Real Estate Professionals Beware

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We frequently hear the expression "Let the buyer beware." Well, we can draw an analogy from that phrase for certain real estate professionals. These folks are eligible to deduct their rental real estate losses against income from all other sources assuming no other tax-law limitation prevents this favorable outcome, but they should be cautious that they satisfy all the requirements of this special passive activity loss limitation rule (the rule is in the Internal Revenue Code at Section 469(c)(7)).

In a nutshell, to qualify as a “real estate professional" and obtain benefit of the special rule, the individual must:

1) Meet two time commitment thresholds by spending:

   a) More than 50% of work time in real property trades or businesses, and

   b) Over 750 hours/year in real property trades or businesses, and

2) Satisfy a material participation test for each rental real estate activity (or have timely elected to group these activities so as to meet a material participation test).

A 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."

Generally, an individual would want to be a real estate professional to be able to produce active losses from rental real estate that otherwise would be passive activity losses. Passive activity losses are only usable against passive activity income (they cannot be used against wages and investment income).

With this basic background, let's look at a recent case, *Todd D. Bailey, Jr., et ux. v. Commissioner*, TC Summary Opinion 2011-22, where the taxpayer failed to meet the time threshold requirements.

Just the Facts

Todd D. Bailey, Jr. and Pamela J. Bailey were married and filed joint tax returns. Todd, a physician, and his wife Pamela jointly owned three rental properties which Pamela operated personally without employing a management company. Todd did not participate in the rental activities. The summary of Pamela’s hours in her real estate activities for 2004 was as follows:

ACTIVITY	HOURS	RENTAL PERIOD
Alisal Road Inn	324	About 3 days at a time
Second Street property	358	Year-to-year tenants
Existing Boise property	24	Rented for all of 2004
New Boise property	105	Not rented
Researching potential acquisitions	192	
Grand total for all properties	1,003	

Court's Analysis

The wife satisfied the time threshold test of spending more than half of her time in real property trades or businesses. However, the IRS did not find that she performed more than 750 hours of services in "real property trades or businesses" during 2004 considering she made the election to combine all of the rental properties into one activity.

If the wife can include the hours she spent on the Inn, then she easily satisfies the 750-hour time threshold requirement because she spent 1,003 hours on all of her real property trades or businesses for the year. If the hours spent on the Inn do not count, then she does not satisfy the 750-hour requirement and would not qualify as a real estate professional. As a result the net loss from her rental real estate would not be deductible in 2004 as it would be a passive activity loss to be carried forward to future years when she has passive activity income.

The wife argued that the statute and its legislative history allows her to include her hours spent on the Inn, because the statute describes a "real property trade or business" to include any real property rental."

The IRS counter-argued by pointing to a regulation that provides the following exclusion: "an activity involving the use of tangible property is not a rental activity" for a year if, among other reasons, "the average period of customer use for such property is seven days or less" during the year (Reg. Sec. 1.469-1T(e)(3)(ii)(A)). The parties agreed that the average period of the guests' use of the Inn in 2004 was 3 days. Therefore, the IRS contended that for passive activity purposes for 2004, the wife must exclude hours spent on the Inn from her other rental real estate activity hours.

The court stated that the rationale for segregating the wife's hours is consistent with the disparate reporting of activities, as the Inn is reported on Schedule C. Managing a property with a short rental period is similar to running a business and the other rental real estate activities are reported on Schedule E as a separate and distinct activity. The statute's legislative history reinforces this rationale. In explaining the then-new passive activity loss rules, a congressional tax committee report stated: "A passive activity is defined under the bill to include any rental activity, whether or not the taxpayer materially participates. However, operating a hotel or similar transient lodging, for example, where substantial services are provided, is not a rental activity."

Conclusion

In summary, the 679 hours the wife spent in 2004 on all of her rental real estate activities excluding the Inn did not exceed 750 hours. Therefore, the wife is not a real estate professional. Consequently, these rental real estate activities are, per se passive (regardless of how many hours she spent in each of them or in the aggregate). Therefore the court supported the IRS disallowance for 2004 of the taxpayer's combined net loss of $16,822 from their Second Street and their existing Boise property.

Planning

For taxpayers to be able to avail themselves of the benefits of being a real estate professional they should plan early and focus on what they can do with their time before year-end to lock in eligibility by working more hours in the rental real estate activities or having people stay longer in real estate rentals so they are considered rentals rather than trades or businesses.