporation's outstanding stock, (2) total combined voting power of all issued corporate stock, or (3) capital *or* profits interest of a partnership.

Election to Combine Rental Real Estate Activities

Once it is determined a taxpayer qualifies as a real estate professional, then nonpassive treatment is available only for rental real estate activities for which the taxpayer materially participates. In order to meet the material participation standard, a taxpayer can elect to treat *all* interests (including limited partner interests) in rental real estate activities as a single activity. This election can be made in any year the special real estate professional rules apply. However, once the election is made, it is irrevocable unless there is a material change in the taxpayer's facts and circumstances [Reg. 1.469-9(g)]. The election must be made by the taxpayer to be effective. Simply grouping activities together and reporting the losses as nonpassive is not sufficient (*Kosonen*; *May*; *Trask*; *Shiekh*). Furthermore, the election must be made on an original return and cannot be made on an amended return (*Schumann*). See Election E602 for further discussion.

Note: Rev. Proc. 2010-13, which requires taxpayers to disclose activities that have been grouped together or kept separate for PAL purposes, has no application to the special real estate rental grouping election for real estate professionals available under Reg. 1.469-9(g). Rev. Proc. 2010-13 applies only to groupings of businesses, groupings of rentals, and groupings of a business and a rental. (See Key Issue 16A.)

Under Rev. Proc. 2011-34, taxpayers can obtain relief for a late election to combine all interests in rental real estate and treat them as one activity. Prior to Rev. Proc. 2011-34, taxpayers had to request relief for late elections through the private letter ruling process. To qualify for relief under Rev. Proc. 2011-34, the taxpayer must have reasonable cause for failing to meet the original election requirements (including a statement explaining the reason for such failure) and must have timely filed all tax returns as if the election had been made. The taxpayer must file an election statement that (1) contains the declaration required by Reg. 1.469-9(g)(3), (2) explains the reason for the failure to file a timely election, (3) identifies the tax year for the election, and (4) contains specific declarations and representations required in Sections 4.01 and 4.02 of Rev. Proc. 2011-34, accompanied by a dated declaration signed by the taxpayer under penalties of perjury. See Election E602 for more information and a sample late election.

If this election is made, material participation is determined for the combined activity as a whole. Generally, if any of the taxpayer's rental real estate activities are held in limited partnership interests, the combined activity is treated as a limited partnership. Accordingly, the taxpayer is considered to materially participate in the combined activity only if he meets one of the three tests applicable to limited partnership interests outlined in Key Issue 16B [Reg. 1.469-9 (f)(1)]. However, if less than 10% of the taxpayer's share of gross receipts from rental real estate activities comes from limited partnership interests, the combined activity is not treated as a limited partnership interest. In this case, the taxpayer is considered to have materially participated in the combined activity if he meets any one of the seven tests outlined in Key Issue 16B [Reg. 1.469-9(f)(2)].

Example 16H-6: Election to combine rental real estate activities.

George is a general partner in a partnership formed to develop and rent office buildings. He is the sole general partner but employs a staff of full-time accounting, leasing, and construction personnel. During the year, he spent approximately 1,500 hours on the development activity and 400 hours on the rental activity. His share of the loss from the rental activity was $20,000. George also owns three small apartment complexes, each with its own resident manager. George spends approximately 75 hours per year managing each complex. Losses incurred on each of the complexes for the year were $5,000. George performs no other personal services.

With or without this election, George will qualify as a real estate professional eligible for the special relief rules, as his participation in the development activity meets both the 750-hour and 50% tests. However, without the election, George does not materially participate in any of the rental real estate activities because he does not pass any of the seven tests outlined in Key Issue 16B. Therefore, all of the rental real estate losses remain passive. If George makes the election, material participation in the rental activities is determined for the combined group. In this case, he will have spent approximately 625 hours [400 hours + (75 hours × 3 complexes)] on the combined rental activity and thus will have materially participated in it. Consequently, George can treat the combined loss of $35,000 [$20,000 + ($5,000 × 3 complexes)] as nonpassive.

