

Part-Time Pitfalls

By Jerrold J. Stern

Many real estate professionals and other individuals own rental properties. One of the benefits is deducting rental losses on their personal tax returns. Full-time real estate professionals (brokers and salespersons, for example) may deduct losses in full. However, special rules apply to those who own and operate real estate rental properties part time and have no other real estate related business activities. A 2014 tax court case highlights the rules for part-timers and demonstrates how deductions might be disallowed.

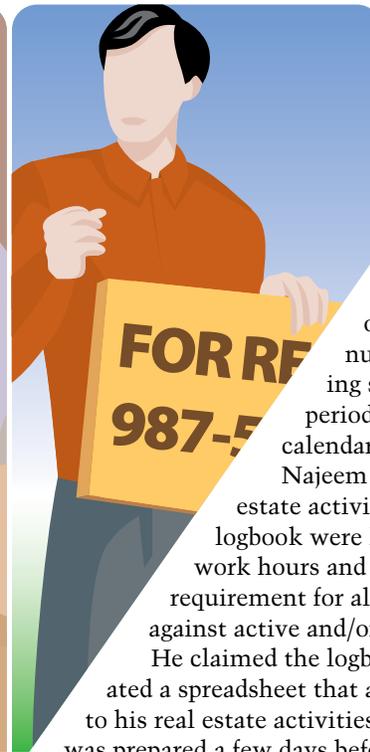
For those who own and manage rental properties part time, the tax law generally treats their real estate investments as “passive” unless they “materially participate” in the management and operations of the property (as described later). A general rule that applies to all investors is that losses from passive activities can only be deducted against passive income. Income from partnerships or corporations in which the investor does not materially participate are examples of passive income. Surprisingly, passive income does *not* include “portfolio income” such as interest, dividends and most capital gains.

The *general* material participation test requires that investors/owners devote 500 hours per year to the activity. In addition, they must document that their involvement in the business activity is “regular, continuous and substantial.”

Unfortunately, for real estate part-timers who own rental property, there is a separate real estate material participation test. For example, John, a high school teacher, may deduct unlimited real estate losses against active and/or portfolio income if (a) more than half of *all* his work hours pertain to real estate business activities in which he materially participates, and (b) he devotes more than 750 hours to those activities. Active income includes sales commissions and salaries.

The results of a 2014 tax court case, *Najeem B. Adeyemo, et ux. v. Commissioner, TC Memo 2014-1*, illustrate how the rules operate for part-timers. In particular, the case focuses on the manner in which records must be kept to document the part-timer’s real estate activities. Najeem, a pharmaceutical sales representative, lost the case because the court did not believe he provided adequate documentation. Thus, the court determined that his rental losses were passive.

The record-keeping requirement may be met in two ways. The investor may keep “contemporaneous” daily time reports



or logs. Alternatively, according to the court case, the investor can identify “services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars or narrative summaries.” Najeem kept a logbook of his real estate activities. But the hours in the logbook were less than one-half of all of his work hours and thus did not meet the tax law requirement for allowing losses to be deducted against active and/or portfolio income.

He claimed the logbook was incomplete and created a spreadsheet that added more details (and hours) to his real estate activities. However, the spreadsheet was prepared a few days before the trial. The IRS argued that the hours and activities recorded on the spreadsheet were “uncorroborated,” “self-serving” and based on “ballpark guesstimates.”

In response, Najeem provided “some 300 pages of documents apparently related to the rental real estate business. The documents were in no discernible order and consisted primarily of receipts, invoices, leases and court documents.” However, Najeem could not explain how the documents directly supported the information in his logbook or spreadsheet.

Najeem and others who have passive losses and no passive income during the tax year may “carry forward” their unused losses to future years to reduce passive income. Unused losses are fully deductible in the year the property is sold.

Had Najeem sought the aid of a tax professional in connection with maintaining documentation of his real estate activities, he might have prevailed. In general, consultation with a tax accountant or tax attorney is recommended for all substantial real estate rental activities. ♣

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THE TAKEAWAY

Full-time real estate professionals who own rental properties may deduct their rental losses in full. However, part-timers must devote over 750 hours per year to real estate activities and compile detailed documentation of their time in order to deduct rental property losses.



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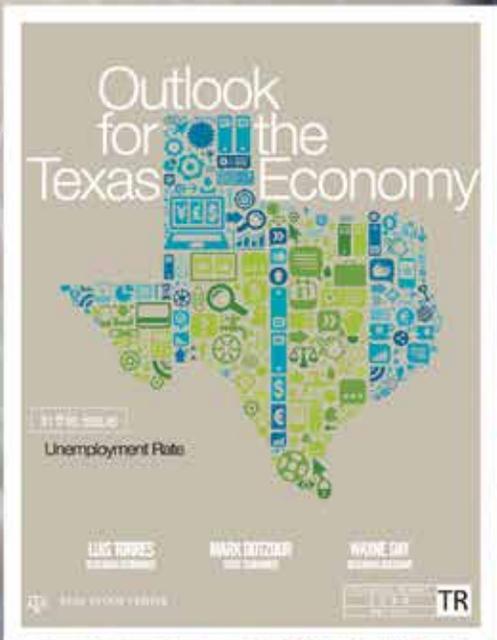
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