MLI #10 Passive Activity Losses (PAL) Under IRC § 469

SUMMARY

This is the first time the disallowance of the passive activity loss and credit (PAL) under Internal Revenue Code (IRC) § 469 has been among the Most Litigated Issues in the National Taxpayer Advocate's Annual Report to Congress.[1] A possible explanation for this increase in cases may be the IRS having nine Compliance Initiative Programs (CIP) between the tax years of 2007-2012, which specifically addressed compliance issues involving PAL.[2]

We identified and reviewed 28 federal court opinions involving a PAL issue that were issued between June 1, 2013 and May 31, 2014. The 28 opinions do not reflect the full number of PAL cases because the courts do not always publish an opinion. Some cases are resolved through settlements, or taxpayers do not pursue litigation after filing a petition or complaint with the court. The courts also dispose of some cases by issuing unpublished orders. Table 10 in Appendix lll provides a detailed list of the PAL opinions we reviewed. The courts affirmed the IRS position in the vast majority of cases (23 out of 28, approximately 82 percent), while taxpayers fully prevailed only about 14 percent of the time (in four out of 28 cases). The remaining case resulted in a split decision.

PRESENT LAW

Generally, IRC §§ 162 and 212 allow taxpayers to deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business or for the production of income.[3] In 1986, Congress enacted IRC § 469 to address concerns regarding abusive tax shelters.[4] IRC § 469 generally disallows passive activity losses from trade or business activities in which the taxpayer does not materially participate and from rental activities.[5]

- A passive activity loss is the aggregate of losses from all passive activities for the taxable year over the aggregate of income from all passive activities for the year.[6]
- A passive activity credit is the sum of the credits from all passive activities allowable for the taxable year over the regular tax liability of the taxpayer for the taxable year allocable to all passive activities.[7]

1 See National Taxpayer Advocate 1998-2013 Annual Reports to Congress.

2 IRS Compliance Initiative Projects, *National CIP Database* (Sep. 16, 2014). *See* SBSE, Project Code 0031, *PAL Limitations - Rental Real Estate*; SBSE, Project Code 0189, *PAL Limitation - Modified AGI Greater than $100000*; SBSE, Project Code 0553, *High Income/High Wealth with Large Investment Income and Low Earnings*; SBSE, Project Code 0685, *Self-Rented Property - FY 05 & 06*; SBSE, Project Code 0685, *Self Rental Property*; SBSE, Project Code 0688, *Investment Interest Expense - FY 05 & 06*; SBSE, Project Code 0688, *Investment Interest Expense*; SBSE, Project Code 0711, *Real Estate Sales - Principal Residence*; and SBSE, Project Code 0793, *Other Income Deduction PAL*. CIPs are used to identify taxpayer compliance issues. One of the fundamental principles of CIPs is to "[i]dentify trends on non-compliance and improper treatment of tax issues." IRM 4.17.1.2(2), *Compliance Initiative Projects* (Feb. 25, 2010).

3 IRC § 469(c)(6)(A), (B). *See also* Most Litigated Issue: *Trade and Business Expenses*, *supra*.

4 Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2085, 2233 (1986).

5 IRC § 469(c)(1).

6 IRC § 469(d)(1)(A), (B); Temp. Treas. Reg. § 1.469-2T(b)(1).

7 IRC § 469(d)(2)(A), (B).

The PAL limitation applies to individuals, estates, trusts, closely held subchapter C corporations, and personal service corporations.[8] Passive activity loss rules apply at the individual taxpayer level, *i.e.*, at a partner or shareholder level rather than the passthrough entity level.[9] Any loss or credit from passive trade or business activities for the taxable year exceeding passive activity income may not be deducted or credited in that year, but will be carried forward to reduce future passive activity income.[10]

In 1993, Congress created a special rule for taxpayers in real property businesses, permitting them to treat certain rental real estate activities as nonpassive activities. To qualify for this special rule under § 469(c)(7), more than half of a taxpayer's personal services performed during a tax year must be performed in real property trades or businesses in which the taxpayer materially participates, and the taxpayer must perform more than 750 hours in real property trades or businesses in which the taxpayer materially participates during the tax year.[11]

The taxpayer must also materially participate with respect to each rental real estate activity. For this purpose, each interest in rental real estate of the taxpayer is treated as a separate activity unless the taxpayer elects to treat all rental real estate interests as one activity. Judicial interpretation of IRC § 469 and the related regulations is focused on review of specific facts and circumstances.