Note: Only George's participation in the rental real estate activities may be used to determine if he materially participates in them. The 1,500 hours he spent on the development activity are not counted, even though they are closely associated with one of the rental real estate activities [Reg. 1.469-9(e)(3)].

The election to combine rental real estate activities may be crucial in allowing some taxpayers to meet the material participation tests or to meet the real estate professional requirements. However, the decision to make the election will need to be made on a case-by-case basis. The following factors should be considered before making this decision.

1. Suspended losses from years before the real estate professional rules apply to the taxpayer are treated as losses from a former passive activity. Any such losses remaining when the entire activity is disposed of in a fully taxable transaction are deductible in the year of disposition. (See the discussion of suspended losses in Key Issues 16D and 16J.) However, if the election is made, the combined rental real estate activity is treated as a single activity for all purposes of IRC Sec. 469, including the disposition rules under IRC Sec. 469(g) [Reg. 1.469-9(e)(1)]. Thus, suspended losses cannot be deducted until all (or substantially all) of the activities have been disposed of. (See Key Issue 16D.) Suspended losses related to partial dispositions are generally not deductible until the remainder of the combined group has been disposed of.

2. If the election is made and 10% or more of the taxpayer's share of gross receipts from rental real estate activities comes from limited partner interests, the combined activity is treated as a limited partner interest. The limited partner material participation tests are harder to pass than the regular material participation tests. (See Key Issue 16B.) Thus, it is possible for an electing taxpayer to fail the material participation tests for the combined activity, even though he could have passed the material participation tests for individual nonlimited partnership activities if the election had not been made.

3. If the taxpayer has net income from rental real estate activities in which he or she does not materially participate, keeping the passive status for those activities will allow that passive income to offset other passive losses. However, if the election is made, and the taxpayer materially participates in the combined group, the net income or loss from the combined group (including the otherwise passive income) is nonpassive.

Observation: The aggregation election only makes sense when it converts passive losses that would otherwise be suspended because of insufficient passive income into nonpassive losses. Even then, the potential downside effects under the disposition rule and the limited partnership rule discussed earlier must be considered. Furthermore, combining rental activities does not mean the combined activity is reported on one Schedule E or Form 8825 but rather that reporting each rental property separately is still appropriate.

Rental Real Estate Activities Held in Pass-through Entities

When a taxpayer holds rental real estate activities via pass-though entities (partnerships and S corporations), he is bound by the entity's grouping of the activities when he holds less than a 50% interest in the entity [Reg. 1.469-9(h)(1)]. When a taxpayer's interest in the entity is 50% or more, each rental real estate interest held by the entity is treated as a separate interest of the taxpayer regardless of how the entity groups the interests [Reg. 1.469-9(h)(2)]. In either case, if a qualifying taxpayer elects to combine rental real estate activities, the election includes those held through pass-through entities. The election is made at the individual level.

Coordination with $25,000 Allowance for Rental Real Estate

Taxpayers who actively participate in rental real estate activities can potentially offset against nonpassive income up to $25,000 of otherwise passive rental real estate losses from such activities. The $25,000 allowance is reduced by 50% of the amount by which the taxpayers' modified AGI exceeds $100,000. (See Key Issue 16E.) In computing modified AGI for this purpose, rental real estate losses treated as nonpassive under the real estate professional exception are not considered—that is, the losses must be added back to the taxpayers' AGI [IRC Sec. 469(i)(3)(F)(iv)].

Observation: This rule applies when a real estate professional who has rental real estate losses in which he or she materially participates and that he or she deducts as nonpassive also has rental real estate losses in which he or she actively (but not materially) participates. (See Key Issue 16E.) It also applies when a real estate professional has suspended loss carryovers from former passive activities that qualify for the $25,000 rental real estate allowance.

