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Tax Court Decision Highlights Passive Loss Rules For Real Estate Professionals

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The passive loss rules of the Internal Revenue Code limit the ability of taxpayers to use "passive" losses to offset "active" income. In general, a rental real estate activity is treated as per se passive under these rules. For real estate professionals, however, rental real estate activities may be treated as being active (i.e., can be used to offset non-passive income) if certain requirements are satisfied. A recent Tax Court decision illustrates the circumstances under which a real estate professional's losses from rental real estate will be active or passive and how an election can sometimes make all the difference.

Background

In 1986, Congress enacted Internal Revenue Code section 469 in order to limit a taxpayer's ability to use losses and credits from passive activities to offset active income. Congress was concerned with the growing participation of taxpayers in tax shelters, enterprises in which taxpayers would engage in certain activities to obtain deductions or credits which exceeded the taxpayers' true economic costs from these activities and then would use these deductions or credits to offset salary or other active income. Under section 469, a taxpayer may net losses from passive activities against income from passive activities, but is precluded from using a net passive activity loss to offset active income. Section 469 applies to any individual, estate, trust, personal service corporation, or closely held C corporation (although closely held C corporations are subject to a modified set of rules).

A "passive" activity, in general, is an activity that involves the conduct of a trade or business and in which the taxpayer does not "materially" participate. The Code states that an individual "materially" participates in an activity only if the individual is involved in the operations of the activity on a basis that is "regular, continuous, and substantial." The Treasury Regulations explain that an individual satisfies the material participation requirement with respect to an activity if he meets any one of seven tests, which include (1) participating in the activity for more than 100 hours during the year, if the individual's participation in the activity for the year is not less than the participation in the activity of any other individual and (2) participating in the activity for more than 500 hours during the year (irrespective of the participation of other individuals).

The Code provides that rental real estate activities generally are per se passive, without respect to the individual's level of participation. However, this general rule of per se passive rental real estate losses does not apply to "real estate professionals." The Code defines "real estate professional" as an individual (1) for whom more than half of his personal services performed in trades or businesses are performed in real property trades or businesses in which he materially participates and (2) who performs more than 750 hours of services during the taxable year in real property trades or businesses in which he materially participates. The term "real property trade or business" is defined as "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." If an individual qualifies as a real estate professional, then his rental real estate activities are passive only if he lacks material participation in these activities. In determining whether his participation meets the materiality threshold, each of his interests in rental real estate is generally treated as a separate activity. However, the Code provides for an election pursuant to which all of a real estate professional's interests in rental real estate will be considered to constitute a single activity.

In the case of a joint return, the return is treated as being filed by a real estate professional if either spouse separately qualifies as a real estate professional. The participation of both

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spouses is taken into account together when determining whether the threshold for material participation has been satisfied for a rental real estate activity.

Miller v. Commissioner

In the recent Tax Court decision of *Miller v. Commissioner*,[1] the Tax Court considered a case involving an individual (Mr. Miller) who was both a pilot of commercial seagoing vessels and a general contractor. In addition, he and his wife owned several rental real estate properties. The Millers did not treat losses from their rental properties as passive activity losses and used these losses to offset active income. The IRS determined that the Millers' rental real estate losses for the years at issue were passive activity losses, disallowed the Millers' use of these losses to offset active income, and assessed accuracy related penalties.

The Tax Court determined that, in each of the years in issue, Mr. Miller performed more than 750 hours of services in real property trades or businesses in which he materially participated (including both his time performing construction work as a contractor and his time on his rental real estate activities). The Tax Court also determined that, in each of the years in issue, he spent more time working on his construction work as a contractor and on his rental real estate activities (combined) than he did piloting vessels (i.e., more than half his personal services performed in trades or businesses were performed in real property trades or businesses in which he materially participated). Therefore, Mr. Miller was a real estate professional and the Millers' rental real estate activities were not *per se* passive.

The Tax Court then proceeded to consider whether the Millers materially participated in their rental activities. Since they did not make the election for all of their rental activities to be treated as a single activity, the Tax Court analyzed their participation with respect to each property separately. With respect to two of the rental properties, the Tax Court found that (1) the Millers participated for over 100 hours per year and (2) their participation was not less than the participation of any other individual. As a result, their losses from these properties were not subject to the passive loss limitations of section 469.

With respect to each of the other rental properties, however, the Tax Court found that the Millers failed to show that they participated for more than 100 hours per year and held that their losses from these facilities were passive activity losses. Yet, the Tax Court rejected the IRS's imposition of accuracy-related penalties, holding that the Millers acted with reasonable cause and in good faith in claiming rental real estate losses for the properties with respect to which the losses were disallowed. In so holding, the Tax Court explained that the Millers "provided extensive records of their rental real estate activities, including contemporaneous timesheets" and gave credible testimony, but "simply failed to meet their burden of proof."