What is a trade or business?

The Supreme Court has interpreted "trade or business" for purposes of § 162 to mean an activity conducted with "continuity and regularity" for the primary purpose of earning income or making profit.[12] IRC § 469 provides that "trade or business" includes any activity:

- Involving research or experimentation (within the meaning of IRC § 174);[13]
- In connection with a trade or business,[14] or
- With respect to which expenses are allowable as a deduction under IRC § 212.[15]

What is material participation?

Generally, a taxpayer can materially participate in an activity only if the participation is regular, continuous, and substantial.[16] A limited partner in a limited partnership cannot generally meet this requirement except as provided in the regulations.[17] Under the temporary regulations for § 469(h), an individual materially participates if and only if he or she satisfies any one of seven material participation tests:[18]

1. The individual participates in the activity for more than 500 hours during the taxable year;
2. The individual's participation constitutes substantially all of the participation in the activity of all individuals (including non-owners) for the taxable year;

8 IRC § 469(a)(2); Temp. Treas. Reg. § 1.469-1T(b).

9 Temp. Treas. Reg. § 1.469-2T(e)(1).

10 IRC § 469(b).

11 Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13143(a) and (b), 107 Stat. 312, 440-41 (1993). The special rule remedied the unfairness of treating real estate professionals as passive investors. *See also* IRC § 469(c)(7).

12 *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987).

13 IRC § 469(c)(5).

14 IRC § 469(c)(6).

15 *Id*.

16 IRC § 469(h).

17 *Id*.; Temp. Treas. Reg. § 1.469-5T(e) (containing exceptions).

18 Temp. Treas. Reg. § 1.469-5T.

3. The individual participates in the activity for more than 100 hours during the taxable year, and his or her participation is not less than that of any other person;
4. The activity is a significant participation activity for the taxable year, and the individual's aggregate participation in all significant participation activities during the taxable year exceeds 500 hours;[19]
5. The individual materially participated in the activity for any five taxable years of the ten tax years immediately preceding the taxable year in question;[20]
6. The activity is personal service activity and the individual materially participated in the activity for any three taxable years preceding the taxable year in question;[21] or
7. Based on all facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the tax year subject to the following requirements:
   - The individual's services in managing the activity will not be taken into account unless no other person receives compensation for performing management services in the activity;
   - No individual performs management services that exceed (by hours) the services performed by the individual; and
   - The individual participates in the activity greater than 100 hours during the taxable year.[22]

However, under IRC § 469 material participation is generally not relevant for rental activities, and is generally not required for working interests in oil and gas properties as long as the taxpayer holds the interest directly or the form of ownership does not limit the liability of the taxpayer.[23]

What are the special rules for taxpayers engaged in real property trades or businesses?

IRC § 469(c)(7) provides a special rule for taxpayers engaged in real property trades or businesses (commonly referred to as the "real estate professional" exception). Under this rule, the rental real estate activities in which the taxpayer materially participates will not be treated as passive activities. For this purpose, each interest in rental real estate of a qualifying taxpayer will be treated as a separate activity unless the taxpayer elects to treat all interests in rental real estate as one activity.[24] A taxpayer will qualify for this exception only if the following two requirements are met: (i) more than half of the personal services performed by the taxpayer in trades or businesses were performed in real property trades or businesses in which the taxpayer materially participated and (ii) the taxpayer performed and materially participated in more than 750 hours of services during the taxable year in real property trades or businesses.[25]

19 A significant participation activity is one in which the individual has more than 100 hours of participation during the tax year but fails to satisfy any other test for material participation. A rental activity may not be included in the significant participation test. If the sum of all the time spent in significant participation activities exceeds 500 hours, such activities are considered nonpassive. Temp. Treas. Reg. § 1.469-5T(c).

