Spring 1996

Will the Final Regulations Under Section 469(C)(7) Renew Taxpayer Interest in Real Estate?

Francine J. Lipman

Available at: https://works.bepress.com/francine_lipman/31/
WILL THE FINAL REGULATIONS UNDER IRC § 469(C)(7) RENEW TAXPAYER INTEREST IN REAL ESTATE?

Francine J. Lipman[FNa] and James E. Williamson [FNb]

Since the 1986 enactment of IRC § 469, which places significant restrictions on how deductions, losses, and credits from a passive activity can be used to offset income from another activity, rental real estate ventures have lost much of their appeal to taxpayers seeking ways to shelter their active and portfolio incomes. However, the 1993 enactment of IRC § 467(c)(7), along with the related final regulations, may allow certain taxpayers, in addition to the real estate professionals specifically targeted by Congress for this relief, to once again offset rental real estate losses against their other taxable income.

Tax Reform Act of 1986, Pub. L. No. 99-514, 1986-3 C.B. 1. Code Section 469 divides a taxpayer's income into three categories: (1) active income from salaries and wages and other income from activities in which the taxpayer materially participates (e.g., income from an insurance agency that he owns and operates); (2) portfolio income (e.g., interest, dividends, and capital gains and losses from the sale of portfolio assets); and (3) passive income from activities in which the taxpayer does not materially participate (e.g., most tax shelters, especially those organized as limited partnerships and rental activities). The basic impact of IRC § 469 provides that a taxpayer's expenses, losses, and credits related to passive activities can be used only to the extent of income from these passive activities. Any net passive activity loss may not be used to offset either active income from wages, salaries, and trades and businesses in which the taxpayer actively participates, or portfolio income. Rather, passive losses that cannot be currently used are held in suspension and carried forward to be used to offset future passive income. Any current or suspended losses from a particular passive activity may be used to offset a taxpayer's active or portfolio income only when the taxpayer disposes of his entire interest in the passive activity. Even then, upon disposition of an entire interest in a passive activity, any current or suspended losses (including any loss realized on the disposition) from that activity must be used in the following order:

a. First, against any gain on the disposition of the passive activity;
b. Second, against any net income from all other passive activities, after taking into account their suspended losses; and
c. Third, against any other active and portfolio income or gain. IRC § 469.

The final regulations [FN4] under Internal Revenue Code (IRC) § 469, providing rules for rental real estate activities of taxpayers engaged in real property trades or businesses, were issued by the IRS on December 21, 1995. [FN5] The final regulations for the most part are the same as the proposed regulations [FN6] released by the Treasury Department in January 1995, with some revisions. When the regulations were proposed, some real estate professionals expressed a belief that they would limit the relief available under IRC § 469(c)(7). However, close scrutiny of the final regulations reveals that taxpayer interest in real estate tax shelters may in fact be renewed; ambiguity in the regulations may allow some taxpayers to qualify their real estate rental losses as nonpassive.

Background of the Per Se Passive Activity Rule

Originally, Section 469 stipulated that all long-term rental real estate activities are per se passive, [FN7] regardless of the amount of time and effort the taxpayer put into these activities. Thus, the per se passive activity definition applied to the casual investor in rental real property and the real estate professionals who were actively involved in the organization, management, and operation of these activities.

Because real estate professionals actively involved in their real property trades or businesses could not offset their rental real estate losses against income from their real property trades or businesses, the law has been considered unfair to real estate professionals compared with the treatment of similar professionals in other
industries. To ameliorate this unfair treatment of real estate professionals, in 1993 Congress added Section 469(c)(7) to the Internal Revenue Code, providing real estate professionals with the potential for relief. While Section 469(c)(7) was meant to provide relief for real estate operators who spend more than half of their time in real property trades or *139 businesses, [FN8] other taxpayers may be able to convert their rental real estate losses into active losses, a consequence of the unclear definitions of real property trades or businesses.

