February 25, 2015

Brokers and Lawyers as Real Estate Professionals

By: Ezra Dyckman and Libin Zhang

Prior to the enactment in 1986 of the passive activity loss rules, many doctors and other high-income individuals would invest in tax shelters that generated tax losses, which could be used to offset their other income. The passive activity loss rules prevent taxpayers from deducting their losses from certain "passive" activities against that taxpayer's active income (such as wages) or portfolio income (such as interest and dividends). Real estate rental activities were once treated as per se passive, but an outcry from the real estate industry caused Congress in 1993 to allow certain "real estate professionals" to deduct their real estate tax losses against their interest, dividends, and other income.

Since 2014, real estate professionals have further benefited from their special tax status by not being subject to the 3.8 percent Medicare tax on some of their real estate rental income and capital gains. This article discusses recent guidance from the Internal Revenue Service (IRS) as to who qualifies as a real estate professional.

Material Participation

It is desirable for a taxpayer to have non-passive activities in order for losses from the activities to be usable against wages and other non-passive income. A trade or business activity is considered non-passive for a taxable year only if the individual materially participates in the activity, such as by spending more than 500 hours on the activity during the year. However, nearly all real estate rental activities are considered per se passive activities, regardless of the taxpayer's level of involvement, unless the taxpayer can prove that he is a "real estate professional."

A "real estate professional" must generally (i) spend more than 750 hours during the year in real property trades or businesses in which he materially participates, and (ii) those hours must constitute more than half of his time spent performing all personal services that year. A taxpayer's time spent as an employee of a real property trade or business is disregarded unless the taxpayer also owns more than 5% of the trade or business.

Real property trades or businesses are specifically defined in Code Section 469(c)(7)(C) as "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." Only an individual working in those real property trades or businesses can qualify as a "real estate professional" by working the requisite number of hours in the business.

The 3.8 percent Medicare tax on unearned income in Code Section 1411, effective after January 1, 2014, generally applies to rental income and capital gains from activities in which the taxpayer does not materially participate. Given the special rules for real estate rental activities, only a real estate professional may be exempt from the 3.8 percent Medicare tax on his rental income and capital gains from rental activities in which he is materially participating.

IRS Guidance

In Chief Counsel Advice (CCA) 2015-04-010, the IRS analyzed whether two hypothetical taxpayers could qualify as real estate professionals.[1]

The first taxpayer in the CCA was a state licensed "real estate agent" who brought together buyers and sellers of real property. The taxpayer worked as an independent contractor for a real estate brokerage firm. Despite the taxpayer not being licensed as a "real estate broker" under state law, the IRS concluded that the taxpayer could qualify as a "real estate professional" by virtue of working in the real property "brokerage" trade or business. The common dictionary definition of "broker," as someone who helps other people buy and sell property, is determinative, regardless of state licensure status. As a result, if the taxpayer worked more than 750 hours a year as a real estate agent and those hours constituted more than half of his time spent performing personal services during the year, the taxpayer may qualify as a real estate professional.

The taxpayer's losses from real estate rental activities in which he materially participates may be offset against

***Ezra Dyckman** is a partner in, and **Libin Zhang** an associate of, the law firm of Roberts & Holland LLP.*

the taxpayer's other income, and the taxpayer's income and gains from such real estate rental activities might not be subject to the 3.8 percent Medicare tax.

The second taxpayer in the CCA was a state-licensed mortgage broker who marketed mortgage loans and brought together lenders and borrowers. Although the taxpayer was considered to be engaged in a "real property brokerage business" under state law, the IRS concluded that the taxpayer could not qualify as a "real estate professional" for income tax purposes. The dictionary construction of the term "real property brokerage" involves someone who brings together buyers and sellers of real property, and it does not include the brokerage of financial instruments. Furthermore, an initial draft of the real estate professional legislation had included "finance operations" in the list of real property trades and businesses; the removal of "finance operations" from the final 1993 bill suggested that Congress did not intend for financing activities to constitute a real property trade or business that could lead to real estate professional status.

Though not mentioned in the CCA, the initial version of the real estate professional legislation (H.R. 3732 and S.2384 in 1990) also included "appraisal" in the list of real property trades and businesses, which was removed from the final enacted bill. Therefore, real estate appraisers similarly may not qualify as real estate professionals merely through their appraisal activities.

Lawyers as RE Professionals

The CCA provided some helpful guidance on the definition of real property trades and businesses. One question that might be addressed in future IRS guidance is the type of involvement that a taxpayer must have with a real property trade or business in order to be considered performing services in that trade or business. Specifically, can a real estate lawyer qualify as a real estate professional as a result of his lawyer activities with respect to real estate matters?

For comparison, a real estate leasing broker is involved in the real property leasing trade or business, which is clearly on the approved statutory list. In-house leasing employees would qualify if they own more than 5 percent of the business. It is arguable that a real estate lawyer who drafts and advises on real estate leases should also be able to qualify as a real estate professional if he spends more than half of his time and more than 750 hours a year on the leasing activities. A similar argument may be extended to real estate lawyers who work on condo development deals, property acquisitions, and other real estate operations.

A real estate lawyer who qualifies as a real estate professional may be able to use losses from real estate rental activities against his lawyer income, while his income and gain from the real estate rental activities would not be subject to the 3.8 percent Medicare tax, as long as the lawyer materially participates in the real estate rental activities.

A few taxpayers who lost in court on their real estate professional status have been lawyers, but the judicial decisions did not analyze whether their time spent on legal matters could be considered a real property trade or business.[2] In *Langille v. Commissioner*, T.C. Memo 2010-49, the Tax Court denied real estate professional status to a lawyer who also owned rental real estate, stating that "[t]he record reflects that [the taxpayer] worked long hours in her law office, and there is no evidence that she worked most of those hours on real estate rental activities and not on legal matters."

The U.S. Court of Appeals for the Tenth Circuit on appeal stated in a footnote that Code section 469(c)(7)(C)'s "definition of 'real property trades or businesses' is explicit and does not include the practice of law." However, neither decision analyzed whether the taxpayer may have worked a sufficient number of hours on real estate trades and businesses in her capacity as a legal advisor. It is unclear what type of law the taxpayer specialized in, though she tried to work on at least one foreclosure-related matter according to her (unrelated) Florida bar disciplinary proceedings.[3]

Just as it seemed unfair to Congress that people who work in the real estate industry were penalized by the passive activity loss rules compared to people who work in other industries, it seems unfair that real estate lawyers may be penalized by the passive activity loss rules in comparison to other professionals who work in real estate. While the definition of "real property trades and businesses" does not specifically include real estate legal matters, legal matters were not explicitly removed from an earlier legislative bill in a way similar to financial and appraisal operations. The inquiry into the real estate professional status of each real estate lawyer is undoubtedly a fact-specific enterprise, but the strongest case for such status may apply to lawyers who work closely with real estate clients on development, construction, acquisitions, leasing, and other enumerated real property trades and businesses (but not real estate financings).

[1] CCAs are legal advice issued by the IRS National Office of the Office of Chief Counsel to other IRS personnel. CCAs reveal the IRS's opinion on certain issues but cannot be used or cited as precedent.

[2] See *Bailey v. Commissioner*, T.C. Memo 2001-296; *Ajah v. Commissioner*, T.C. Summary 2010-90.

[3] *Florida Bar v. Birdsong*, 661 So.2d 1199 (Fla. 1995).