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1408 Passive Losses of Real Estate Professionals

1408.1 There is a special exception to the passive activity loss (PAL) rules for taxpayers engaged in real property trades or businesses [IRC Sec. 469(c)(7)]. If a taxpayer meets eligibility requirements indicating material participation in real property trades or businesses, the PAL rules do not apply. As a result, losses from such activities can offset nonpassive income (i.e., salary, interest, and dividends).

1408.2 The regulations interpreting this provision include an important election for combining activities. (See the discussion beginning at paragraph 1408.17.)

1408.3 **Warning:** Practitioners should be aware that the treatment of rental real estate income and loss as active rather than passive is not an election. There may be times when the treatment of rental real estate income and loss as active income is required, even though that treatment is detrimental to the taxpayer.

Qualifying Taxpayers

1408.4 Taxpayers qualify for the special relief provision of IRC Sec. 469(c)(7) in any tax year during which they perform more than 750 hours of personal services (and more than half of their total personal service hours for the year) in real property trades or businesses in which they materially participate. For a couple filing a joint return, one spouse must individually satisfy both the more than 50% of total personal service hours and the more than 750 hours of personal services test with respect to the rental real estate [IRC Sec. 469(c)(7)(B) and *Oderio*]. The existing rules for determining material participation in an activity apply to determine material participation for this purpose. (See the discussion beginning at paragraph 1404.14 for more on the material participation rules.) Accordingly, participation by one spouse (even if it does not rise to the level of material participation) is treated as participation by the other spouse for the purposes of

determining if the second spouse materially participates in an activity [IRC Sec. 469(h)(5); Reg. 1.469-9(c)(4)]. This concept is illustrated in Example 14-14.

Example 14-14: Personal service and material participation tests.

Ben and Beth Hodge file a joint return for the current year. Ben owns a 75% interest in H&J Partners, a general partnership that brokers commercial real estate properties. Ben spends 70% of his working hours—about 1,400 hours per year—as a broker for H&J Partners. Beth works part-time (about 600 hours per year) as an apartment manager for Mansfield Apartments Partnership (MAP), a general partnership that owns and leases residential apartments. Ben owns a 10% interest in MAP and is allocated a $15,000 rental loss from the partnership. The Hodges deduct the $15,000 loss as a nonpassive loss on their current year return. Ben spends more than 750 hours (and more than half of his total working hours for the year) in a real property trade or business (H&J Partners) in which he materially participates. Although he does not materially participate in MAP, he is allowed to take Beth's material participation into account. Consequently, they together materially participate in MAP and can claim the $15,000 loss as nonpassive.

1408.5 In CCA 201244017, the IRS held that a trust could not qualify as a real estate professional because only individuals could perform personal services. However, in *Aragona*, the Tax Court determined that a trust, which held and developed rental and other real estate properties, qualified for the IRC Sec. 469(c)(7) exception for real estate professionals and was not subject to the PAL limitations. The Court found that the services performed by the individual trustees on behalf of the trust were considered personal services performed by the trust.

1408.6 The IRS has indicated in the Passive Activity Loss ATG that it will be very difficult for a taxpayer to prove material participation if there is on-site management because:

a. Rental activities, by nature, normally do not require significant day-to-day involvement, i.e., they are not time intensive.

b. For many taxpayers using any kind of outside management, the only material participation test available is the 500-hour test. In many situations, the other tests will not apply.

c. In many circumstances, an individual rental activity will not require 500 hours of participation, nor will the taxpayer have sufficient time available to spend 500 hours on each individual rental real estate activity.

1408.7 Reg. 1.469-9(e)(3)(i) provides that a qualifying taxpayer may not group a rental real estate activity with any other activity of the taxpayer for determining material participation under the real estate professional exception. For example, if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or construction activity.