In any event, taxpayers need to be aware that the relief provisions under IRC § 469(c)(7) merely afford to qualifying taxpayers the opportunity for possible deduction of their rental real estate losses. Qualified taxpayers must further satisfy the material participation requirements to receive nonpassive treatment for their rental real estate losses.

For example, in 1995 George Jones performed 2,500 hours of personal services as owner of the Jones Real Estate Development Co., a sole proprietorship. 1995 was a good year for the development company, whose development activities generated taxable income of $3,000,000. However, Jones had a large net rental loss of ($2,000,000) in 1995 (because of several repossessions and other unforeseen economic events). It would appear that Jones is exactly the type of taxpayer that Congress specifically targeted for relief through its enactment of Section 469(c)(7). However, while Jones clearly qualifies as a real estate operator for 1995, he still may not be able to deduct his losses from the rental properties, unless he can also show material participation in those activities. Unfortunately, Jones was so busy in the development activities that he hired a professional real estate management company to take over the management and operations of the rental properties. Because the final regulations under Section 469(c)(7) provide that rental properties cannot be aggregated with nonrental trades or businesses for purposes of testing for material participation, Jones's net rental loss may be characterized as a passive loss that cannot be used to offset Jones's active income from the development company, but will be suspended and carried forward to future years. [FN9]

*140 In the next two sections, first the steps necessary to qualify as a real estate operator and then the steps necessary to demonstrate material participation in real estate activity are examined. Both of these conditions must be met for the real estate activity to qualify for nonpassive loss treatment. The first condition is necessary to qualify for the exception to the per se passive loss rule under Section 469(c)(7). The second condition is necessary to show through material participation that the rental real estate activity is an active, rather than passive, trade or business.

Qualifying as a Real Estate Operator

Qualifying as a real estate operator is necessary for each year in which a taxpayer wishes to obtain the relief available under Section 469(c)(7). There is no automatic long-term qualification because of a history of real estate operator activity. Both individuals and closely held C corporations [FN10] can qualify as real estate operators eligible for relief under Section 469(c)(7), but the requirements for each are different.

Closely Held Corporations

The only requirement necessary for closely held C corporations is that more than 50 percent of the corporation's gross receipts for a year be derived from real property trades or businesses in which the corporation materially participated. [FN11]

For example, in January 1996 ABC Co., a closely held C corporation, sold its chain of retail jewelry stores, resulting in a taxable gain of $20,000,000. ABC disposed of the jewelry business in order to concentrate on the expansion of its real estate development business. Although ABC believes the development business will have superior long-run profitability, it expects to report an operating loss of ($15,000,000) from this segment of its business in 1996. In addition, ABC has projected a net loss of ($10,000,000) for 1996 from its rental real estate activities. If ABC structures its activities in 1996 so that more than half of its gross receipts are from real property trades or businesses, it may be able to use not only the operating loss from its real estate development business but also the loss from the rental real estate activities to offset its gain from the sale of the jewelry chain.
Individual Taxpayers

An individual taxpayer must meet two requirements. First, more than half of the individual's personal services performed in trades or businesses must be performed in real property trades or businesses in which she materially participates. Second, the individual must perform more than 750 hours of personal services in these real property trades or businesses in which she materially participates. [FN12] This requirement is further limited by a provision in the regulations stating that work performed in the individual's capacity as an investor does not qualify as personal services. [FN13] Furthermore, for purposes of these requirements, personal services performed as an employee are not includable in the computation of hours unless the individual is at least a 5 percent owner of the employer. [FN14]

To illustrate, Sue and Sara Donovan are full-time employees of the Whitmer Real Estate Development Co. (Whitmer). During 1996, each performs 2,200 hours of personal services for Whitmer and is paid a salary of $250,000. Also in 1996, Sue and Sara jointly owned rental real estate in which they each participated for more than 500 hours. Because the rental real estate reported a net rental loss of ($400,000) for that year, both Sue and Sara would like to offset their one-half of the rental loss of ($200,000) against their salaries of $250,000. A problem arises, however, because while Sue owns 5 percent of all of the stock of Whitmer, Sara owns only 4 percent of the stock. Therefore, Sue qualifies as a real estate operator and will be allowed to offset her salary of $250,000 with her net rental loss of ($200,000). Sara does not qualify as a real estate operator because she owns only 4 percent of Whitmer, her employer. Her personal services performed as an employee do not count for purposes of this requirement. For 1996, Sara’s net rental loss of ($200,000) will be a suspended passive loss and cannot be offset against her salary.

