

Project 2 – Passive Activity Losses
Course: AC 623-59
Team: Student 1, Student 2, Student 3
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Team Anonymous
10 Main Street
Springfield, MA 01119

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Mr. Anthony Entrepreneur
100 State Street
Springfield, MA 01119

Dear Anthony:

Thank you for choosing our firm for your tax planning and preparation. You have asked for our advice on the tax implications of your three rental properties. This letter will explain the fundamental concepts of the tax treatment of rental income and losses, including passive activity losses, real estate professional status, and the grouping of activities.

In rendering our advice, we used judgments in resolving questions where the tax law was unclear or where conflicts existed between legal authorities. Team Anonymous cannot guarantee the outcome in the event the IRS challenges our opinion. You remain responsible for any tax and related liabilities resulting from an adverse IRS determination or judicial decision.

I. Analysis

A. History of Passive Activity Rules

To curb the abuse of tax shelters, Congress introduced the passive activity loss rules within the Tax Reform Act of 1986, which President Ronald Reagan signed into law. Before this Act, taxpayers were able to deduct an unlimited amount of passive losses against other income. The passive activity rules disallowed the deduction of losses if the taxpayer did not materially participate in the trade or business or for any rental activity.¹

The reason for the change was as follows. Until the enactment of the passive activity rules, real estate investments were a popular investment for wealthy taxpayers to generate large paper losses that they could use to offset their other income. The tax benefits of these losses usually exceeded the value of the investment. With the passing of the passive activity rules these tax shelters became less attractive to investors. Analysts have attributed the real

¹ IRC § 469(c)(1)&(2), Passive activity defined

estate crash of the late 1980s to be a direct result of the enactment of the passive activity rules.

Recently, the passive activity rules have become an integral part of President Obama's health care reform. Effective in 2013, the new law imposed a 3.8% Net Investment Income Tax on passive income, including rental income, if the taxpayer's modified adjusted gross income was over \$200,000. The law provides an exception if the taxpayer qualifies as a real estate professional.²

B. Definition of a Passive Activity

The passive activity loss rules define a passive activity as any trade or business in which the taxpayer does not materially participate. A taxpayer materially participates in an activity only when he or she engages in the operations of the activity on a regular, continuous and substantial basis.³

The operative Treasury Regulations provide several tests to determine if a taxpayer materially participates in an activity.⁴ An interest in a limited partnership is not a material participation. The regulations also include rental activities in the definition of passive activities, regardless whether the taxpayer materially participates.⁵ This means that your rental properties are subject to the passive activity loss rules.

C. \$25,000 Deduction with Active Participation

Since your rental properties are subject to the passive activity loss rules, you generally would not be able to deduct your rental losses against your salary. However, the Code provides an exception that allows a deduction of up to \$25,000 of passive rental loss against other income provided the taxpayer actively participated in the activity during the year. This exception does not apply if the taxpayer owns less than 10% of the activity.^{6,7}

The regulations require a phaseout of the \$25,000 deduction when the taxpayer's adjusted gross income (AGI) exceeds \$100,000, which was not indexed for inflation.⁸ The

² Treasury Reg. § 1.1411-4(g)(7), Treatment of certain real estate professionals

³ IRC § 469(h)(1)&(2), Material participation defined.

⁴ Treasury Reg. § 1.469-5T(a), Material participation, In general.

⁵ IRC § 469(c)(1),(2),(4), Passive activity defined.

⁶ IRC § 469(i)(1)&(6), \$25,000 offset for rental real estate activities.

⁷ *James R. Madler, et ux v. Commissioner*, TC Memo 1998-112. Held: taxpayer must materially participate in rental activity to qualify for \$25,000 rental loss offset.

⁸ IRC § 469(i)(3)(A) &(F), Phase-out of exemption.

phaseout reduces the allowable passive loss by 50% of the amount by which the taxpayer's AGI exceeds this threshold.⁹

If you were to hire a management company to manage, operate, and make all of the decisions regarding your rental properties you would not actively participate in the activities. Therefore, you would not be eligible to deduct any of the losses generated from the properties against your other income. If instead you managed the properties yourself, you would meet the active participation requirement and you would be able to deduct \$25,000 of your rental losses against your other income.

D. Real Estate Professional

A taxpayer who qualifies as a real estate professional is not subject to the passive activity loss limitation. The Code has two requirements to qualify. First, the taxpayer must perform more than one-half of all his or her personal services in a real property trade or business in which her or she materially participated.¹⁰ Secondly, the taxpayer must perform more than 750 hours of services in real property trades or businesses in which you materially participate.¹¹

Accordingly, you qualify as a real estate professional because you spent more than 750 hours performing services for the three properties and you spent more than half your time managing the properties as opposed to your job at the hardware store.^{12,13} You can therefore deduct the entire \$53,000 rental loss against your salary.

A qualified real estate professional who participates in rental real estate activities for more than 500 hours during a year will not be subject to the Net Investment Income tax of 3.8% usually imposed on rental income.