1408.8 A court decision (*Bailey*) held that hours spent on a property held by a taxpayer that had an average period of customer use of less than seven days (a rental lake cabin in this case) could not be combined with hours spent on real estate trades or business to determine whether the 750-hour test was met. The court held the property was not a rental activity, or a *rental real estate activity*, and therefore could not be included in the taxpayer's election to treat all interests in rental real estate as a single rental real estate activity. Another court decision (*DeGuzman*) held that hours spent by a husband taking care of a property his wife used in her medical practice were not spent in a real property trade or business since the hours were put in voluntarily and the property was leased from a third party. The court noted that the taxpayer did not perform the services for profit, but rather provided the services gratuitously in a desire to aid his wife. Similarly, in the *Hoskins* case, the Tax Court held that a taxpayer's activities as a real estate sales associate were separate from his activity as the owner of residential real estate properties, precluding the taxpayer from combining the hours spent in the two activities to qualify under the 750-hour test. See also the *Gragg* case, where there was a similar result.

1408.9 In *Moss*, the Tax Court determined that the time a taxpayer spends "on call" does not count toward meeting the 750-hour test. The taxpayer unsuccessfully argued that he was "on call" for the rental properties for all of the hours that he was not working at his regular job. See also *Harnett*, *Ani*, and *Hill* where the Tax Court questioned noncontemporaneous records of taxpayers' participation in rental activities where the taxpayers also held time-consuming non-real estate positions. These cases are in contrast to the *Miller* case where a marine pilot who worked as a contractor on the side and kept contemporaneous time sheets with detailed information about his activities was treated as a qualifying real estate professional. In addition to the detailed records, there was additional testimony regarding the taxpayer's extraordinary "work ethic."

1408.10 **Planning Tip:** For individuals with full-time jobs outside real estate, the

50% rule is just as likely to cause problems as the 750-hour rule. However, in cases where the first spouse works full-time outside real estate and the second spouse does not, it may be possible to structure the second spouse's time to pass both the 50% test and the 750-hour test. Practitioners should also consider aggregating rental activities when the spouses participate in more than one such activity. However, the aggregation election makes sense only when it converts passive losses that would otherwise be suspended under the PAL rules into currently deductible nonpassive losses. Even then, the client must carefully consider any potential negative effects of aggregating the activities as described beginning at paragraph 1408.23.

1408.11 For the IRC Sec. 469(c)(7) relief provision, personal services performed as an employee are not treated as performed in a real property trade or business unless the employee owns more than 5% of the employer for the entire year [IRC Sec. 469(c)(7)(D)(ii); Reg. 1.469-9(c)(5)]. A closely held C corporation qualifies for IRC Sec. 469(c)(7) relief if more than 50% of its gross receipts for the year are from real property trades or businesses in which it materially participates [IRC Sec. 469(c)(7)(D)(i); Reg. 1.469-9(c)(2)].

1408.12 **Planning Tip:** If clients have significant participation in real estate trades or businesses, practitioners may want to consult them at the beginning of the fourth quarter each year to see if a small increase in participation will qualify the clients for the exception for real estate professionals.

Real Property Trade or Business Defined

1408.13 A real property trade or business is broadly defined to include real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage [IRC Sec. 469(c)(7)(C)]. The regulations provide that a *facts and circumstances* test applies to determine a taxpayer's real property trades and businesses, and that any reasonable method may be used in making this determination [Reg. 1.469-9(d)]. However, the regulations fail to address whether certain types of business are considered real property trades or businesses.

Example 14-15: Real property trade or business.

Tom, a self-employed lawyer, spends 90% of his time working on real estate legal matters. His brother, Dick, spends 100% of his time in the real estate mortgage brokerage business working for a firm in which he is a 50% owner. Both spend more than 750 hours in their respective businesses during the year. Each has several rental properties that have substantial losses each year.

Although the issue is still unsettled, it appears the brothers' participation in business activities involving real estate transactions does not qualify as participation in a real property trade or business even though both spend a substantial amount of time dealing with real property (see paragraph 1408.16). Taxpayers in businesses that fall into this category (which probably also includes real estate appraisers and inspectors) should be careful to document their participation and continue to monitor IRS activity in this area.