*142 Joint Returns

In the case of a joint return, there are some additional restrictions and some additional benefits. One drawback is that two spouses cannot combine their efforts to satisfy either of the two requirements necessary to qualify for real estate operator status. However, if either spouse does satisfy both requirements and qualifies as a real estate operator for any tax year, then all rental real estate activities of both spouses are eligible for potential relief from the passive loss rules for that year.

If one spouse performs all of his personal services in real property trades or businesses in which he materially participates, he would meet the first requirement. But if the total number of hours worked was 750 less than, he would not meet the second requirement and would not qualify as a real estate operator for that year. If his spouse performed more than 750 hours of personal services in real property trades or businesses in which she materially participated, but if this number of hours was less than half of the total number of hours of personal services performed in all trades or businesses in which she materially participated, she would satisfy the second requirement but not satisfy the first requirement and also would not qualify as a real estate operator for that year. Accordingly, this couple that actively works in real property trades or businesses would not qualify for relief from the per se passive activity rules.

Should one of the spouses satisfy both requirements and qualify as a real estate operator for a particular tax year, then all rental real estate activities of both spouses would qualify for potential relief from the passive loss rules for that year, provided they file a joint tax return. If, for example, one spouse performs more than 750 hours of personal services in a real property trade or business in 1996 and that is his only job, he would qualify as a real estate operator for that year. During the same year, his wife performs 2,000 personal service hours in her non-real estate law practice and more than 500 hours materially participating in the operation and management of her separate rental real estate activity. If the couple files a joint tax return for 1996, the wife’s net rental loss would be deemed nonpassive and available to offset active and portfolio income.

What if the rental real property described above had been deliberately structured as a passive income generator (PIG), in order to offset passive losses coming from other non-real estate tax shelters? This might have been
accomplished by the elimination of mortgage debt from the rental real estate and electing a 40-year depreciation life. However, under the regulations, even if the husband inadvertently qualifies as a real estate operator for 1996, if the couple files a joint return, the income from the wife's rental real estate activity must be treated as active income and cannot be used to offset the passive losses. If the wife wants to receive passive treatment for her net real estate income, she would have to file as married filing separately, which could result in several tax disadvantages.

Determining Material Participation in a Rental Real Estate Activity

Qualifying as a real estate operator for a particular tax year is not, in itself, sufficient to obtain relief under Section 469(c)(7). The taxpayer's rental real estate activities will remain passive for that taxable year unless she can also demonstrate material participation in each of those activities for that year. As we will demonstrate in the following section, it may be easier to show material participation on an aggregated real estate activity basis than on an individual real estate interest basis. On either basis, the Internal Revenue Code (the Code) and related regulations provide several ways to demonstrate material participation. In the case of ownership in a limited partnership interest, however, the taxpayer is allowed only three ways to demonstrate material participation.

Under the Code, "material participation" is the involvement of the taxpayer in the operations of an activity on a regular, continuous and substantial basis. The regulations prescribe seven quantitative tests for determining whether a taxpayer materially participates in an activity, which are generally based on the number of hours worked. These are the same tests used by individuals to determine material participation in a trade or business activity that is not a real estate activity. A taxpayer is deemed to have materially participated in a trade or business activity for the tax year if the individual satisfies one or more of these seven tests.

Prior to the enactment of Section 469(c)(7), these tests were not available to demonstrate material participation in a real estate activity. However, under Section 469(c)(7) and the related regulations, these tests become available to qualified real estate operators to demonstrate material participation in a rental real estate activity. All of the following explanations assume that the taxpayer has qualified as a real estate operator for that year.