20 The five tax years need not be consecutive.

21 A personal service activity is one that involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor. Temp. Treas. Reg. § 1.469-5T(d).

22 Temp. Treas. Reg. § 1.469-5T(b)(2).

23 IRC § 469(c)(4), (7)(A), and (3)(A).

24 IRC § 469(c)(7)(A); Treas. Reg. § 1.469-9(e)(1).

25 IRC § 469(c)(7)(B). "Real property trade or business" is defined as "any business that deals in any real property development, construction, redevelopment, reconstruction, acquisition, rental, conversion, operation, leasing, management, or brokerage trade or business." IRC § 469(c)(7)(C).

In the event of a joint return, these requirements are satisfied only if at least one spouse separately satisfies both statutory requirements.[26] This means the spouses' activities cannot be aggregated to satisfy either requirement, *i.e.*, the requirements will not be satisfied if one spouse meets one of the requirements and the other spouse satisfies the other prong.[27] For example, in *Adeyemo v. Commissioner*, discussed below, the court noted that the two requirements for the real-estate professional exception must be independently satisfied by one of the spouses in the case of a joint return.[28] However, in determining whether a taxpayer materially participates in a real property trade or business for this purpose, the work performed by the taxpayer's spouse will count as work performed by the taxpayer.[29]

What is the $25,000 offset for rental real estate activities?

Except as provided in § 469(c)(7), any losses from the taxpayer's rental activities are treated as passive activity losses. However, under § 469(i)(1), the taxpayer may be eligible to annually deduct up to $25,000 of the losses attributable to rental real estate activities in which he or she actively participated during the taxable year.[30] This special allowance begins to phase out when a taxpayer's modified adjusted gross income (MAGI) exceeds $100,000.[31] The $25,000 offset amount is reduced by 50 percent of the amount by which the taxpayer's MAGI exceeds $100,000,[32] and phases out entirely when the MAGI equals or exceeds $150,000.[33]

The deduction is also subject to the phase-out amounts for the rehabilitation credit, commercial revitalization deduction, and low-income housing credit.[34] There are also special rules for estates, surviving spouses, married individuals filing separately, and taxpayers not living apart.[35]

ANALYSIS OF LITIGATED CASES

We reviewed 28 decisions entered between June 1, 2013, and May 31, 2014, involving passive activity loss deductions and credits claimed by taxpayers. Table 10 in Appendix lll contains a list of the cases. The IRS prevailed in full in 23 cases (82 percent), the taxpayers prevailed in full in four cases (14 percent) and one case (four percent) resulted in a split decision.

Taxpayers appeared *pro se* (without representation) in 17 cases (61 percent) and convinced the court to allow their loss deduction in one (six percent) of those cases.[36] Represented taxpayers fared slightly better, achieving full or partial relief in their ability to claim a PAL deduction in four of the 11 cases

26 IRC § 469(c)(7)(B). *See also* Temp. Treas. Reg. § 1.469-5T(f)(3).

27 IRC § 469(c)(7)(B).

28 T.C. Memo. 2014-1.

29 Treas. Reg. § 1.469-9(c)(4).

30 Generally, taxpayers that have less than 10 percent of an interest in rental real estate activity are ot considered as actively participating. IRC § 469(i)(6)(A). Active participation is a lesser standard than material participation in that there is no requirement for "regular, continuous, and substantial participation" and there are no requirements involving rehabilitation and low-income housing credits, or commercial revitalization deductions as a result of real estate activity. IRC § 469(i)(6)(B).

31 IRC § 469(i)(3)(A), (F)(iv). Computed without regard to passive activity losses.

32 IRC § 469(i)(3)(A), (F).

33 IRC § 469(i)(3)(A).

34 IRS § 469(i).

35 *Id*.