1408.14 The recent *Bailey* case clarified that hours spent on short-term rentals do not count as hours spent on a real property trade or business under the 750-hour test. In this case, the court held that when a taxpayer spends time on a real estate property that the taxpayer rents for periods averaging less than seven days, that property is no longer a rental activity. Therefore, the taxpayer must exclude or disregard the time he or she spent on the property for purposes of counting hours for the 750-hour IRC Sec. 469(c)(7)(B)(ii) test to be a real estate professional.

1408.15 It is clear that taxpayers engaged in financing activities (e.g., mortgage brokers) do not qualify for the real estate professional relief provision—nor do attorneys and accountants who deal with real estate transactions. However, it was unclear if real estate agents who were not brokers qualified for the exception. In *Agarwal*, the Tax Court held that a licensed real estate agent's activities counted towards satisfying the real estate professional's exception to the passive activity rules, even though the agent was not a broker under state law. The court determined that under the IRC Sec. 469 rules, the term *broker* has its common or ordinary meaning and includes any person whose activities include (a) selling, exchanging, purchasing, or leasing real property; (b) offering to do those activities; (c) negotiating the terms of a real estate contract; (d) listing real property for sale, lease, or exchange; or (e) procuring prospective sellers, purchasers, lessors, or lessees. See also the *Fitch* case where a licensed agent who worked as an independent contractor for a real estate firm was considered a real estate professional.

1408.16 **Observation:** Individuals such as electricians, plumbers, and other subcontractors may qualify under the construction or reconstruction portion of the real property trade or business definition. Based on the Code's definition of a real property trade or business, it seems clear these individuals should qualify; however, this might be a situation where a letter ruling would be appropriate (when the dollars involved justify the cost of requesting one). Absent additional IRS guidance, many taxpayers and their advisers will be faced with applying this provision *using any reasonable method of applying the facts and circumstances* to determine the taxpayer's real property trades or businesses.

Election to Combine Rental Real Estate Activities

1408.17 In accordance with IRC Sec. 469(c)(7)(A), the regulations provide an election allowing qualifying taxpayers to treat all rental real estate activities (including those held as limited partnership interests) as a single activity, regardless of how the activities were treated in prior years. The election can be made in any year in which the special real estate professional rules apply to the taxpayer. The election cannot be made on an amended return. (See Appendix 14D for a sample election.) Once made, the election generally is irrevocable unless there is a material change in the taxpayer's facts and circumstances [Reg. 1.469-9 (g)(3)]. [Note that the Tax Court in *Kosonen* held that a taxpayer must actively elect to aggregate rental real estate activities under this rule, and that merely reporting the activities on a tax return as if the election had been made was *not* an election. Similarly, in *Shiekh*, the Tax Court concluded that the taxpayer's consolidation of the properties for reporting on Schedule E (Supplemental Income and Loss) on his Form 1040 was not a de facto election to treat them as a single activity.] Under the regulations, the fact that the election is less advantageous to a taxpayer in a tax year is not, of itself, a material change in his facts and circumstances. Similarly, if the taxpayer no longer meets the definition of a *qualifying taxpayer* as discussed in paragraph 1408.4, a material change in his facts and circumstances has not occurred [Reg. 1.469-9(g)(2)].

1408.18 If the election was not made timely on the original return, IRS procedures allow a late election to be made on an amended return with a statement attached as required by Reg. 1.469-9(g)(3) explaining the reason for the failure to file a timely election and including representations that affected tax returns have been filed timely and consistent with the requested aggregation [Rev. Proc. 2011-34].