Test number 1.

If a taxpayer participates for more than 500 hours in a rental real estate activity in any year, he would satisfy the material participation requirement.

Test number 2.

If a taxpayer performs substantially all of the participation in a rental real estate activity (including participation by individuals who do not own any interest in the activity), that would satisfy the material participation requirement.

Test number 3.

If a taxpayer participated for more than 100 hours in a rental real estate activity and this participation is at least as much as any other individual's participation (including individuals who do not own any interest in the activity), that would be material participation.

Test number 4.

If the rental activity is a significant participation activity (SPA) (participation between 100 and 500 hours) and an activity for which the taxpayer does not otherwise qualify as materially participating, then the hours spent on it can be aggregated with the hours spent participating in all the taxpayer's other SPAs for that year (perhaps most important, including the taxpayer's non-real estate SPAs) and the aggregate hours for all SPAs exceeds 500 hours, then the taxpayer is deemed to have materially participated in all of these activities.
For example, Millie is employed as a full-time department manager by a large real estate development company in which she has a 5 percent ownership interest. Millie also owns interests in a clothing store and a large apartment building. Each of these activities has several full-time employees, who each worked 2,000 hours during the year. In addition to her full-time job, which qualified her as a real estate operator, Millie worked 350 hours at the clothing store and spent 175 hours in the operation and management of the apartment building. Because Millie's aggregate participation in the clothing store and the apartment building exceeded 500 hours, she is deemed to have materially participated in both activities. [FN21]

Test number 5.

A taxpayer may qualify as materially participating in an activity if he materially participated in the activity for any five *145 (not necessarily consecutive) of the previous ten tax years. [FN22] When determining material participation for years beginning before 1987, only the 500 hour test may be applied.

For example, Burt, age 66, performs fifteen hours of personal services each week in a real property trade or business in which he is a 5 percent owner. Because this is his only personal service activity in 1996, Burt qualifies as a real estate operator for purposes of Section 469(c)(7). In addition, although Burt is no longer active in his rental real estate activities, he may still be able to treat them as nonpassive if he can demonstrate material participation for any five years out of the preceding ten tax years (1986-1995). [FN23]

Test number 6.

This not relevant to rental real estate activities because it deals only with personal-service activities. A real estate activity could be a personal-service activity only if it involves the performance of personal services in a trade or business in which capital is not a material income producing factor. [FN24]

Test number 7.

If, on the basis of all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during the tax year, this test is passed. [FN25]

Limited Partners

While an individual taxpayer may satisfy the material participation requirement in an activity by meeting any one of these seven tests, limited partners are generally treated as not materially participating in the activities conducted by the partnership, unless test 1, 5, or 6 is satisfied. [FN26] A taxpayer is not treated as a limited partner if the taxpayer was a general partner in the partnership at all times during the partnership's tax year ending with or within the taxpayer's tax year.

Aggregation of Activities: Advantages and Disadvantages

Material participation may be easier to establish if all of the taxpayer's real estate interests are grouped into one activity.

*146 Aggregation of Rental and Nonrental Interests

The regulations do not allow real estate operators to aggregate nonrental real estate activities with rental real estate activities for purposes of meeting the criteria for material participation in the rental operations. [FN27] While the IRS was adamant on this point when discussing the proposed regulations, [FN28] and the final regulations retain the rule, the IRS has subsequently invited comments on whether the material participation tests in regulation Section 1.469-5T(a) should be amended to include a look-back material participation test for taxpayers significantly
involved in the development or construction of their rental real estate interests. However, unless the rules are amended, a taxpayer who spends all of his time in a real property trade or business may not qualify for passive activity loss relief, because he does not materially participate in his rental real estate activities.

