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SUBJECT

REAL ESTATE PROFESSIONAL - SUBSTANTIATION OF PARTICIPATION IN ACTIVITIES

SUMMARY

Two recent Tax Court cases have examined substantiation of taxpayers' qualification as real estate professionals. On April 17, 2017, in the case of *Zane W. Penley, et ux. v. Commissioner*, TC Memo 2017-65, the Tax Court found that the documentation provided by the taxpayer did not prove the taxpayer worked more hours in his real estate business than in his full time employment. As such, the taxpayer was not a real estate professional and his rental real estate losses were subject to passive loss limitations and could not be deducted against his active income. Conversely, in *Patricia S. Windham v. Commissioner*, TC Memo 2017-68, the Tax Court held that the taxpayer was a real estate professional and her rental real estate losses were not subject to the passive activity loss limitations as she was able to credibly substantiate the amount of time she spent in her real estate business compared to her part-time employment.

DETAILS

Background

Taxpayers are generally allowed to deduct business and investment expenses under sections 162 and 212, but section 469 puts strict limits on the deductibility of expenses incurred in a "passive activity."¹ A passive activity is any trade or business in which the taxpayer does not materially participate.² Subject to a few exceptions, passive activity losses are deductible only to the extent of passive activity income.

¹ Unless otherwise indicated, all "section" references herein are to the Internal Revenue Code of 1986, as amended, and all "Treas. Reg. §" references are to the Treasury regulations promulgated thereunder.

² Section 469(c)(1)

CONTACT:

JEFFREY N. BILSKY
Partner, National Tax Office
Technical Practice Leader,
Partnerships
404-979-7193 / jbilsky@bdo.com

DAVID PATCH
Managing Director, National Tax Office
703-336-1520 / dpatch@bdo.com

JULIE ROBINS
Managing Director, National Tax Office
512-391-3534 / jrobins@bdo.com

WILL HODGES
Manager, National Tax Office
404-942-2937 / whodges@bdo.com

Individuals, trusts, estates, and personal service corporations may not use losses from passive activities to offset salary, dividends, interest, royalties, portfolio gains, and income from active business activities. Income and losses from rental activities are always considered passive unless the taxpayer is in the real property business (i.e., a “real estate professional”).³ Special rules provided under section 469(c)(7) allow real estate professionals to deduct rental losses against other income provided that the taxpayer materially participates in the rental activity. Two requirements must be met for a taxpayer to be considered a real estate professional:

1. More than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
2. 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.

Recent Court Cases - Overview

In *Zane W. Penley, et ux. v. Commissioner*, Mr. Penley was employed full-time in a profession that was not a real property trade or business in which he spent 2,194 hours working during 2012. In addition to his full time employment, Mr. Penley and his wife participated in various rental real estate activities through a subchapter S corporation, Harvey Herbet, Inc. (“HHI”), in which they each owned 50 percent. In the course of managing HHI’s affairs, Mr. Penley and his wife spent time finding tenants, managing finances, and making repairs to their real estate properties. Mr. Penley and his wife filed a joint tax return for 2012 on which they reported a nonpassive loss that was passed through from HHI. Upon examination by the Internal Revenue Service (“IRS”), it was determined that a portion of this loss was a passive loss from rental real estate activities and that Mr. Penley did not qualify as a real estate professional under section 469(c)(7).

The taxpayer in *Windham v. Commissioner* was a part-time stock broker who also owned and managed 12 rental real estate properties during 2010. The taxpayer managed all aspects of her rental properties including finding tenants, collecting rent, and coordinating repairmen when repairs were needed. In addition to her managerial duties, the taxpayer maintained insurance on each rental property, maintained services and upkeep on vacant rental properties, maintained records for each rental property, and completed the necessary documents for her certified public accountant to prepare her Federal income tax returns. The Tax Court determined that the taxpayer in this case qualified as a real estate professional and was allowed to deduct losses on her rental real estate properties.

Substantiation

A taxpayer can use “any reasonable” means to prove the extent of their participation in real estate activities. In addition to contemporaneous daily time reports, logs, or similar documents, reasonable means may include identifying the services performed over a period of time and the approximate number of hours spent performing such services by using appointment books, calendars, or other narrative summaries.⁴ In order to substantiate his treatment as a real estate professional, Mr. Penley provided a monthly calendar indicating he spent approximately 2,520 hours on his real estate activities during 2012. This calendar contained information pertaining to the property where he worked on a particular day and a brief description of the work performed, an estimate of the number of hours worked, and the number of miles driven to and from the property. The Tax Court found that the calendar provided by Mr. Penley greatly exaggerated the time he spent on his real estate activities. As Mr. Penley represented working approximately 2,520 hours on real estate activities in 2012, the Tax Court noted that he would have had to work approximately 4,714 hours (i.e., 2,194 for his full-time employment and 2,520 on real estate activities) during 2012 to account for the total amount of time that he claimed to have worked. The Tax Court further commented that Mr. Penley would have had to work approximately 13 hours per day, every day, for the hours provided to reconcile. In addition to the issues with respect to the number of hours worked, the Tax Court also found that the calendar provided by Mr. Penley was unreliable due to the fact that substantially all of the entries were rounded to the nearest hour or half-hour, did not specify a start or end time for work, did not include the time spent driving to and from his properties, and did not separate out any time for meals or other breaks.

³ Section 469(c)(2); Section 469(c)(7)

⁴ Treas. Reg. Sec. 1.469-5T(f)(4)

Even though contemporaneous records are not required for substantiation purposes, the courts have previously found that the use of post-event “ballpark guesstimate” is not sufficient to prove participation in a real estate activity.⁵ Accordingly, the Tax Court determined that the calendar was untrustworthy and disallowed it as substantiation for treatment of Mr. Penley as a real estate professional. Consequently, Mr. Penley did not satisfy the requirements to be considered a real estate professional and the nonpassive loss claimed by Mr. Penley and his wife related to the rental real estate activities was disallowed.

Contrary to *Penley v. Commissioner*, the taxpayer in *Windham v. Commissioner* was able to provide information that the Tax Court deemed credible to substantiate her treatment as a real estate professional. This was due in large part to the documentation and the testimony that the witness provided to the Tax Court. In addition to this information, the Tax Court noted that she only worked part-time in her stock brokerage office and examined additional facts surrounding the taxpayer and her real estate activities. As a result of downturns in the economy that occurred in the mid-2000s, the taxpayer withdrew approximately \$180 thousand from her retirement account in 2010 to meet her rental real estate business expense requirements. The Tax Court took notice to the considerable amount of time and money that was spent by the taxpayer to keep her rental real estate activities afloat. After reviewing all of the information available, the Tax Court ultimately concluded that the taxpayer substantiated her participation in the activities as a real estate professional and could deduct the losses from her rental real estate properties.

BDO INSIGHTS

Taxpayers involved in rental real estate activities are encouraged to practice reasonable means when substantiating their participation in an activity. Substantiation is increasingly important for taxpayers who wish to qualify as real estate professionals pursuant to Section 469(c)(7). Taxpayers should be encouraged to maintain contemporaneous daily time reports, logs, or similar documentation. However, in the absence of contemporaneous daily time reports or logs, taxpayers may use other reasonable means of tracking the amount of time spent and the services performed for an activity such as through the use of appointment books, calendars, or other narrative summaries. Taxpayers should always use caution that the documentation created is credible to avoid future challenges of the documentation. Even though contemporaneous documentation is not required for substantiation under the regulations, it is strongly recommended and considered a best practice.

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