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A Primer on Deducting Losses from Real Estate Activities for "the Rest of Us"

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Your client has been reading the news about deducting real estate losses and comes to you wanting to know: why didn't you tell me about all the deductions I could have been taking for my rental real estate losses? And can I pay a lower tax rate on my gains? You explain to your client that it is much harder to deduct real estate losses than the current news makes it seem. But your client, who owns several businesses, only one of which is real estate, wants to know – how do I start taking advantage of this deduction?

Now, imagine your client is a commercial real estate developer who also owns restaurant franchises. He spends most of his time on his real property business: development, construction, management and rental of buildings, free-standing or in malls, at several sites in his home state. When developing a site, his primary goal is to find a profitable tenant to lease the space. But if a suitable tenant cannot be found, this taxpayer opens a restaurant franchise and rents the vacant space to his restaurant company. The taxpayer's two businesses feed off each other: his restaurant operations experience makes him a better developer and landlord to unrelated restauranteurs, and his real estate activities give him important experience that he uses in his restaurant business.

In today's "gig" economy, it is becoming increasingly common for taxpayers to have more than one job or business endeavor they are working on at the same time. This article explores how, if at all, a taxpayer who is not exclusively a real estate professional can deduct real estate losses in excess of the passive loss limitations.

Passive Loss Limitations

Individual taxpayers generally cannot deduct losses from passive activities.[1] A passive activity is any trade or business[2] of a taxpayer in which the taxpayer does not materially participate, and any rental activities of the taxpayer, regardless of the taxpayer's level of participation.[3] "Material participation" means that the taxpayer is involved in the operations of the activity on a regular, continuous and substantial basis.[4]

1 I.R.C. § 469.

2 Determining whether a trade or business exists is a factual determination. *Higgins v. Commissioner*, 312 U.S. 212 (1941). The Supreme Court has held that a trade or business (a) must be undertaken to earn a profit and (b) the taxpayer's activities must be continuous and regular. *Commissioner v. Groetzinger*, 480 U.S. 23 (1987).

3 I.R.C. § 469(c)(1), (2).

4 I.R.C. § 469(h)(1).

The regulations offer seven tests that may be used to satisfy the "regular, continuous and substantial" standard.[5] The first test provides that a taxpayer will be treated as materially participating in an activity if she participates in the activity for more than 500 hours during the tax year. A taxpayer only needs to meet one of the seven tests to prove material participation, and her participation in an activity may be established by any reasonable means. Contemporaneous daily time reports or logs are not required if her participation can be shown by other reasonable means that identify services performed over time and the approximate number of hours spent performing them during that period, based on appointment books, calendars, or narrative summaries.[6] However, taxpayers who keep contemporaneous, thorough records will save themselves a significant amount of time, effort, and professional fees later.[7]

Given the strong public policy against allowing passive losses to offset tax that would otherwise be due from ordinary income, the Code and regulations seem designed to make it as difficult as possible for people who rent real estate to deduct losses. Taxpayers who rent real estate and participate in a closely related business, however, may be able to take advantage of the grouping rules in the Section 469 regulations to deduct real estate losses. And all taxpayers who deduct real estate losses should take care to document their activities to prove their material participation and consider filing the election to treat all interests in rental real estate as a single activity.

Grouping rules for passive activities

Treas. Reg. § 1.469-4 sets forth rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss limitation rules. One or more trades or businesses or rental activities may be treated as a single activity if the activities constitute an "appropriate economic unit."[8] Whether activities constitute an appropriate economic unit depends on the facts and circumstances, and a taxpayer may use any reasonable method of applying the facts to group his activities.[9] The regulations give "greatest weight" to the following factors:

5 Temp. Treas. Reg. § 1.469-5T(a). The seven tests are:

1. The individual participates in the activity for more than 500 hours during the tax year.
2. The individual's participation in the activity for the tax year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for the year.
3. The individual participates in the activity for more than 100 hours during the tax year, and the individual's participation in the activity for the tax year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for the year.
4. The activity is a significant participation activity for the tax year, and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours.
5. The individual materially participated in the activity for any five tax years (whether or not consecutive) during the 10 tax years that immediately precede the tax year.
6. The activity is a personal service activity, and the individual materially participated in the activity for any three years (whether or not consecutive) preceding the tax year.
7. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the year.