36 The taxpayer was *pro se* and won a favorable outcome in *Montgomery v. Comm'r*, T.C. Memo. 2013-151.

(36 percent); business taxpayers represent two of these cases.[37] Figure 3.10.1 shows the breakdown of *pro se* and represented taxpayer cases and the decisions rendered by the courts.

FIGURE 3.10.1, *Pro Se* and Represented Taxpayer Cases and Decisions

Court Decisions	*Pro Se* Taxpayers		Represented Taxpayers	
	Volume	% of Total	Volume	% of Total
Decided for IRS	16	94%	7	64%
Decided for Taxpayer	1	6%	3	27%
Split Decisons	0	0%	1	9%
Totals	**17**	**100%**	**11**	**100%**

All twenty-eight cases addressed whether the taxpayer's activity was a passive activity and 15 of the 28 involved the taxpayers' qualification for the exemption under § 469(i). Twenty-three cases were related to rental real estate, four cases were related to business activity, two of which dealt with breeding animals, and one was related to an aircraft rental.[38] The other issue discussed, which also affected the court's analysis in some cases, was the lack of substantiation or poor recordkeeping to substantiate claimed expenses or hours worked.

Cases Not Involving Real Estate Activities

In cases not involving real estate activities, the most prevalent issue was whether the taxpayer materially participated in the trade or business.[39] Courts generally upheld the IRS's determinations that losses claimed by taxpayers were passive and non-deductible within the meaning of IRC § 469.

For example, in *Bartlett v. Commissioner*,[40] the taxpayers sought to deduct a loss related to bull breeding. The taxpayers claimed to have materially participated in the operation. The Tax Court disagreed and decided the taxpayers did not materially participate and did not allow the claimed losses to be deducted because the taxpayers failed to provide documentary evidence to prove that they met the 500-hour or 100-hour tests.[41] Conversely, the taxpayers in *Tolin v. Commissioner*[42] sought to deduct losses related to their thoroughbred horse breeding activity under IRC § 469. The Tax Court agreed that they materially participated in the business and their activity was not passive, and allowed the loss deduction.

In *Moreno v. United States*,[43] the taxpayer owned an aircraft leasing business and leased out a Lear jet. The U.S. District Court found this activity was not passive and allowed the taxpayer's deductions because the average period of customer use was less than seven days and therefore was a trade or business activity and

37 Two of the cases are designated as business taxpayers, which includes corporations, partnerships, trusts, and sole proprietorships – Schedule C, E, and F filers.

38 In several of the 23 rental real estate cases, the courts did not always use the term "rental real estate," and instead used more generic terms when describing these activities, such as real estate.

39 Temp. Treas. Reg. 1.469-5T(a). An individual taxpayer is considered to have materially participated in an activity if and only if any one of the seven tests that are prescribed in the regulations is met.

40 T.C. Memo. 2013-182.

41 Temp. Reg. 1.469-5T(a).

42 T.C. Memo. 2014-65.

43 *Moreno v. U.S.*, 113 A.F.T.R.2d (RIA) 2149 (W.D. La. 2014). One of the four business taxpayers in our review.

not a rental activity for purposes of § 469. The IRS had conceded that the taxpayers materially participated with respect to the airplane leasing activity.[44]

In *Montgomery v. Commissioner*,[45] married taxpayers were members of a limited liability company that was treated as an S-Corporation for tax purposes and sought to deduct losses from their business activity. The IRS determined the wife did not materially participate in the engineering business and her activity was passive. However, the taxpayers prevailed in Tax Court by showing that the wife materially participated by working more than 500 hours during the tax year.

Activities of Rental Real Estate Businesses or Professionals

Rental real estate activities of real estate professionals may qualify for the exception under § 469(c)(7) but the taxpayers must show that they materially participate in their rental real estate activities in addition to meeting the two qualification tests as real estate professionals. In the majority of these cases, the taxpayers struggled with substantiating that they met the two qualifying tests, and the courts determined their rental real estate activities were passive.[46] However, in some cases the court considered whether the taxpayer qualified for the $25,000 offset for rental real estate activities under IRC § 469(i). As discussed above, the $25,000 offset allows for a deduction of up to $25,000 in rental real estate losses on the taxpayer's tax return, which may be deducted against the taxpayer's non-passive income.