Discussion

Unfortunately for the Millers, the fact that Mr. Miller qualified as a real estate professional did not automatically exempt their rental real estate losses from the passive loss limitations of section 469. While his status as a real estate professional did make inapplicable the general rule that a rental real estate activity is per se passive, they still needed material participation in order for their losses not to be passive activity losses. Since the Millers did not make the election for all of their interests in rental real estate activities to be treated as a single activity (the "single activity election"), each of their rental properties was treated as a separate activity. This meant that their losses from each property would be passive unless they met one of the tests for material participation with respect to that property in isolation.

Single Activity Election

What if the Millers had made the single activity election? All of their interests in rental real estate would have been treated as a single combined activity and their rental real estate losses would have been exempt from the passive loss limitations if their participation in the combined activity met the threshold for materiality. Since the Millers spent more than 100 hours participating in rental real estate activities during the years in question, making the single activity election would have caused all of their rental losses to be active if they spent more time on all of the rental activities combined than any other individual. Also, even if they did not spend more time on all of their rental activities combined than any other individual, making the single activity election would have caused all of their rental losses to be active if they spent more than 500 hours participating in rental real estate activities during the years in question (regardless of the participation of any other individuals).

Thus, it seems likely that none of the Millers' losses would have been subject to the passive loss limitations of section 469 if they had made the single activity election, and their failure to make the election likely was an unfortunate oversight on their behalf. It should be noted, though, that there are certain circumstances under which it would be advantageous for a real estate professional to have not made the election. For example, if a real estate professional anticipates having net income from rental activities, he would prefer that his income from these activities would be passive so that this income could be offset by other passive activity losses. This must be taken into account when determining whether to make the single activity election, given that the election can be revoked only if there is a "material change in the taxpayer's facts and circumstances" (which cannot simply be the fact that the election is less advantageous in a subsequent year).

This discussion about the impact of the single activity election on the passive loss rules for real estate professionals highlights a couple of points that may be surprising to some. First, the 750 hours test for qualifying as a real estate professional, which looks to time spent in "real property trades or businesses," includes participation that is

unrelated to rental real estate activities. In the Millers' case, it included the time that he spent both on his rental real estate activities and on his construction work as a general contractor. Thus, the fact that the Tax Court found that Mr. Miller qualified as a real estate professional (which means that he spent at least 750 hours during the relevant years in real property trades or businesses) does not by itself automatically mean that the Millers spent enough hours on all of his rental properties together to meet the material participation threshold. On the other hand, if an individual who makes the single activity election qualifies as a real estate professional, losses from all of his rental activities would be active even if he spent only 100 of his hours participating in these activities, as long as no other individual spent more time on these rental activities. Thus, all of the rental real estate losses of a broker could be nonpassive losses if the broker spends 650 hours selling properties and an additional 100 hours on the rental properties.

Penalties

In addition to the points that *Miller v. Commissioner* raises with respect to passive activity losses for real estate professionals, the case is also noteworthy for its discussion related to penalties. Although the Tax Court held that the Millers failed to prove that they had materially participated in certain of the rental properties in question, it determined that they acted with reasonable cause and in good faith with respect to the understatement and refused to uphold the IRS's assessment of accuracy-related penalties. This finding is noteworthy in light of the fact that, although the IRS must initially come forward with evidence that a penalty is appropriate, a taxpayer bears the burden of proof with respect to a reasonable cause defense to penalties. Thus, the Tax Court determined that the evidence that the Millers presented did not meet their burden of proof to demonstrate that they had materially participated in all of the rental real estate activities, but did meet their burden of proof to demonstrate that they acted with reasonable cause and in good faith with respect to their underpayment of tax.

On what basis did the Tax Court conclude that the Millers acted with reasonable cause and in good faith? It apparently stemmed in part from the Tax Court's conclusion that the Millers presented credible testimony and evidence, but failed to meet their burden of proof. Interestingly, the Tax Court also took into account that it agreed with the Millers with respect to some of their contentions (i.e., that Mr. Miller was a real estate professional and that the Millers materially participated in two of the rental properties). It is not clear exactly how this fact was relevant to the reasonable cause analysis, but it may have been that the Millers having prevailed over the IRS on certain of their contentions contributed toward the Tax Court viewing them in a favorable light. In addition, it is at least possible that the Tax Court's decision to decline to impose penalties was influenced by the Tax Court considering the IRS to have been unreasonable in assessing penalties given that all of the Millers' rental real estate losses would have been active losses but for a mere oversight on their behalf in not making the single activity election.

Conclusion

In sum, *Miller v. Commissioner* provides real estate professionals with a reminder of the inner-workings of the passive activity loss rules and the importance of considering the single activity election, as well as some encouragement from the fact that the Tax Court declined to impose penalties in a case where it technically could have done so.

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[1]. Memo 2011-219.