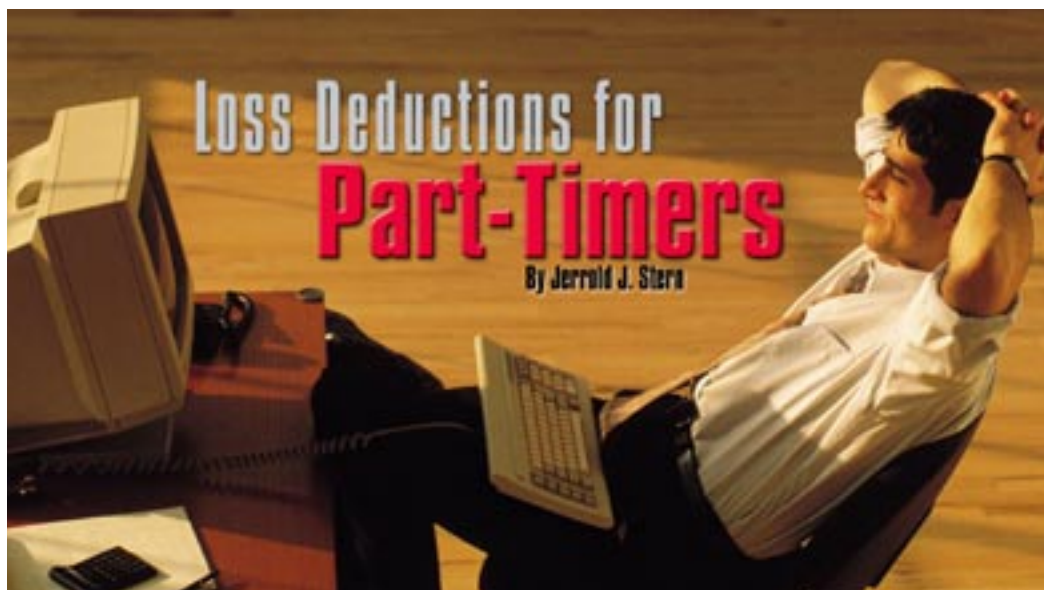


A Reprint from *Tierra Grande*

Since 1994, real estate brokers, sales associates and other real estate professionals have been able to deduct unlimited real estate activity losses from their other sources of income, such as self-employment, salaries, interest and dividends. However, a new U.S. Tax Court case demonstrates how part-time real estate professionals can lose deductions if key requirements are not met (*Jahina*, TC Summary Opinion 2002-150).

Under the general rules, individuals are eligible to deduct unlimited real estate losses if two conditions are met. More than half of all personal services they perform during the year must be for real property trades or businesses in which they materially participate. Real property trades and businesses include real estate brokerage, management, rental, operation, leasing, development, construction, reconstruction, acquisition or conversion. Material participation requirements are met if the taxpayer is involved in real estate operations on a regular, continuous and substantial basis. Limited partners typically do not materially participate because active involvement could cause them to lose their limited liability status.

Individuals also must perform more than 750 hours of service per year in those real estate activities. Married couples filing joint returns meet the eligibility requirements as long as at least one spouse meets both the material participation and 750-hour requirements.

An example based on the facts of the new court case helps illustrate real estate loss rules and computations for part-time real estate professionals.

Birgit Jahina's rental properties comprise five apartment buildings with a total of 109 units and three single-family condominiums. She has an undergraduate degree in English and an MBA. Prior to 1996, she had six years' experience working in the fields of financial accounting, auditing and banking. She does not have expertise in taxation.

During the two tax years in question, 1996 and 1997, she worked 18 months full time and six months part time in

Part-timers should keep detailed documentation of time spent on real estate activities.

accounting and banking. Her husband, Karl, worked full time as a structural engineer and spent no time on work related to the rental properties or any other real estate activities.

In addition to working in her full-time and part-time jobs, Birgit was actively engaged in managing the rental properties. She often worked in the early morning hours, prior to her salaried employment, on her rental property financial statements, tenant

correspondence and other paperwork related to the rental properties. In her own words, she monitored "every phase of the business."

Birgit stated that she devoted more than 1,800 hours annually (more than 35 hours per week) to the rental activities. While there were resident property managers at three of the properties, Birgit made all the decisions affecting the properties.

The Jahinas claimed they were entitled to deduct their real estate losses against their non-real estate income because Birgit was a real estate professional, and the rental properties made up a trade or business in which Birgit materially participated.

Two factors caused the Jahinas to lose the court case and the ability to deduct the real estate losses. First and foremost, the Jahinas did not file an election (a one-paragraph statement) with any of their tax returns to treat their rental properties as one rental activity rather than multiple ones. A tax professional would not have overlooked this technicality. Without the election, Birgit had to satisfy the 750-hour requirement for each rental property, and this was not possible.

Second, Birgit's documentation of her time spent on the rental units was not complete or precise. Birgit admitted in court that her summaries of time spent were overstated. She said the summaries were hurriedly prepared for the IRS audit based on her calendars, phone records, correspondence, bills and other records.

As a result of the court case, the Jahinas were not allowed to deduct real estate losses of \$128,168 for 1996 and \$95,553 for 1997. They were required to pay \$19,336 and \$26,084, respectively, for 1996 and 1997 taxes owed, plus interest.

Real estate investment activities typically have a variety of tax complexities. Consultation with a competent tax accountant or tax attorney is recommended. ♣

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Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, \$20 per year.

Views expressed are those of the authors and do not imply endorsement by the Real Estate Center, Mays Business School or Texas A&M University.

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