6 Temp. Treas. Reg. § 1.469-5T(f)(4); *Estate of Ramirez*, T.C. Memo. 2018-196 (daily time sheets not required but uncorroborated, implausible testimony of time spent also insufficient); *Miller v. Commissioner*, T.C. Memo. 2011-219 at *5, 102 T.C.M. (CCH) 250 (contemporaneous time spent logs together with "compelling" testimony supported real estate professional finding.

7 The best evidence is always contemporaneous evidence that tells a complete picture: who, what, when, where, why, and most importantly for IRS purposes: how much.

8 Treas. Reg. § 1.469-4(c)(1).

9 Treas. Reg. § 1.469-4(c)(2).

(i) Similarities and differences in types of trades or businesses;

(ii) The extent of common control;

(ii) The extent of common ownership;

(iii) Geographical location; and

(iv) Interdependencies between or among the activities (for example, the extent to which the activities purchase or sell goods between or among themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).[10]

The Tax Court has found that a taxpayer's commercial and residential real estate development businesses constituted an appropriate economic unit because the businesses were similar, shared common control and ownership, shared an office and consolidated financial reporting.[11] The regulations, however, limit the grouping of rental activities with other trade or business activities, even those that make up an appropriate economic unit, unless:

(A) The rental activity is insubstantial in relation to the trade or business activity;

(B) The trade or business activity is insubstantial in relation to the rental activity; or

(C) Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.[12]

The regulation then provides an example of married taxpayers filing a joint return, one of whom owns a grocery store trade or business and one of whom owns a building that is rented to the spouse's grocery store business.[13] The couple are treated as one taxpayer, the sole owner of both the grocery store business and the grocery store rental.[14] The example provides that the grocery store business and the grocery store rental may be grouped together into a single trade or business activity, if the grouping constitutes an appropriate economic unit.[15]

A seeming contradiction exists between Treas. Reg. § 1.469-4(d)(1), which clearly shows that a rental business—even a real estate rental business—can be grouped with another trade or business, and Treas. Reg. § 1.469-9(e)(3)(i) (titled "Grouping rental real estate activities with other activities"), which states:

For purposes of this section, a qualifying taxpayer may not group a rental real estate activity with any other activity of the taxpayer. For example, if a qualifying taxpayer develops real property, constructs buildings, and owns an interest in rental real estate, the taxpayer's interest in rental real estate may not be grouped with the taxpayer's development activity or

10 Treas. Reg. § 1.469-4(c)(2).
11 *Lamas v. Commissioner*, T.C. Memo. 2015-59 at *11-12, 109 T.C.M. (CCH) 1299.
12 Treas. Reg. § 1.469-4(d)(1)(ii).
13 Treas. Reg. § 1.469-4(d)(1)(ii), Example 1.
14 Treas. Reg. § 1.469-4(d)(1)(ii), Example 1.
15 Treas. Reg. § 1.469-4(d)(1)(i) and Treas. Reg. § 1.469-4(d)(1)(ii), Example 1.

> construction activity. Thus, only the participation of the taxpayer with respect to the rental real estate may be used to determine if a taxpayer materially participates in the rental real estate activity under § 1.469-5T.