For example, John and Joe own and work full-time in a real estate brokerage firm and share equally in the firm's 1996 taxable income of $2,000,000. They also own equally a commercial rental real estate property that generates a ($1,500,000) taxable loss in 1996. Because the property is leased to a single tenant under terms of a triple net lease, neither John nor Joe spent more than a few hours in 1996 on this activity. In addition, neither spent more time than the other. Additionally, because this is the only rental property they own, they are unable to aggregate it with other rental real estate interests. Consequently, they may not be able to establish material participation in this rental real estate activity, even though they qualify as real estate operators. In that case, they would not be allowed to offset their brokerage firm income with the loss from the rental property. If, on the other hand, they were allowed to group the rental activity with the nonrental real estate activity, they would be able to establish material participation and the loss would be treated as nonpassive.

The All or Nothing Election

Material participation may be easier to establish if all of a taxpayer's rental real estate interests were grouped into one activity. The regulations, however, require that each rental real estate interest be treated as a separate rental real estate activity unless the taxpayer elects to aggregate all rental real estate interests into a single activity. [FN29] [FN30]

The problem with this "all or nothing" election is that it is binding for all future years in which the taxpayer qualifies as a real estate operator. Consequently, a taxpayer must be sure that aggregation will be appropriate on a long-term basis before making the election. Although the regulations contain a procedure for revoking the election if there is material change in the taxpayer's facts and circumstances, the revocation may be difficult to achieve. The fact that the election is less advantageous for tax purposes for a particular year will not be considered an appropriate material change in facts and circumstances, and such a request for revocation will most likely be denied. [FN31]

The timing of this election appears to be very critical, and when the proposed regulations were issued there was confusion as to when the election could be made. The most liberal interpretation was that the election can be made in any year (i.e., not making the election in one year does not preclude the taxpayer from making the election in a subsequent year). [FN32] Other commentators indicated that the election may not have to be made until the first year in which it would affect the computation of taxable income. [FN33] Some commentators believed that the proposed regulations were even more restrictive, requiring that the election be made on the original return for the first year in which Section 469(c)(7) was effective and the taxpayer qualified as a real estate operator. [FN34]

The final regulations ended this confusion, stating that the election may be made in any year in which the taxpayer is a qualifying taxpayer--the most liberal interpretation--and that the failure to make the election in one year does not preclude making the election in a subsequent tax year.

The election will not have any effect in a subsequent year in which the taxpayer does not qualify as a real estate operator. The grouping of the taxpayer's activities in that year will be determined under Regulation Section 1.469-4. The final regulations did, however, retain the rule that the aggregation elections must be made or revoked on an original return. The election to treat all interests in rental real estate as a single rental real estate activity is made by filing a statement with the taxpayer's original return for that year. The statement must include a declaration that the taxpayer is a qualifying real estate operator for that year and is making the election pursuant to Section 469(c)(7)(A).

What could be an advantage of electing to treat all rental real estate interests as an aggregated activity is the use of more permissive rules to establish material participation in limited partnership interests. If less than 10 percent of the taxpayer's gross rental income from the aggregated activity is from limited partnership interests, the taxpayer may use any of the seven broader material participation tests. [FN35] There is also a potential disadvantage: if 10 percent or more of the gross rental income from the aggregated activity is from the limited partnership interests, the
aggregated activity will have to establish material participation under one of the three stricter tests that apply to limited partnerships. [FN36]

For example, assume that Karen and Scott, who qualify as real estate operators for 1996, own a commercial rental building and a 50 percent interest in a limited partnership that owns a similar adjacent commercial building. In 1995, Karen and Scott elected to aggregate all of their rental real estate interests. A potential problem exists in 1996 because, while the nonpartnership activity could have qualified on its own under one of the seven broader tests, the aggregated entity must now satisfy one of the three higher threshold material participation tests that apply to limited partnerships. Assuming the resultant aggregated entity could not meet one of these three tests, the entire activity would remain passive for that year.