1408.19 If the election is made, material participation is determined for the combined activity as a whole. Generally, if any of the taxpayer's rental real estate activities are held as limited partnership interests, the combined activity is treated as a limited partnership interest. Consequently, the taxpayer is considered to have materially participated in the combined activity only if one of the three material participation tests applicable to limited partners (see paragraph 1404.18) is satisfied. However, if less than 10% of the taxpayer's share of gross receipts from rental real estate activities comes from limited partnership interests, the combined activity is not treated as a limited partnership interest. In such cases, a taxpayer is considered to have materially participated in the combined activity if any of the seven material participation tests in paragraph 1404.17 are satisfied [Reg. 1.469-9 (f)]. In the recent *Chambers* case, the Tax Court treated the taxpayer's interest in a real estate LLC as a general partner interest where the taxpayer participated in the management of the member-managed LLC. (See the discussion beginning at paragraph 1404.18 for more on the material participation requirements for limited

partners and LLC members.) The following example illustrates the election to combine rental real estate activities.

Example 14-16: Combining rental real estate activities.

George is a general partner in a partnership formed to develop and rent office buildings. He is the sole general partner, but employs a staff of full-time accounting, leasing, and construction personnel. During the current year, he spent about 1,500 hours on the partnership's development activity and 400 hours on the rental activity. His share of the current year losses from the rental activity is $20,000. George also owns three small apartment complexes, each with its own resident manager. George spends about 75 hours per year managing each complex. A loss of $5,000 was incurred on each of the complexes for the current year. Should George make the election to treat all his rental activities as a single activity?

Probably. George qualifies as a real estate professional eligible for the special relief rules because his participation in the development activity meets both the more than 750 hours and more than 50% tests. However, without the election, George does not materially participate in any of the rental real estate activities because he does not pass any of the seven tests discussed in paragraph 1404.17. Without the election, all the rental real estate losses would remain passive.

If George makes the election, material participation is determined for the combined group. Because George has spent about 625 hours [400 hours + (75 hours × 3 complexes)] providing services for the group, he is treated as materially participating in the activity under the *more than 500 hours during the tax year* test. Accordingly, George can treat the combined loss of $35,000 [$20,000 + ($5,000 × 3 complexes)] as nonpassive.

1408.20 In the *Jahina* case, the election to combine rental real estate activities would have aided the taxpayer in deducting rental real estate losses as a real estate professional. In *Jahina*, a taxpayer with a job not related to real estate tried to qualify as a real estate professional on the basis of a rental real estate business with multiple rental real estate interests. The court held that, because of the separate activity rule, the taxpayer had to qualify as a real estate professional (material participation, etc.) for each rental real estate interest unless the taxpayer made the election to combine rental real estate activities.

Interest in Rental Real Estate Held by Partnership or S Corporation

1408.21 Generally, a taxpayer's interest in rental real estate held by a partnership or an S corporation is treated as a single interest in rental real estate if the partnership or S corporation grouped its rental real estate as one rental activity under Reg. 1.469-4(d)(5). If the partnership or S corporation groups its rental real estate into separate activities, each rental real estate activity is treated as a separate activity for the partner or shareholder. However, the partnership's or S corporation's separate activities can be regrouped into one activity at the owner level if elected [Reg. 1.469-9(h)(1)].

1408.22 A special rule applies if a taxpayer holds a 50% or more interest in the capital, income, gain, loss, deduction, or credit of a partnership or S corporation at any time during the tax year. In such case, each interest in rental real estate held by the partnership or S corporation is treated as a separate activity for the taxpayer, despite the partnership's or S corporation's grouping of the activities. The qualifying taxpayer may still elect to treat all interests in rental real estate, including the interest held in the partnership or S corporation, as a single activity [Reg. 1.469-9(h)(2)].

Downside to Making the Aggregation Election

1408.23 The biggest potential negative associated with making the election is the effect on the complete disposition rule under IRC Sec. 469(g). Any combined suspended passive losses allocable to the rental real estate activities will not be *freed up* until there is a disposition of substantially all of the combined interests [Reg. 1.469-4(g)]. If significant suspended passive losses are allocable to individual properties that are likely to be sold in the near future, the taxpayer should probably wait until the tax year *after* the dispositions to make the aggregation election to allow the losses to be deducted.