E. Carryover of Passive Losses and Dispositions

The passive activity loss rules limit the amount of losses you can deduct against other income. The unused losses are not lost though forever. Instead, the Code suspends the unused passive activity losses indefinitely and then allows an offset against passive activity

⁹ *Id.*

¹⁰ IRC § 469(c)(7)(A)&(B), Special rules for taxpayers in real property business.

¹¹ *Id.*

¹² *James F. Moss, et ux v. Commissioner*, 135 TC 365 (2010). Held: Taxpayer could not use “on-call” time towards 750 hours of service.

¹³ *Raymond Vandegrift, et ux v. Commissioner*, TC Memo 2012-14. Held: Taxpayer cannot use “ballpark guesstimate” to determine percentage of time spent in rental activity when they have another full-time job.

income in future years.¹⁴ The taxpayer can allocate the amount of loss to carryover on a pro rata basis between any activities with a loss based on the total passive loss for the year.¹⁵

When a taxpayer sells a rental property in a fully taxable arms-length transaction, the passive loss for that year and any suspended losses from that activity become non-passive losses. The losses first offset other passive income and the remainder offset other income.¹⁶

In summary, if you hired a management company, you would need to suspend all of your rental losses. Similarly, if you actively participated in the rental activities, but were not a real estate professional, you would need to suspend a portion of your rental losses because your income exceeded the threshold. This pro rata allocation would mean the suspension of an \$8,842 loss from Property 1 and a \$19,158 loss from Property 2.

F. Grouping of Passive Activities

A taxpayer can group one or more rental activities into a single activity if the activities constitute an appropriate economic unit. The taxpayer can use any reasonable method to determine a unit. Factors include: similarities in the type of business, the extent of common control, the extent of common ownership, geographical location, and the interdependencies between the activities. Taxpayers generally cannot group rental activities with trade or business activities.¹⁷

The benefit of grouping is that the grouping would make it easier for you to satisfy the real estate professional requirements. You would only need to satisfy the tests with respect to the activities in the aggregate instead of each one separately. Unfortunately, once grouped you cannot regroup the activities in subsequent years.¹⁸ The downside to grouping is that the taxpayer cannot recognize suspended losses from individual properties within the group until disposing of all properties in the group.

II. Conclusion

The intention of the Tax Reform Act of 1986 was a massive tax code simplification. Ironically, however, the passive activity rules have evolved into anything but simple. While we agree that the objective of preventing the abuse of tax shelters by high income taxpayers is necessary, we believe that the non-indexed phaseout limits for active participation are now unrealistic. An AGI of \$100,000 is hardly high income. Many taxpayers in that income

¹⁴ IRC § 469(b), Disallowed loss or credit carried to next year.

¹⁵ IRC § 469(j)(4), Allocation of passive activity loss and credit.

¹⁶ IRC § 469(g)(1), Dispositions of entire interest in passive activity.

¹⁷ Treasury Reg. § 1.469-4(c)&(d), General rules for grouping activities.

¹⁸ Treasury Reg. § 1.469-4(e)(1), Disclosure and consistency requirements.

range are hard-working people who invest in real estate for legitimate business purposes, not just for the tax benefits.

III. Closing

Once again, thank you Anthony for choosing our firm. Should you need any further information on this or any other tax subject, please do not hesitate to contact us.

Best regards,

Team Anonymous

Table of Authorities

Student 1

Statutes

- 26 U.S. Code § 469(c)(1)&(2)&(4), Passive activity defined.
- 26 U.S. Code § 469(c)(7)(A)&(B), Special rules for taxpayers in real property business.
- 26 U.S. Code § 469(h)(1)&(2), Material participation defined.

Regulations

- Treasury Reg. § 1.1411-4(g)(7), Treatment of certain real estate professionals.
- Treasury Reg. § 1.469-5T(a), Material participation, In general.

Case Law

- *James R. Madler, et ux v. Commissioner*, TC Memo 1998-112

Student 2

Statutes

- 26 U.S. Code § 469(i)(1)&(6), \$25,000 offset for rental real estate activities.
- 26 U.S. Code § 469(i)(3)(A) &(F), Phase-out of exemption.
- 26 U.S. Code § 469(j)(4), Allocation of passive activity loss and credit.

Regulations

- Treasury Reg. § 1.469-4(c)&(d), General rules for grouping activities.

Case Law

- *Raymond Vandegrift, et ux v. Commissioner*, TC Memo 2012-14

Student 3

Statutes

- 26 U.S. Code § 469(b), Disallowed loss or credit carried to next year.
- 26 U.S. Code § 469(g)(1), Dispositions of entire interest in passive activity.

Regulations

- Treasury Reg. § 1.469-4(e)(1), Disclosure and consistency requirements.

Case Law

- *James F. Moss, et ux v. Commissioner*, 135 TC 365 (2010).