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Keeping Time: How the IRC Defines Real Estate Professional and Material Participation

By Marc Wieder, CPA

According to the Internal Revenue Code's definition, a *real estate professional* must satisfy specific rules in order to qualify for certain tax benefits that are not granted to other property owners and taxpayers. One requirement is to perform more than 750 hours of real estate-related services. A Tax Court case tested the nature of the hours that accrue toward this requirement and whether *being on call* counted as service time.

Definition of Real Estate Professional

There are two requirements to qualify as a real estate professional for tax purposes:

1. Considering the totality of the taxpayer's personal services, he or she must perform more than 50% of their professional services in real property trades or businesses in which he or she *materially participates*, and

2. The real estate professional must perform more than 750 hours of services in real property trades or businesses in which he or she materially participates. (Note: this is the equivalent of almost five months of 40-hour weeks.)

In the case of a taxpayer filing a joint return, one spouse must separately meet both requirements.

Generally, real estate professionals prove the percentage or extent of *material participation* by tracking the services performed over time and the corresponding hours, using date books and calendars, to meet the standard of *reasonable means*.

Definition of Passive Activity and Passive Activity Losses

Passive activity refers to a business where the taxpayer does not *materially participate*. In other words, it is not a regular, continuous and substantial activity or source of income. A *passive activity* loss represents the excess of the aggregate losses from all passive activities for the year over the aggregate income from all those activities. Therefore, if rental properties do not produce sufficient income to cover the cost of maintaining the properties, the result would be passive activity losses. Taxpayers may only deduct passive activity losses to the extent they receive passive activity income. In addition, any excess loss can be carried forward to offset passive income in future years, or taxpayers may choose to deduct the loss when the property is sold in a fully taxable transaction.

Ordinarily, rental properties are treated as passive activity by property owners. In the case of real estate professionals, however, the IRC considers managing rental properties to be their business, and therefore losses **can** be deducted.

Summary of the Tax Court Case: *James F. Moss v. Commissioner*

A power plant employee, James F. Moss owned four rental properties in New Jersey and three in Delaware. He often performed maintenance, rent collection and preparation for new tenants on the various rental properties.

In 2007, Moss and his wife filed a joint return and reported a total loss of $40,490 from the rental properties. However, $31,318 (about 75%) was disallowed by the IRS, resulting in a tax underpayment of $8,070.

Although Moss did not meet the requirements of a *real estate professional*, the couple was permitted to deduct $9,172, because they materially participated in the management of the properties. According to IRC Section 469(i), taxpayers may deduct up to $25,000 of passive activity losses from nonpassive income when they actively participate in passive real estate rental activity. When modified adjusted gross income (MAGI) is more than $100,000, however, this special allowance phases out.

In this case, even though the taxpayer actively participated in managing the rental properties, the couple's MAGI proved to be greater than $100,000, so most of the $25,000 special allowance was phased out.

Seeking a redetermination of the tax liability, they claimed Moss met the definition of a real estate professional. To meet the test, he provided a 2007 calendar that listed all the dates he performed services on the rental properties (although the hours were not noted), and also a summary of the time spent, as recorded in 2009. Together, these documents were the basis for his claim of 507.75 hours performing real estate related services plus 137.75 hours of travel -- in all, 645.5 hours.

In order to arrive at the required 750 hours, the couple claimed that Moss *was on call* to perform services at the rental properties during the hours when he was not working at the power plant job. In their view, he might have been summoned at any time to provide maintenance or other services.

On-call Time **Disallowed and an Unexpected Penalty**

According to the Tax Court, the claim of *on-call time* was not viable because the property owner, although on call, never performed any services at those times. With the total hours less than the required 750 hours of the second requirement, Moss was not a real estate professional. The Tax Court deemed it unnecessary to consider the first requirement of the definition.

It is also interesting to note that, when disallowing most of the loss from the rental properties, the IRS imposed an **additional** and unexpected penalty related to accuracy of reporting. The IRS may charge a 20% penalty on that portion of an underpayment that is either due to negligence of rules or regulations or is attributable to substantial understatement of income tax. This understatement of income tax is calculated as the greater of 10% of the tax that should have been reported on the tax return or $5,000. The understatement was greater than $5,000 in the *Moss* case, and so merited closer scrutiny.

The IRS does not impose a penalty on that portion of underpayment when the taxpayer is able to show he or she acted in good faith, or with reasonable cause, or with a reasonable basis for the improper tax treatment. The Moss couple could not show that they had a reasonable basis for the losses they claimed, and they were duly penalized.

When is a Property Owner also a Real Estate Professional?

In the current weak rental market, a property owner may wish to consider whether or not he or she can legitimately deduct passive activity losses. The opportunity to utilize the exception allowed for real estate professionals requires exceeding the 750-hour mark, as shown by the ruling in the *Moss* case. Therefore, it is best to seek advice from a tax professional and real estate advisor regarding the dual requirements for real estate professionals before claiming the passive activity loss.

Should you have any questions about this topic, please contact me at 212.840.3456 or marc.wieder@anchin.com