The IRS asserted in *Stanley v. United States*[16] that this regulation prohibits real estate professionals from grouping rental activity with any other activity for all purposes. The court rejected the IRS's argument, finding instead that Treas. Reg. § 1.469-9(e)(3)(i) limits grouping only for purposes of determining material participation in a rental activity. The court reasoned that the regulation is self-limiting, because it applies only "for purposes of this section," *i.e.*, only for purposes of Treas. Reg. § 1.469-9, and does not apply to overrule Treas. Reg. § 1.469-4(d)(1).[17] In other words, there is no contradiction between Treas. Reg. § 1.469-9(e)(3)(i), which applies only to the material participation analysis, and Treas. Reg. § 1.469-4(d)(1), which allows grouping of rental and other activities into an appropriate economic unit if the proportionate ownership of the rental and other activities is the same, or one of the activities is insubstantial compared to the other.

The *Stanley* court held that grouping of rental and other activities is prohibited only for purposes of determining material participation and not prohibited for applying the passive activity loss rules of section 469.[18] The court therefore considered whether the taxpayer's real estate rental activities were an appropriate economic unit with his other business activities as president and general counsel of a property management company, and found that they were.[19] Finally, the court found that the taxpayer materially participated in the grouped activity, as the IRS did not dispute that the taxpayer spent more than 500 hours per year on the combined activity.[20]

Real estate professional rules

A real estate developer that develops and sells certain properties, and develops and rents other properties, cannot offset losses on his rental activities against income from his sales activity unless he meets the requirements of section 469(c)(7), listed below. In other words, a real estate rental activity is *per se* passive unless the taxpayer meets the requirements of section 469(c)(7).[21] Section 469(c)(7) provides that a taxpayer's real estate rental activity will fall outside the general rule that rental activities are passive activities if these two conditions are met:

> (i) more than one-half of the personal services performed in trades or businesses by the taxpayer in 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 services during the taxable year in real property trades or businesses in which the taxpayer materially participates.[22]

A taxpayer who meets the forgoing two tests is commonly referred to as a "real estate professional," although the term used in Treas. Reg. § 1.469-9 is "qualifying taxpayer."

16 2015 WL 7012853, at *6 (W.D. Ark).
17 *Id.*
18 *Id.* at *7.
19 *Id.* at *8.
20 *Id.* at *9.
21 I.R.C. § 469(c)(2); *Miller v. Commissioner*, T.C. Memo. 2011-219 at *4, 102 T.C.M. (CCH) 250.
22 I.R.C. § 469(c)(7)(B).

The term "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.[23] That is, all of a taxpayer's real estate activities are taken into account in determining whether the 750-hour requirement is met, not merely the rental activities.[24]

A taxpayer who qualifies as a real estate professional has overcome the presumption that all rental activities are passive. The taxpayer still must prove, however, that he materially participated in the rental real estate activity.[25]

For purposes of testing material participation, a qualifying taxpayer (i.e., a real estate professional) may elect to treat all of his interests in rental real estate as a single rental real estate activity.[26] The election is made by filing a statement with the taxpayer's original income tax return for the taxable year in which the election is made.[27] Revenue Procedure 2011-34 allows taxpayers to make late elections to treat all interests in rental real estate as a single rental real estate activity in certain circumstances.[28] A timely election, however, is always the preferred method for ensuring the best possible tax result.

Section 199A deduction potentially available to real estate developers

Section 199A was enacted as part of the 2017 tax legislation (commonly referred to as the TCJA) and applies to taxable years beginning after 2017 and before 2026. Congress enacted section 199A to give a deduction to non-corporate businesses of up to 20% of the taxpayer's qualified business income from qualified trades or businesses, including those operated through a partnership, S corporation, or sole proprietorship. The stated purpose of section 199A was to give individuals and pass-throughs some parity with the 21% income tax rate applicable to C corporations under the TCJA.