1408.24 Also, if the election is made and one or more of the rental real estate interests is a limited partnership interest, the entire combined unit is subject to the much stricter material participation standards [see Temp. Reg. 1.469-5T(e)(2)] that apply to limited partnership interests. This may negate the expected benefits of making the election. However, this rule does *not* apply if the taxpayer's share of gross rental income from all the limited partnership interests generates less than 10% of the gross rental income from all of the taxpayer's rental real estate interests for the year [Reg. 1.469-9(f)(2)].

1408.25 The election is also inadvisable if the rental real estate properties are in the aggregate throwing off passive income. Passive income is always good, and combining the interests could result in the income becoming nonpassive. This may do no harm, but neither can it do any good.

1408.26 Finally, if rental real estate properties are in the aggregate throwing off passive losses but those losses are being used to offset passive income from other sources, the election is unnecessary.

1408.27 **Observation:** The aggregation election only makes sense when it converts passive losses that otherwise would be suspended because of insufficient passive income into nonpassive losses. If this happens, the effects of the disposition rule and the limited partnership rule discussed previously must also be considered. Additionally, practitioners should consider that the election is effective at the first of the year for which it is made. Consequently, a taxpayer that is counting on a large passive gain from a property sale made early in the year could see that gain turn into nonpassive income if the election is made.

1408.28 **Regrouping Activities**

As discussed in section 1405, Reg. 1.469-4 defines *activity* for the PAL limitations. This regulation imposes a consistency requirement for the grouping of activities [Reg. 1.469-4(e)]. Generally, once a taxpayer has grouped activities, they cannot be regrouped. However, the regulations provide an exception to this requirement where the original grouping was clearly inappropriate or a material change in facts and circumstances makes the original grouping clearly inappropriate. As noted in paragraph 1405.23, this regrouping must be reported to the IRS.

Suspended Losses

1408.29 When the treatment of a rental real estate activity becomes nonpassive under the real property business rules of IRC Sec. 469(c)(7), any suspended losses for the activity do not suddenly become deductible. Instead, they are treated as suspended losses from a former passive activity [Reg. 1.469-9(e)(2)]. (See section 1411 for a discussion of suspended passive losses.) Suspended losses from a former passive activity are carried forward and are deducted first to the extent the taxpayer recognizes income from the same activity [IRC Sec. 469(f)(1)]. Any remaining suspended passive losses continue to be treated as passive losses. This means they can be used to offset unrelated passive activity income in the same manner as any other suspended passive loss. The suspended losses are also eligible for the special $25,000 rental realty allowance that applies if the taxpayer meets the requirements described in paragraph 1406.14. Otherwise, the suspended losses cannot be used to offset nonpassive income until substantially all of the taxpayer's interest in the activity is disposed of in a fully taxable transaction [IRC Sec. 469(g); Reg. 1.469-4(g)].

1408.30 **Observation:** This last point is the most significant disadvantage of an IRC Sec. 469(c)(7)(A) election. By making the election, substantially all of the

taxpayer's combined group of rental real estate properties (rather than the individual interests) must be disposed of before any unused suspended losses can be claimed against nonpassive income.

Coordination with the $25,000 Offset for Rental Real Estate

1408.31 Taxpayers who actively participate in rental real estate activities can offset up to $25,000 of otherwise passive losses from such activities against nonpassive income [IRC Sec. 469(i)]. This $25,000 offset is reduced by 50% of the amount by which the taxpayers modified AGI exceeds $100,000. As discussed in paragraph 1406.19, for computing modified AGI, losses recharacterized as nonpassive by qualifying taxpayers (based on the more than 50% and more than 750 hours tests) are not considered. That is, losses that have been converted to nonpassive because of the IRC Sec. 469(c)(7) exception must be added back to the taxpayer's AGI to determine modified AGI under the phaseout rule [IRC Sec. 469(i)(3)(F)(iv)].

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