For example, in *Herwig v. Commissioner*,[47] the taxpayers were married business partners who claimed a loss deduction from "suspended" passive losses after Fifth Third Bank foreclosed on their Florida condominium units.[48] The Tax Court disallowed the deduction of the suspended passive losses under § 469(g), ruling that a foreclosure of a rental real estate property is not a disposition of the taxpayers' entire interest in their rental real estate activity.[49] In *Almquist v. Commissioner*,[50] the taxpayer could not substantiate the number of hours he worked. The Tax Court held the taxpayer did not qualify as a real estate professional; therefore, his rental real estate activity was passive and the passive activity loss was disallowed.[51] In *Oderio v. Commissioner*,[52] married taxpayers filed separate returns and claimed a rental loss deduction that the IRS disallowed. The Tax Court held that a married filing separately taxpayer must separately satisfy the requirements of § 469(c)(7)(B) in order to avoid *per se* passive activity loss treatment.[53] The taxpayers, who filed married filing separate, could not combine their efforts under § 469(c)(7)(B)(i) and (ii). The Tax Court stated that the taxpayers could only claim spousal attribution under Temp. Treas. Reg. § 1.469-5T(f)(3) to satisfy the § 469(c)(7)(B) requirements under material participation, however;

44 *Moreno v. U.S.*, 113 A.F.T.R.2d (RIA) 2149 (W.D. La. 2014) (stating that "an activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year – (A) the average period of customer use for such property is seven days or less …" *quoting* IRC § 1.469-1T(e)(3)(i)).

45 T.C. Memo. 2013-151.

46 *See Adeyemo v. Comm'r*, T.C. Memo. 2014-1; *Graffia v. Comm'r*, T.C. Memo. 2013-211; *Merino v. Comm'r*, T.C. Memo. 2013-167; and *Ohana v. Comm'r*, T.C. Memo. 2014-83.

47 T.C. Memo. 2014-95, *appeal docketed*, No. 14-13644, (11th Cir. Aug. 14, 2014). A business taxpayer case.

48 A "suspended" passive activity loss is a loss or credit that was disallowed for a taxable year and treated as a credit or deduction carried forward to and arising in the next taxable year. *See* IRC § 469(b). A taxpayer's suspended losses from an activity may be "freed up" and allowable as a deduction against non-passive income in the taxable year in which the taxpayer disposes of the entire interest in the activity giving rise to the loss in a fully taxable transaction to an unrelated party. *See* IRC § 469(g).

49 T.C. Memo. 2014-95.

50 T.C. Memo. 2014-40.

51 *Id*.

52 T.C. Memo. 2014-39.

53 *Id*., citing IRC § 469(c)(7)(B) and Treas. Reg. § 1.469-9(c)(4).

spousal attribution was not allowed in meeting the other requirements, *i.e.*, that a taxpayer perform more than one half of his or her personal services and more than 750 hours in a real estate trade or business.[54]

However, in *Graffia v. Commissioner*,[55] married taxpayers filed joint returns and were shareholders of an S corporation. The husband materially participated in the business, but the wife did not, and they claimed a business loss deduction. The Tax Court ruled in favor of the taxpayers and held a married shareholder's participation in an activity will be treated as participation of the shareholder's spouse in that activity, regardless of whether the spouses filed a joint return. In *Adeyemo v. Commissioner*,[56] the taxpayers filed a joint return and claimed losses related to rental real estate activity, but the Tax Court determined that their activity was passive, the $25,000 offset was phased out, and the passive activity loss deduction was disallowed.[57] In *Ohana v. Commissioner*,[58] the taxpayers sought to deduct rental and non-rental expenses. The Tax Court found the taxpayers were not involved in a business of real estate development, their rental real estate activities did not amount to a trade or business and therefore were passive activities, and the taxpayers could only deduct their rental expenses to the extent of their rental income.