The benefits of section 199A are limited to taxpayers with income from a trade or business. Regulations finalized on January 18, 2019 (199A Final Regulations), define "trade or business" by reference to section 162 trade or business expenses.[29] Treasury deemed the cross reference to section 162 practical because "many taxpayers who will now benefit from the section 199A deduction are already familiar with the trade or business standard under section 162."[30]

Commenters on the proposed regulations asked that the 199A Final Regulations incorporate the real estate professional provisions in section 469(c)(7), under which a taxpayer may treat rental real estate activities as nonpassive if the taxpayer materially participates in the activities. Treasury rejected this request on the ground that the material participation tests "cannot be used to determine whether the activity itself is a trade or business," asserting that "the § 1.469-5T material participation tests are not a proxy to establish

23 I.R.C. § 469(c)(7)(C).

24 *See* Treas. Reg. § 1.469-9(d); CCA 201427016 (Apr. 28, 2014) (time spent on two rental properties and a real property development trade or business may count towards meeting the qualifications of section 469(c)(7)(B)).

25 Treas. Reg. § 1.469-9(e)(1) ("[A] rental real estate activity of a qualifying taxpayer is a passive activity under section 469 for the taxable year unless the taxpayer materially participates in the activity."); *Hoskins v. Commissioner*, T.C. Memo. 2013-36, 105 T.C.M (CCH) 1242; *Perez v. Commissioner*, T.C. Memo. 2010-232, 100 T.C.M. (CCH) 351 ("[A] taxpayer claiming deductions for rental real estate losses [must] meet the 'material participation' requirements of section 1.469-5T, even where the Commissioner has conceded that the taxpayer is a real estate professional pursuant to section 469(c)(7)(B).").

26 Treas. Reg. § 1.469-9(g)(1).

27 Treas. Reg. § 1.469-9(g)(3).

28 Rev. Proc. 2011-34; *see also* I.R.M. 21.5.3.4.16.

29 Treas. Reg. § 1.199A-1(b)(14) (2019).

30 T.D. Preamble, at 12.

regular, continuous, and considerable activity that rises to the level of a trade or business for purposes of section 199A."[31]

Treasury also refused to adopt a rule that any rental real estate activity is a section 199A trade or business. Instead, Treasury stated:

> In determining whether a rental real estate activity is a section 162 trade or business, relevant factors might include, but are not limited to (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner's or the owner's agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease).

Neither the Preamble nor the 199A Final Regulations themselves provide any further details on how these factors may be applied, but we surmise that the IRS is more likely to agree that a rental real estate activity is a trade or business if the taxpayer is leasing a number of commercial properties and providing daily, on-the-ground services to lessees under traditional, long-term leases.

Along with the 199A Final Regulations, Treasury issued Notice 2019-07, which includes a proposed revenue procedure with a safe harbor under which a rental real estate enterprise will be treated as a trade or business, solely for purposes of the section 199A deduction. Under the safe harbor, a rental real estate enterprise may be treated as a trade or business if the following requirements are satisfied during the taxable year with respect to the rental real estate enterprise:

> (A) Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
>
> (B) 250 or more hours of rental services are performed per year with respect to the rental enterprise; and
>
> (C) The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2019.

Rental services for purpose of the safe harbor include:

- advertising to rent or lease the real estate,
- negotiating and executing leases,
- verifying information contained in prospective tenant applications,
- collecting rent,
- daily operation, maintenance, and repair of the property,

31 T.D. Preamble, at 15.

- management of the real estate,
- purchase of materials, and
- supervision of employees and independent contractors.

Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners.

Rental services do ***not*** include:

- financial or investment management activities, such as arranging financing,
- procuring property,
- studying and reviewing financial statements or reports on operations,
- planning, managing, or constructing long-term capital improvements, or
- time spent traveling to and from the real estate.

