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Passive Losses and Real Estate Professionals: Sometimes the Best Advice is to Leave a Benefit on the Table

REAL ESTATE INVESTMENTS are tax-favored. However, under the passive activity loss rule, these benefits are generally limited unless you are a “real estate professional” and you “materially participated.” People often ask me for help meeting these tests. But that’s hard to do and hard to prove. It requires discipline. It requires restructuring your life. To them and to you, I give this advice: Unless your friends think you’re a real estate professional in real life, you probably shouldn’t try to pose as one for tax purposes.

The Passive Activity Loss Rule

First, a primer on the rule. Our tax law generously subsidizes real estate. We don’t tax appreciation until sale; we let you borrow tax-free against that appreciation; borrowing leads to deductible interest and depreciable basis; depreciation is accelerated; depreciation recapture is taxed at lower rates; you can exchange the property for other real estate tax-free; your heirs can sell it for cash tax-free. We’re less generous with service providers (doctors, lawyers, actors). And yet, it used to be that doctors could enjoy many of these benefits, simply by owning real estate. The leveraged tax shelters of the 1970s and 1980s took advantage of this.

In 1986, these shelters were killed overnight by the new passive activity loss rule. This rule works in three steps.



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- (1) First, for all your income sources, it labels you as either passive or active.
- (2) Second, within each category, it determines whether you have net income or a net loss.
- (3) Third, for taxpayers with active income and passive loss (say, a lawyer who owns real estate, which throws off depreciation and interest deductions), it forbids using the latter to shelter the former.

But the other permutations are fine—you can shelter (i) passive income with passive losses; (ii) active income with active losses; and (iii) passive income with active losses.¹ This suggests two ways to escape the passive loss limitation.

- First, you could bring yourself into (i), by restructuring your active activity to be passive. However, this is hard—activities are active because they involve your personal services, which isn’t likely to change.
- Second, you could bring yourself into (ii), by restructuring your passive activity to be active. This is where people focus their efforts.

When the passive activity is rental real estate, the way to make it active is to be a real estate professional and materially participate. Oversimplifying a bit, taxpayers do this by ensuring that, of all the work they did in the year, more than 50%—and more than 750

hours—is in real estate businesses in which they materially participated. (For details, see Bloomberg Tax Portfolio 549, Passive Loss Rules.)

Meeting the Tests is Hard

Meeting these tests is easier for retirees or recently-exited tech founders than it is for employed people. Yet in my experience, everyone finds them hard. Unless you would already meet these tests without the influence of a tax avoidance motive—say, because you’re an actual professional landlord or developer—it is not easy to get to 750 hours or 50%.

People often get tripped up on these rules:

1. Burden of Proof. It’s your burden to keep records of hours worked. A “ballpark guesstimate” will not suffice. The court need not accept noncontemporaneous logs and self-serving testimony when uncorroborated by underlying records. All this sounds obvious, until you’re the one doing it. Keeping records is tedious. If you struggle to record your attorney billable hours, why would it be easier when the hours are non-billable?

2. Proving 50%. Even if you meticulously document your real estate hours, that’s not enough. You must also meticulously document your non-real estate hours (e.g., time practicing law), to show they did not

represent more than half your hours worked.

3. Proportionality of Time to

Task. People tend to think they can record just any old hours. In fact, the credibility of your records is diminished if the number of hours reported appears excessive in relation to the tasks described. The Tax Court docket overflows with examples of taxpayers learning this the hard way. Here is one, from *Hairston v. Commissioner*, 118 T.C.M. (CCH) 174 (2019):

Every task recorded on the calendars, no matter how trivial, is listed as having taken at least one hour to complete. Of the 360 recorded entries, 121 (or roughly one-third) record tasks that allegedly consumed exactly one hour. These include 36 entries for doing nothing more than receiving a rent payment, issuing a receipt for a payment, or depositing a check at the bank. There are 13 distinct one-hour entries for “paying mortgage.” There are 11 distinct one-hour entries ... for “hunting down” or “remind[ing]” the tenant to pay rent. Three of these entries appear in the same week, including two on the same day. There are nine distinct one-hour entries for “inspecting vacant property,” i.e., walking next door to 6330 Bell to make sure it had not been broken into. This pattern of inflating recorded hours undermines the credibility of petitioners’ calendars overall. ...

An inflationary pattern also emerges from the calendar entries recording time that Mr. Hairston allegedly spent supervising contractors. He recorded many hours during which he allegedly watched contractors work, including 33

hours while they installed and cleaned carpet. During one week in December, he recorded another 40 hours “supervising” contractors who were painting the interior of 6330 Bell. We understand that Mr. Hairston, having recently retired, had time on his hands. But we cannot believe that he spent an entire week watching paint dry.

4. Don’t Count On-call Time.

“On call” hours do not count, because no services have been performed.

5. Don’t Count Investor Work.

If you’re not directly involved in the day-to-day management or operations, you can’t include work done “as an investor” for testing whether you materially participated. That includes studying and reviewing financial statements or reports on operations; preparing or compiling summaries or analyses of the finances or operations; and monitoring the finances or operations in a non-managerial capacity.

6. Don’t count tax-motivated work.

For material participation, you also can’t count work not customarily done by an owner, if your principal purpose for doing it is to avoid disallowance of losses or credits. In the related area of solar credits, I’ve heard of cases where the person who markets the investment helps the taxpayer meet his hours requirement by providing online classes on how to be a good solar farm owner. This strikes me as failing both prongs.

The Hazards of Tax-Motivated Engineering


All this illustrates a broader point about tax planning. People commonly think of my job as a have-your-cake-and-eat-it-too activity: thanks to some loophole

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in my pocket, I will help you avoid the passive loss limits, without your having to make any meaningful sacrifice.

In fact, the opposite is true. I like to say that tax planning is the “art of the sacrifice.” After all, it’s an income tax—the whole thing is structured so that, to pay less tax, you must become worse off. My job is to identify possible sacrifices you could make; success is when the non-tax cost is less than the tax savings.

In the case of the passive loss rule, the sacrifice you’re asked to make is being a real estate professional. You actually need to show up to work, have work to do, do the work, and keep records of the work. For some taxpayers, this is worth the effort. For others, it isn’t.

But nobody benefits from having these things sugarcoated. Tax planning is about weighing costs and benefits. Sometimes the best service we can give to a client is to help them decide to leave a benefit on the table. 

¹ Under a separate rule, individuals who “actively participate” in a real estate investment can use up to \$25,000 of passive losses against their active income. However, this benefit phases out as AGI increases from \$100,000 to \$150,000. Thus, it is not commonly used by the sorts of people who are shopping for tax shelters.