

Memorandum of Law

Passive Activity Loss Rules

The purpose of this memorandum is to set forth some of the many rules pertaining to passive activity losses in general and more specifically for so-called real estate professionals. Special rules apply to real estate professionals so that they may not be unfairly discriminated against because of their substantial involvement with rental real estate. Section 469 is entitled *Passive Activity Losses and Credits Limited*. The Revenue Reconciliation Act of 1993 (P.L. 103-66, Section 13143(a)) made substantive changes to the passive activity loss rules that applied before the 1993 Act. The changes were beneficial to real estate professionals. Prior to the 1993 Act the rental of real estate was carved out for especially onerous tax treatment. The rental of real estate was a passive activity as a matter of statute. This was the result no matter how much an owner of real estate participated in the real estate rental activities. Even if the owner of the real estate materially participated in the rental activity, it was still a passive activity and the losses generated by such activity could not offset income other than passive activity income.

General Passive Activity Loss Rules

For certain individuals, passive activity losses and passive activity credits are not allowed as deductions or credits. Section 469(a)(1)(A) and (B). The unfortunate result is that passive activity losses cannot offset other income such as wages, dividends, or capital gains, etc. Entities for which a passive activity loss is to be disallowed are individuals, estates and trusts, closely held C corporations and personal service corporations. Section 469(a)(2)(A)(B) and (c). The disallowed loss (or credit) may be treated as a deduction or credit in subsequent years. Section 469(b)

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A passive activity is any (1) activity which involves the conduct of a trade or business, in which a taxpayer does not materially participate. Section 469(c)(1)(A) and (B). A passive activity (2) is also any *rental activity*. Section 469(c)(2).

A trade or business is defined as any activity in connection with a trade or business or any activity for which deductions are allowed under Section 212. Section 469(c)(6)(A) and (B).

Rental Real Estate Activity

A rental real estate activity is by statute a passive activity. Section 469(c)(2). If an individual owns and leases real property, spending substantial time in the management and operation of the rental activity, the result is a passive activity unless the so-called real estate professional exception applies. A taxpayer can materially participate in a rental real estate activity and still be subject to the passive activity loss limitations.

Congress felt that it was wrong for individuals to incur rental activity losses, with not much effort or activity, to offset earned and other income. S. Rep. No. 313, 99th Cong., 2d Sess. 718 (1986). Congress came to realize, however, that the passive activity loss limitations did not make economic sense for individuals who were in the real estate business, and acquired rental real estate as part of the real estate business. The 1993 Act provides that if a taxpayer materially participates in a rental activity, *and* meets two other tests, the rental activity losses will not be treated as passive activity losses. *Id.* See Reg. 469-9(e).

A rental real estate activity shall **not** be treated as a passive activity (as provided in Section 469(c)(2)) for a taxable year if two tests are met. Section 469(c)(7)(B). The **first** test is that more than one half of the personal services performed in trades or businesses by a taxpayer during such year are performed in real property trades or businesses in which the taxpayer materially participates. Section 469(c)(7)(B)(i). The **second** test is the taxpayer must perform more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. Section 469(c)(7)(B)(ii). 750 hours is about 94 days at eight hours per day.

If these tests are met a taxpayer is considered to be a real estate professional. The 750 hours in a real property trade or business test and the personal services performed in a real property trade or business in which the taxpayer materially participates test are met only if either spouse separately satisfies the requirements. Section 469(c)(7)(B) flush language. (In other words, one spouse must perform 750 hours in a real property trade or business, for the exception to apply). This is to be distinguished from the rule that for determining whether a taxpayer materially participates, participation of both spouses shall be taken into account. Section 469(h)(5).

A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Section 469(c)(7)(C). Thus, a real property trade or business is broadly defined. Personal services means any work performed by an individual in connection with a trade or business, but not as an investor. Reg. 1.469-9(b)(4). Work as an investor includes studying and reviewing financial statements, preparing financial summaries or analysis for an individual's own use, and monitoring the finances in a non-managerial capacity. Reg. 1,469-5T(f)(2)(ii)(B). Thus, work as an investor in an activity is not participation in the activity unless the individual is directly involved in the day-to-day management or operations of the activity. Reg. 469-5T(f)(2)(ii)(A).

