December 23, 2009

Grouping a Rental Activity Under the Passive Loss Rules

By: Ezra Dyckman and Daniel W. Stahl

In a recent case, the United States Tax Court addressed the grouping of activities under the passive loss rules when one of the activities is a rental activity. The case highlights some of the rules affecting how the passive loss limitations affect real estate owners.

Section 469

In 1986, Congress enacted Internal Revenue Code section 469 to limit a taxpayer's ability to use losses and credits from "passive" activities to offset other 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 use these deductions or credits to offset salary or other income.

Section 469 allows a taxpayer to net losses from passive activities against income from passive activities, but prohibits a taxpayer from using a net passive activity loss to offset active income. Section 469 applies to any individual, estate, trust, closely held C corporation, or personal service corporation. However, a closely held C corporation which is not a personal service corporation is treated differently from other entities to which section 469 applies, in that it may use a net passive activity loss to offset active income (although not portfolio income).

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.[1] An individual "materially" participates in an activity if he meets any one of seven tests in the Treasury regulations (e.g. if the individual participates in the activity for more than 500 hours during the taxable year, or if based on all the facts and circumstances the individual participates in the activity on a "regular, continuous, and substantial basis" during the taxable year).[2] Notwithstanding this definition of a passive activity that applies generally, the Code provides a special rule for rental activities -- in general, any rental activity is a passive activity, without regard to the individual's level of participation.[3]

Definition of an "activity"

The way in which "activity" is defined for purposes of section 469 is often of great significance, since trade or business activities that are grouped together will all be considered to be active if the individual's *aggregate* participation in all of them meets the test for materiality. While the Code does not define "activity," the Treasury Regulations state that one or more activities may be treated as a single activity if the activities constitute an "appropriate economic unit" for the measurement of gain or loss for purposes of section 469. This determination involves a facts and circumstances test, in which the most significant factors are: (1) similarities and differences in types of trades or businesses, (2) the extent of common control, (3) the extent of common ownership, (4) geographical location, and (5) interdependencies between or among the activities.[4] For example, if one partnership conducts a wholesale business and another partnership (under common control) conducts a trucking business that mostly consists of transporting the wholesaler's goods to stores, these two businesses will be considered to be a single activity.

Senra v. Commissioner

In *Senra v. Commissioner*,[5] the Tax Court considered a case in which Carlos Senra was an 86.75% shareholder of a closely held C corporation that was in the business of the retail sale of granite and marble, and both he and his wife were employees of the corporation. In addition, Carlos owned a 100% interest in a single member limited liability company (LLC), a disregarded entity for Federal income tax purposes. The LLC's only business activity was renting a warehouse to the corporation, which the corporation used as a storehouse and a showroom for its inventory. The rental business had net losses in the years in question, and the Senras contended that the two activities constituted an appropriate economic unit and therefore should be grouped. Since the

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

Senras materially participated in the retail activity, they argued that their material participation caused the entire aggregated activity to be active, allowing them to use the losses from the rental activity to offset their wages. The IRS countered that net losses from the rental business could not be used to offset their wages, regardless of whether the two activities constituted an appropriate economic unit.

The Tax Court indicated that, but for a special rule regarding the grouping of activities conducted through a closely held C corporation, it might have agreed with the Senras' analysis. In general, the relevance of grouping activities is that the aggregated activity is active if the taxpayer's combined participation in the aggregated activity is material. A rental activity, though, generally is passive regardless of whether the taxpayer materially participates, so making the Senras considered to have materially participated in the rental activity would not have made the rental losses active. Still, the Tax Court explained, the Treasury Regulations allow, under certain circumstances, for a rental activity to be grouped with a trade or business activity such that the resulting activity would not be per se passive (i.e., it would be active if the taxpayer's combined participation was material). The Tax Court indicated that it considered the Senras' two activities to be an appropriate economic unit. While the Tax Court noted special restrictions which limit the circumstances in which a taxpayer may group a rental activity with a trade or business activity, it did not determine whether the activities in question complied with these requirements because the retail activity was conducted through a closely held C corporation. The Regulations provide that an activity conducted through a closely held C corporation may be grouped with another activity only for purposes of determining whether the taxpayer materially participates in the other activity. Since a rental activity is passive regardless of the taxpayer's participation, the Tax Court held that a rental activity can never become active by being aggregated with an activity which is conducted through a closely held C corporation. Therefore, the Tax Court did not allow the Senras to use their losses from the rental activity to offset their wages.

The Tax Court noted that section 469(c)(7) provides an exception to the per se rule that a rental activity is passive even if the taxpayer materially participates. Section 469(c)(7) applies to taxpayers in the real estate business for whom, during a taxable year, more than half of the personal services performed in trades or businesses, involving more than 750 hours of services, are performed in real property trades or businesses in which the taxpayer materially participates. However, this exception was not applicable to the situation in *Senra*.

Conclusion

The taxpayers in *Senra* lost because of the rule that rental activities are per se passive, regardless of the taxpayer's involvement. However, in many cases, the question of whether activities constitute an appropriate economic unit and may be grouped together is crucial under the passive loss rules. As noted above, aggregation can transform multiple passive trade or business activities into one active activity, by causing an individual's combined participation in all of the activities to be considered for purposes of determining whether his participation meets the threshold for being material. For example, an individual in the hotel business (which is not per se passive) may split his time between various projects. Are they one activity or many? Would it make a difference if some of the projects are luxury resorts and others are economy motels?

Does it matter whether this individual in the hotel business conducts these activities in separate entities? While the intuitive response of many taxpayers would be that a business conducted in a corporation would not be part of the same activity as a business conducted in a partnership, it is important to understand the distinction between entities and activities. Section 469 focuses on activities and not entities, so two businesses conducted in separate entities might be grouped into one activity, while two businesses conducted in the same entity could be separate activities. Although the holding in *Senra* is not surprising, it illustrates the circumstances under which activities may be grouped, underscores the rule that a rental activity is per se passive, and illustrates the significance of aggregation.

---

1 I.R.C. § 469(c)(1).
2 Treas. Reg. § 1.469-5T(a).
3 I.R.C. §§ 469(c)(2); 469(c)(4).
4 Treas. Reg. § 1.469-4(c).
5 2009 T.C.M. (RIA) ¶ 2009-79.