Will Changes to the Passive Income Rules Renew Interest in Real Estate?

Francine J. Lipman
James E. Williamson

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by Francine J. Lipman and James E. Williamson

The final regulations under Internal Revenue Code section 469 (c) (7) were issued by the IRS on December 22, 1995. These regulations, which explain and interpret provisions regarding the rental real estate activities of taxpayers engaged in real property trades or businesses originally issued in the Omnibus Budget Reconciliation Bill of 1993, affect all taxable years beginning on or after January 1, 1995. While the new rules offer no relief for taxpayers that take no active part in real estate activities, ambiguity in the regulations allows some additional taxpayers to qualify their real estate rental losses as non-passive.

Although real estate professionals involved more than 50 percent of the time in their trade or business can already deduct their real estate losses as active losses, the possibility

Defining a Trade or Business

Although the phrase “trade or business” appears in more than 50 code sections, it is never defined. Indeed, instead of presenting a detailed definition, the final regulations provide that any reasonable method can be used for determining a taxpayer's real property trades or businesses. This ambiguity may open the door to individuals in fringe real estate businesses who now wish to qualify as real estate operators.

For example, Joan Miller is a lawyer with many real estate clients. Is her trade or business a real property trade or business? It is not clear if Miller's personal service hours would satisfy the test for real estate operator status.

In response to comments caused by ambiguities in the laws and the proposed regulations, the IRS has clarified that a qualifying real estate operator may count management activities toward material participation in real estate activities.

How Much Is 50 Percent?

Another ambiguity that still exists in the final IRS regulation is a method of determining whether the personal services performed meet the 50-percent/750 hours threshold. If a taxpayer's claim is challenged, substantiation of hours worked in various trades or businesses may not be readily available. However, Daniel N. Shaviro, Esq., contends that any reasonable means of proof—such as appointment books, calendars, and even narrative summaries—may be sufficient proof of time spent. In the absence of a record-keeping requirement in the regulations, the IRS may not be in a position to challenge such services as acceptable.

A Joint Deduction

Married taxpayers filing a joint return may not combine their efforts to satisfy either the personal service or material participation requirement for real estate operator status. However, if either spouse does satisfy both requirements and qualifies as a real estate operator for a tax year, all rental income activities for both spouses are eligible for potential relief from the passive-loss rules for that year. This provision may provide a renewed interest in real estate as a tax shelter.

For example, assume that Bobbie Boyd, a professional football player will earn $5 million a year for the next 10 years. He wants to shelter some of his income. His accountant suggests that he buy a large office building that will generate sizable tax losses for the next several years. However, in order to take the deductions in an active form, the accountant tells Bobbie that he will have to spend at least 750 hours a year actively operating the property. Moreover, because it would be difficult for Bobbie to show that he spent more than half his time performing personal services in the real estate business, his wife, Betty, must qualify as a real estate operator by

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working at least 750 hours in a real property trade or business in which she has more than a 5-percent ownership interest and in which she materially participates. In this way, the losses from the office building will qualify for non-passive tax treatment.

**Not All Positive**

One change not made in the new final regulations was a provision allowing real estate operators to aggregate non-rental real estate activities with rental real estate activities for the purposes of meeting the criteria for material participation in rental activities.

However, the IRS has subsequently invited comments on whether the material participation tests should be amended to include a look-back material participation test for taxpayers significantly involved in development or construction of rental real estate.

Unless the rules are amended, the consequences are that a taxpayer who spends all of his or her time in a real estate trade or business may still not qualify for passive activity loss relief because he or she does not materially participate in rental real estate activities.

**Summary**

The final regulations under Code Section 469 (c) (7) have not clarified all of the ambiguities that have been criticized by commentators. Many believe that the inability of real estate professionals to aggregate rental and non-rental real estate for the purposes of testing material participation is contrary to congressional intent.

However, because the regulations do not answer certain questions on how records of personal service must be kept and exactly what constitutes real property trades or businesses, the new regulations may renew interest in rental real estate as a tax shelter for some groups of investors. Permitting both married partners to deduct active losses if one partner is a qualifying real estate operator also expands the appeal of real estate investment.

Francine J. Lipman, an attorney with Irell & Manella in Newport Beach, Calif., holds a LRM in taxation and is a CPA. James E. Williamson, CPA, is professor of accounting and taxation at San Diego State University. The authors have collaborated on articles for Tax Notes, Trust & Estates, British Accounting Review, and Los Angeles Lawyer.