Disposition of Aggregated Interests

There is ambiguity in the regulations regarding what constitutes a disposition of an activity if a taxpayer has elected to aggregate his rental real estate activities. This concern is critical, because Section 469(g) allows suspended passive activity losses to be used to offset active and portfolio income upon the disposition of an entire interest in an activity. The regulations provide that the election to aggregate all rental real estate interests into one activity applies not only to the determination of whether the taxpayer materially participates in the activity, but also to the grouping of interests in determining when the taxpayer disposes of an entire interest in an activity. [FN37] This presents another potential disadvantage of aggregation. Under these regulations, the sale of a rental real estate property in an aggregated activity may not be classified as a disposition that will release suspended passive losses.

These regulations appear unduly harsh and may even be contrary to what Congress intended when IRC § 469(c)(7) was enacted. Final regulation Section 1.469-4(g), which currently requires the sale of "substantially all" of an activity to take place, replaced proposed activity regulation Section 1.469-4(k), which set forth a lesser requirement by stating that there could be a disposition when a "substantial part of an activity" is sold. It should be noted that when Congress enacted Section 469(c)(7), the proposed activity regulations had not yet been replaced by the final activity regulations. Therefore, it is likely that Congress considered and applied the lesser standard in its decision.

Indeed, commentators have supported the idea that treating individual real estate properties as "substantial parts" of the aggregated activity may be appropriate. This approach may permit any net loss from a single property sale to be treated as nonpassive, which may be a more appropriate result than suspending losses until the taxpayer sells substantially all of his rental real estate interests. [FN38]

For example, in 1995 Millie and Burt Steinberg sold a 500-unit apartment complex located in St. Louis for $20,000,000. In 1994, they had elected to aggregate all of their rental real estate interests, consisting of six properties in total. The Steinbergs elected to aggregate their rental real estate interests into one activity to obtain material participation for all the properties, including some properties that required only a few personal service hours from the Steinbergs.

The Steinbergs would like to report the sale as a disposition because the property has generated substantial pre-1994 suspended passive losses, which they would like to use to offset other income in 1995. If the IRS requires literal compliance with the final activity regulations, the Steinbergs will have a difficult time establishing that the sale of one property is a disposition of "substantially all" of the activity. Under the lesser standard of the previously proposed activity regulation, it would be easier to argue that although the property sold represents only one-sixth of the aggregated activity and is not of proportional significance, it is in substance a "substantial part" of the activity. Thus, the Steinbergs could argue that the rental real estate interest is substantial by its very nature. In other words, any large property is, in and of itself, substantial, and therefore, any sale of a large property is a sale of a substantial part of any aggregated entity. However, in light of both the final real estate operator regulations and the final activity regulations, this argument will probably fail.

Ambiguities Under the Regulations
The regulations may appear attractive to industry representatives because they are simple in principle. However, their very simplicity leaves considerable room for interpretation and application that could result in additional complication in the passive activity rules. This ambiguity may open the door for renewed interest in rental real estate tax shelters, by allowing seemingly unlikely candidates to qualify under the new regulations as real estate operators.

Qualifying as a Real Estate Operator--Revisited

How does a taxpayer determine that more than half of all of her personal services performed in all trades or businesses were performed in real property trades or businesses? While a taxpayer's claim to being a qualified real estate operator would probably be challenged only in marginal cases, substantiation of hours worked in a taxpayer's various trades and businesses may not be readily available. However, a taxpayer who claims to have qualified by using noncontemporaneous means of measurement, [FN39] because she failed to maintain substantiating records, may still prevail because, in the absence of a record-keeping requirement, the IRS may not be able to challenge her. [FN40]

*151 The factors that determine whether a taxpayer's trades or businesses are real property trades or businesses are somewhat unclear and may be subject to broad interpretation by taxpayers seeking loopholes to convert their rental real estate passive losses into nonpassive losses. [FN41] While "real property trades or businesses" are defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business, [FN42] the ambiguity inherent in each of these terms may allow taxpayers who are not typical real estate professionals to qualify as real estate operators.

