



Documentation matters in real estate professional exception

You certainly couldn't be blamed if you thought a dentist wouldn't qualify as a "real estate professional" allowed to deduct rental real estate losses — after all, the IRS thought the same thing. You'd be wrong, though. The U.S. Tax Court found that a dentist who also operated a real estate business qualified for the real estate professional exception, based largely on his extensive documentation of the hours he'd spent.

Real estate professional exception defined

Rental real estate activities are generally considered passive, meaning activities in which the taxpayer doesn't materially participate. Losses associated with passive activities can be offset against passive income only. As a general rule, rental activities are per se passive, regardless of whether you materially participate in them.

The Internal Revenue Code, however, grants an exception for taxpayers who are real estate professionals and materially participate in rental activities.

To qualify as a real estate professional, you must satisfy two requirements:

1. More than 50% of the "personal services" you perform in trades or businesses must be performed in real property trades or businesses in which you materially participate.
2. You perform more than 750 hours of services in real property trades or businesses in which you materially participate.

The IRS defines material participation as regular, continuous and substantial involvement in business operations. The material participation requirement is satisfied if you meet any one of seven tests. In the case of a joint return, the couple meets the requirements if either spouse separately satisfies them.

IRS challenges rental loss deduction

In the recent case, the taxpayer owned a dental practice with his wife, also a dentist. They worked in alternate shifts that allowed him to also operate a real estate business consisting of brokerage activity and management of four rental properties the couple owned. The husband spent more than 1,000 hours annually on the business in 2011, 2012 and 2013.

The dental practice showed a net profit each year, which the couple offset on their tax returns with losses from the real estate business. The IRS disallowed the losses, finding that they were passive activity losses that couldn't be used to offset the couple's nonpassive income.

On appeal, the dentist argued that the exception applied to his activities. The IRS conceded that the husband met the material participation requirement because his participation in his real estate activities for each year constituted substantially all of the participation in the activities by anyone.

Court sides with the taxpayer

Tax regulations allow you to establish your hours of service by "any reasonable means," including appointment books, calendars or narrative summaries that identify the services and approximate number of hours spent performing them. While the rules don't require contemporaneous daily time reports, logs or similar documents, a postevent "ballpark guesstimate" won't cut it.



In this case, the husband kept contemporaneous logs showing that he spent more than 1,000 hours per year on real estate activities. (Because the wife didn't participate in the real estate business, the Tax Court considered only the husband's activities.) In testimony, he was able to recall extensive details relating to the entries, and other witnesses, including his wife, backed him up. In addition, the court found that his logs of real estate activities — and the testimony of other witnesses about the time the taxpayer put in on real estate activities — tended to corroborate his limited schedule at the dental practice.

Because his dental practice hours came out to about 728 hours per year, the court concluded that the taxpayer satisfied both prongs of the real estate professional test. As such, the IRS should have allowed his losses from the rental properties.

Documentation saves the day

Keeping close records of your time spent on rental activities can seem tedious and time-consuming. But, if you ever find your deduction for losses related to those activities challenged by the IRS, you'll be glad you invested the effort.

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