In *Gragg v. United States*,[59] a married couple filed a joint return and one spouse was a real estate professional. The taxpayers claimed they were not required to show material participation in their rental real estate activities before deducting losses from those activities under IRC § 469(c)(7). The U.S. District Court for the Northern District of California held that in order to deduct losses from a rental real estate activity, the taxpayers were required to establish that they materially participated in each rental real estate activity listed on their return.[60]

Finally, in *Frank Aragona Trust v. Commissioner*,[61] a trust with rental real estate properties claimed loss deductions and the IRS determined the rental real estate activities were passive.[62] The Tax Court found this case to be of first impression. It decided the trust:

- Was capable of performing "personal services" in real-property trades or businesses and qualified as a real estate professional;[63]
- Materially participated in its rental real estate activity through the work performed by its trustees in that activity; and therefore
- Was allowed to deduct its rental real-estate losses.[64]

54 T.C. Memo. 2014-39.

55 T.C. Memo. 2013-211, *appeal docketed*, No. 13-3757 (7th Cir. Dec. 11, 2013).

56 T.C. Memo. 2014-1.

57 *See also*, *Azimzadeh v. Comm'r*, T.C. Memo. 2013-169 (married taxpayers' rental activity was passive, the $25,000 offset under § 469(i) completely phased out and the Tax Court disallowed their passive activity loss deduction) and *Merino v. Commissioner*, T.C. Memo. 2013-167 (the Tax Court denied the passive activity loss deduction because married taxpayers failed to prove they materially participated in their business activity and the Tax Court ruled that the activity was passive, and they exceeded the $150,000 MAGI amount under § 469(i) and therefore were not eligible for the $25,000 offset for rental real estate activities).

58 T.C. Memo. 2014-83.

59 *Gragg v. United States*, 113 A.F.T.R.2d (RIA) 1647 (N.D. Cal. 2014) (not reported in F.Supp.2d), appeal docketed, No. 14-16053, (9th Cir. May 30, 2014).

60 *Id*.

61 *Frank Aragona Trust v. Comm'r*, 142 T.C. No. 9 (2014).

62 *Id*.

63 IRC § 469(c)(7)(B)(i). The regulations define "personal services" as "work performed by an individual in connection with a trade or business." Treas. Reg. § 1.469-9(b)(4).

64 *Frank Aragona Trust v. Comm'r*, 142 T.C. No. 9 (2014).

CONCLUSION

The courts upheld the IRS's determination regarding passive activity losses in 23 of the 28 cases. Taxpayers appear to be confused by the application of IRC § 469; specifically the substantiation requirements (recordkeeping and consistent documentation of participation) and the Temp. Treas. Reg. § 1.469-5T(a)(4) requirement to log the taxpayer's hours (taxpayers did not keep logs or did not know the required hours needed). The courts largely favored the IRS's disallowance of passive activity loss deductions, relying on IRC § 469; Treas. Reg. § 1.469-1; and Temp. Treas. Reg. §§ 1.469-4T and 1.469-5T (and the seven material participation tests therein). While most taxpayers struggled with the substantiation requirements, the courts' application of the specific facts and circumstances analysis provided positive outcomes for four taxpayers.

Given that this is the first time the disallowance of passive activity loss and credit under IRC § 469 has appeared in this report and the frequency that substantiation appeared in the courts' analysis, we recommend that the IRS highlight the available passive activity loss guidance on its website (with specific attention to rental real estate taxpayers). Due to the complex nature of these laws, the IRS also should undertake additional efforts to educate taxpayers, advisors, and return preparers through webinars, news releases, social media, and similar outreach. By educating taxpayers on the application of IRC § 469 and by suggesting best practices for substantiating real estate activities, the IRS can help taxpayers avoid having their passive loss deductions denied.