For example, Julie Ken is a lawyer with many real estate clients. Does Julie Ken's trade or business constitute a real property trade or business? Neither the legislative history nor the regulations provide sufficient guidance to readily answer that question. Thus, it is not clear whether Ms. Ken's personal service hours in her law practice count toward satisfying the test for real estate operator status. [FN43]

Additionally, there is some ambiguity concerning taxpayers whose personal services fail to qualify as being performed in a real property trade or business, because they were performed as an employee who is not at least a 5 percent owner of her employer. The rule exists to ensure that only real estate professionals with an entrepreneurial stake in their real property trades or businesses will qualify for real estate operator status. [FN44] However, the rule may not succeed in including only such taxpayers; because this rule does not exclude services performed as an independent contractor, contract labor status would certainly be preferable over employee status for less-than-5-percent owners of real property trades and businesses.

Hypothetical New Shelters

Because of these ambiguities in the regulations, it is not clear who can qualify for relief under IRC § 469(c)(7). This ambiguity might result in a renewed interest in rental real estate as a tax shelter. The following illustrations are just two out of many possible examples.

Rod Lander is a professional tennis player with an expected annual income of $5,000,000 per year for the next ten years. Lander is *152 concerned that because so much of his current income is being taxed away, he and his wife may have little for retirement when his tennis career is over. Jim Little, CPA, has suggested that they acquire a large rental real estate property that will generate tax losses of ($3,000,000) per year for the next few years. Little has indicated that, under the regulations to section 469(c)(7), the Landers could use this loss to offset Rod's income from professional tennis. However, Little said, the Landers would have to restructure their lives somewhat to accomplish this favorable tax scenario. Specifically, Rod would have to spend more than 500 hours each year actively operating the rental property to establish material participation. In addition, because it would be very difficult to show that Rod spends more than half his time performing personal services in real property trades or businesses, his wife Randee would have to qualify as a real estate operator. Randee could do this by becoming a real estate professional and working more than 750 hours in a real property trade or business in which she has more than a 5 percent ownership interest and materially participates. Once Randee qualifies as a real estate operator, then all of their rental
real estate would become eligible for nonpassive treatment if they could show material participation in the activity.

In our second illustration, John and Anne, middle class Americans, own rental property in which they significantly participate and which has been generating a loss of ($25,000) each year. This worked out well during the years 1991 through 1994, because Anne was going to law school and they were able to use the ($25,000) loss to offset John’s $100,000 salary. In 1995, Anne graduated from law school and earned $75,000. John and Anne had an adjusted gross income of $175,000 in 1995. Accordingly, it appeared that they would not be able to deduct their ($25,000) rental loss. [FN45] John and Anne have contemplated several possibilities, including divorce, [FN46] to save their real estate loss deduction. Finally, upon a close examination of the regulations, they decided that because Anne’s legal work in 1995 involved mostly real estate clients she might qualify as a real estate operator. If so, by demonstrating material participation in the rental *153 property they would be able to treat the ($25,000) loss as nonpassive and offset it against their salary income.

Summary

The final regulations under IRC § 469(c)(7) have not clarified all the ambiguities in the proposed regulations that have been criticized by commentators. Many believe that the inability of real estate professionals to aggregate rental and nonrental real estate for purposes of testing for material participation is contrary to Congressional intent to put real estate professionals on par with taxpayers in other businesses by allowing them to offset their profits and losses. [FN47] (Although even after substantial criticism of this provision in the proposed regulations, the federal government did not modify it in the final regulations.) However, the federal government has invited comments on whether the material participation tests in regulation Section 1.469-5T(a) should be amended to include a look-back material participation test for taxpayers significantly involved in the development or construction of their rental real estate interests.

While the provision that treats each interest in rental real estate as a separate interest can be overridden by an all-or-nothing election to aggregate rental real estate interests, it may not be possible to revoke this election in subsequent years if the aggregation becomes less tax advantageous. Additionally, the mandatory nature of the regulations could cause an inadvertent conversion of planned passive rental real estate income, which may offset other passive losses, into nonpassive income, which could not offset these other passive losses.