Personal services performed as an employee are not to be treated as performed in the real property trade or business unless such employee is a 5% or more owner of an entity, etc. Section 469(c)(7)(D)(ii). It is important to keep records, preferably contemporaneous records, showing the time spent in order to qualify for the exception to the rule that a rental activity is a passive activity.

If the tests are met, a rental real estate activity shall not be treated as a passive activity, and each interest in the rental real estate activity shall be treated as a separate activity. Section 469(c)(7)(A)(i)(ii). However, a taxpayer may elect to treat all interests in rental

real estate as one activity. Section 469(c)(7)(A) flush language.

A passive activity loss is the amount of losses from all passive activities that exceed the income from all passive activities for the year. section 469(d)(1).

Material Participation

Material participation in an activity exists if the taxpayer is involved in the operations of the activity on a regular continuous and substantial basis. Section 469(h)(1). A limited partner should not be treated as materially participating except as provided in regulations. Section 469(h)(2). The participation of both spouses shall be counted for purposes of determining whether a taxpayer materially participates. Section 469(h)(5). The temporary regulations provide seven definitions of material participation. Reg. 1.469-5T(a)(1) through (7). They are:

- (1) The taxpayer participates more than 500 hours in the activity in the tax year,
- (2) The taxpayer's participation in the activity for the taxable year constitutes substantially all of the participation in the activity.
- (3) The taxpayer participates more than 100 hours during the taxable year, and such taxpayer's participation in the activity is not less than the participation of any other individual.
- (4) A taxpayer's participation in the activity is significant and the taxpayer's aggregate participation in all significant participation activities exceeds 500 hours.
- (5) The taxpayer materially participated in the activity for five years during the 10 taxable years preceding the taxable year.
- (6) The activity is a personal service activity and the taxpayer materially participated in the activity for three taxable years preceding the taxable year.
- (7) Based on the facts and circumstances the taxpayer must participate in the activity on a regular continuous and substantial basis.

Under the **500 hours test**, any work performed by an individual in connection with an activity in which the individual owns an interest at the time the work is done is treated as participation in the activity. The capacity in which the individual does the work is generally not relevant. Temp. Reg. Section 1.469-5T(f)(1). Work that is (1) not of the type customarily performed by the owner, of an activity, and (2) work performed for which the principal purpose of the work is to avoid the passive activity loss rules are not counted as participation. Section 1.469-5T(f)(2)(I). Work performed in an individual's capacity as an investor is not participation in the activity unless the individual is directly involved in the day-to-day management or operations of the activity. In other words, the reviewing of financial statements, reports, preparing summaries of analysis, etc. does not count unless the individual is directly involved in the day-to-day management or operations of the activity.

Pursuant to the **substantially all of the participation test** an individual materially participates in an activity for a taxable year if the individual's activity constitutes substantially all of the participation in the activity for a taxable year including individuals who were not owners. Reg. 1.469-5T(a)(2).

The **100 hours of participation test** is met if the individual's participation is more than 100 hours during the taxable year and is not less than the participation of any other individual, including persons who were not owners. Reg. 1.469-5T(a)(3).

The **significant participation test** is met if the activity is a 'significant participation activity' and the taxpayer's aggregate participation in all such activities exceeds 500 hours in a year. A significant participation activity is a trade or business activity in which the individual participates for more than 100 hours during the tax year. This concept is that an individual who devotes more than 500 hours during a year to several activities, each of which is a significant activity of such individual, should be treated similarly as the equivalent amount of time to a single activity. TD 8175.

The **material participation in prior years** test is met if an individual materially participates in an activity for a taxable year if the individual materially participated in the activity for any five prior taxable years, whether or not consecutive, during the prior 10 years immediately preceding the tax year. Reg.1.469-5T(a)(5). The theory is that if an individual participated in an activity for a long time period, the activity is likely to be a livelihood rather than a passive investment.

The **personal service activity test** is met if the activity is a 'personal service activity' and the taxpayer materially participated in the activity for any three taxable years preceding the taxable year. The performance of personal services includes activities in the fields of health, law, engineering, accounting, or any other trade or business in which capital is not a material income-producing factor. Reg. 1.469-5T(a)(6). This approach recognizes the fact that such activities represent an individual's livelihood rather than a passive investment.