Real estate used by the taxpayer as a residence is not eligible for the safe harbor, and neither is real estate rented under a triple net lease, which is a lease that requires the lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for the property. Such leases are common in the commercial context as they allow the landlord to devote more of his efforts to buying and selling other properties.[32]

Landlords in triple net leases can take small comfort from the fact that failure to meet the safe harbor does not preclude a rental real estate enterprise from being a section 162 trade or business, as such a determination is based on all facts and circumstances.[33] But triple net lease landlords also should consider renegotiating those agreements so that the landlord can provide at least 250 hours of services per year (cumulatively as to all leases that the landlord can aggregate). Practitioners already have criticized the safe harbor, saying it accomplishes nothing because taxpayers that spend 250 hours per year on their rental real estate activity likely already satisfy the section 162 trade or business standard, and that the exclusion of triple net leases and taxpayer residence rental from the safe harbor eviscerates it.[34]

Under the 199A Final Regulations, certain trades or businesses can be aggregated, which potentially increases the taxpayer's deduction amount. The aggregation rules in the 199A Final Regulations hinge on whether the businesses provide products or services typically sold together; whether they share centralized back-office services; and whether they are interdependent. Some commenters on the proposed regulations pointed out that section 469 already contains grouping rules, which could be leveraged for section 199A, but Treasury rejected the suggestion, saying that it "do[es] not consider the grouping rules under section 469 an appropriate method for determining whether a taxpayer can aggregate trades or businesses for

32 *See* A. Gassman, *Why Is The IRS Punishing Triple Net Landlords* (Jan. 26, 2019), available at https://www.forbes.com/sites/alangassman/2019/01/26/why-is-the-irs-punishing-triple-net-landlords/#3ee5bbf82d75 (accessed Jan. 28, 2019).

33 *Higgins v. Commissioner*, 312 U.S. 212 (1941) (cited by T.D. Preamble, at 13).

34 *See* E. Yauch, *Real Estate Businesses Are Dissatisfied With Parts of 199A Guidance* (Jan. 23, 2019), available at https://www.taxnotes.com/taxpractice/exemptions-and-deductions/real-estate-businesses-are-dissatisfied-parts-199a-guidance/2019/01/28/292lg? (accessed Jan. 28, 2019).

purposes of applying section 199A."[35] Treasury is still studying whether the reverse—i.e., use of a taxpayer's aggregation for purposes of section 199A for section 469 grouping purposes—might be allowed.[36]

The 199A Final Regulations do not cross reference section 469 or any of its regulations. Thus, for now, the aggregation rules of section 199A are completely separate from the grouping rules of section 469.

Putting it all together: Can the restaurant owner / developer deduct real estate losses?

Under the facts set out in the beginning of this article, our hypothetical client may deduct real estate losses. All his real estate development, construction, management and rental activities can be grouped under the authority of Treas. Reg. § 1.469-9(d) and CCA 201427016. In addition, the restaurant operations can be grouped with the real estate activities under the authority of Treas. Reg. § 1.469-4(d)(1)(ii) and *Stanley*, given that the two businesses constitute an appropriate economic unit. The two businesses make up an appropriate economic unit because of their similarities—the taxpayer markets space to the same type of restaurants that he himself operates; he owns and controls both businesses, in the same geographical area; and the businesses are interdependent—each is facilitated by the other.

Our client can prove that he materially participates in the combined activity, by way of the first of the seven tests for material participation, participation in the activity for more than 500 hours during the tax year. If he does not have a contemporaneous log (and we hope he does), we can reconstruct his records using e-mails and phone records with brokers, agents, contractors, city government officials, and tenants, as well as calendar records showing his site visits. We will hope that the records show that the taxpayer spent more than 750 hours per year, and more than half of his total time, on the real estate activity, making him a real estate professional. This means that his combined real estate and restaurant activities are non-passive. Crucially, this taxpayer must file the election under Treas. Reg. § 1.469-9(g) to treat his multiple real estate projects as a single real estate activity, and keep clear, contemporaneous records of his activities and time spent in both businesses to prove his material participation on an annual basis.

Conclusion

Despite the high hurdles in the Code and regulations for treating rental real estate as active, taxpayers who have a complementary business and spend substantial time in the combined activity may be able to take advantage of the grouping rules in the section 469 regulations to deduct real estate losses. To sustain their tax return position on audit, taxpayers should carefully document their time spent. ■

35 T.D. Preamble, at 61.
36 T.D. Preamble, at 62.