Some of these undesirable or unexpected results may occur because of the confusing provisions that combine the efforts of spouses for purposes of testing for material participation in a rental real estate activity, but do not allow spouses to combine their efforts for purposes of qualifying as a real estate operator.

Furthermore, because the regulations do not answer the question of how to determine whether more than half of a taxpayer’s personal services performed in trades or businesses were performed in real property trades or businesses, and because they do not require contemporaneous record keeping to prove the number of hours spent in a taxpayer's trade or business activities, taxpayers in marginal situations will be confronted with the difficult problem of interpreting *154 and applying these complex rules to their facts and circumstances to maximize their relief from the passive loss rules. Additionally, although the term “trade or business” appears in more than fifty IRC sections, the Code does not define the phrase. [FN48] Indeed, the final regulations, instead of adopting a detailed definition of real property trades or businesses, 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 trades or businesses who wish to qualify as real estate operators.

Although Congress intended to provide relief from the passive loss rules for mainstream real estate professionals by enacting IRC § 469(c)(7), the ambiguity of the regulations may renew interest in rental real estate as a tax shelter.

[FNa] Attorney at Law, Irell & Manella, Newport Beach, California.
[FNb] Professor, School of Accountancy, San Diego State University.

[FN5] The rules contained in regulation Section 1.469-9 apply for taxable years beginning on or after January 1, 1995, and to elections made under regulation Section 1.469-9(g) with returns filed on or after January 1, 1995.


[FN7] IRC § 469(c)(2) (setting forth that, except as provided for in paragraph (7), a passive activity includes any rental activity).

[FN8] In order for a taxpayer to obtain relief under Section 469(c)(7), he must be deemed a qualified real estate operator. A taxpayer qualifies for a taxable year if:
   (i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates; and
   (ii) such taxpayer performs more than 750 hours of personal services during the taxable year in real property trades or businesses in which the taxpayer materially participates. IRC §469(c)(7)(B).

[FN9] The IRS has invited comments, however, on whether the material participation tests in regulation Section 1.469-5T(a) should be amended to include a look-back material participation test for taxpayers significantly involved in the development or construction of their rental real estate interests.

[FN10] IRC § 469(a)(2) (stating that closely held C corporations are subject to the passive loss rules).


[FN12] IRC §469(c)(7)(B).


[FN14] IRC §469(c)(7)(D)(ii). The final regulations clarify that an employee may count services performed in a real property trade or business during the portion of the tax year in which the employee is a 5 percent owner in the employer and need not be a 5 percent owner of the employer for the entire tax year. Treas. Reg. Section 1.469-9(c)(5).

[FN15] IRC §168(g)(7).


[FN32] "NYSBA Tax Section Says Proposed Regulations Limit Scope of Relief Available Under Statute," 95 Tax Notes Today 115-141 (June 14, 1995). Moreover, the NYSBA Tax Section states that a qualified real estate professional should not be bound by his pre-1995 election.


[FN37] It does appear that the final regulations clarify that a qualifying taxpayer who makes the election to aggregate will be treated as having a single activity for all purposes of IRC § 469, including 469(g).


[FN39] See, e.g., Daniel N. Shaviro, Esq., "Compliance and Enforcement Under the Passive Loss Regulations," 4 Tax Mgmt. Real Est. J. 107 (May 1988) (Instead, any reasonable means of proof may be sufficient--including, for example, appointment books, calendars, or narrative summaries.) Id.

[FN40] Id.


[FN42] IRC § 469(c)(7)(C).


[FN44] Id. at 54(2)-54(3).
[FN45] IRC §469(I) provides an exception to the passive loss rules that allows small investors to use up to $25,000 of net rental real estate losses to offset active and portfolio income. This exception phases out at the rate of one dollar of allowable loss for each two dollars of adjusted gross income (AGI) above $100,000. Therefore, by the time AGI reaches $150,000, the entire $25,000 exception is phased out.

[FN46] Id. If John and Anne were not married, both of them would be entitled to a $25,000 net rental loss exception on each of their separate returns. This is another example of the harshness of the married penalty that can occur in some cases.