The facts and circumstances test results in material participation after the fact, but should not be used as a planning technique because it is so vague. An activity must exist on a regular, continuous and substantial basis to be material participation. Reg 1.469-5T(a)(7).

Activity - Segregation and Aggrigation

It is important to determine what an activity is because material participation exists or does not exist at the activity level. If there is material participation at an activity level, losses are deductible against all types of income, and profits offset losses whether the losses result from material participation in an activity, or not.

The regulations set forth 5 factors to be considered in determining what is an activity. Reg 1.469-4(c)(2). The five factors to be considered are: (1) similarities and differences in types of business, (2) the extent of common control, (3) the extent of common

ownership, (4) geographical location, and (5) the interdependence between activities.
Id. etc.

Generally, if Section 469(c)(7) provides that a rental real estate activity may not be a passive activity, and such activity may be treated as a separate activity. An owner, however, may elect to treat all interests in rental real estate as one activity. Section 469(c)(7)(A) flush language. Generally, the election would be beneficial if an owner has several rental activities, and does not materially participate in any one activity. By electing to combine all such rental real estate activities as one activity, the owner may be determined to materially participate in the combined rental real estate activity. The result being the ability to deduct the rental real estate activity losses against other income. Once elected by filing a statement on the taxpayer's original return, the election applies to all subsequent years unless there is a material change in the facts and circumstances Reg. 1.469-9(g).

The general rule is that each interest in rental real estate will be treated as a separate rental real estate activity unless the taxpayer makes an election to treat all interests in rental real estate as a single rental real estate activity. Reg. 1.469-9(e).

A rental real estate activity may *not* be grouped with other activities. Thus, if a taxpayer develops real property and owns an interest in rental real estate, the taxpayer's interest in the rental real estate may not be grouped with the taxpayer's development activity. Reg. 1.469-9(e)(3).

A special rule applies to limited partnership interests in rental real estate activities. If a taxpayer elects to treat all interests in rental real estate activities as a single rental real estate activity, and the taxpayer has at least one interest in rental real estate through a limited partnership, the combined rental real estate activity shall be treated as a limited partnership interest for purposes of determining material participation. Reg. 1.469-9(f). Also, for purposes of determining material participation, only three of the material

participation prerequisites may be used to determine whether a taxpayer materially participates through a limited partnership. Reg. 1.469-5T(e)(2). They are (1) more than 500 hours of material participation, (2) material participation in 5 of the 10 prior taxable years, and (3) material participation via personal service activities in 3 prior years. *Id.* However, if a taxpayer's share of gross income, from rental real estate through limited partnership interests in rental real estate, is less than 10% of the taxpayer's share of gross rental income from all the taxpayer's interests in rental real estate for the taxable year, material participation shall be determined by using the 7 alternatives for determining material participation. Reg. 1.469-9(f)(2). Importantly, a partnership interest of an individual shall not be treated as a limited partnership interest if the individual is also a general partner in the partnership at all times during the taxable year. Reg. 1.469-5T(e)(3)(ii).

An interest in rental real estate held by a partnership or S Corporation (pass-through entity) is treated as a single interest in rental real estate, if the pass-through entity grouped its rental real estate as one activity. Reg. 1.469-9(h). On the other hand, if the pass-through entity grouped its rental real estate into separate rental activities, each rental real estate activity of the pass-through entity shall be treated as a separate interest. *Id.* Importantly, an election may be made to treat all interests in rental real estate including the rental real estate interests held through pass-through entities as single rental real estate activity. *Id.*

If a taxpayer owns directly or indirectly 50% or more of an interest in a pass-through entity for a taxable year, each interest in the rental real estate held by the pass-through entity shall be treated as a separate interest in the rental real estate of the pass-through entity. Importantly, a taxpayer may elect to treat all interests in rental real estate, including such interest held through a pass-through entity, as a single rental real estate activity. Reg. 1.469-9(h)(2).

If a pass-through entity owns 50% or more of another pass-through entity, such interest in the rental real estate held by the lower tier entity will be treated as a separate interest in the rental real estate of the upper tier entity, regardless of the lower tiers grouping of activities. Reg. 1.469-9(h)(3).

Thus, a rental real estate activity is treated as a passive activity even if a taxpayer materially participates in the activity, unless the taxpayer meets the above described tests to be a real estate professional. A real estate professional may deduct any rental real estate loss in which he materially participates.