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Passive Activities: An Explanation of Legislation and Real Estate Tax Planning Strategies

Greg Schlaefer
College of Saint Benedict/Saint John's University

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PASSIVE ACTIVITIES: AN EXPLANATION OF LEGISLATION AND REAL ESTATE TAX PLANNING STRATEGIES

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In Partial Fulfillment
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and the Degree Bachelor of Arts
in the Department of Accounting

by
Gregory F. Schlaefer
April 1995
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PASSIVE ACTIVITIES: AN EXPLANATION OF LEGISLATION AND REAL ESTATE TAX PLANNING STRATEGIES

APPROVED BY:

Mrs. Lucy Larson
Associate Professor of Accounting

Mr. Thomas Murray
Professor of Accounting Emeritus

Mr. Paul Pladson
Professor of Accounting

Mr. James O'Meara
Chair, Department of Accounting
Professor of Accounting

Dr. Margaret Cook
Director, Honors Thesis Program
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INTRODUCTION

Tax shelters were a sought-after investment in the early and mid 1980's, and still are today. Investments in real estate were commonly tax-shelter type investments. Real estate investments allowed investors to make capital investments up front and depreciate the property quickly, which resulted in losses that would reduce their taxable income. In addition, when the investment was sold, the investor could take advantage of lower capital gains tax rate (up to 20% lower). However, the passive activity regulations activated through the Tax Reform Act of 1986 (TRA of 1986) minimized the usefulness of these shelters and significantly affected the real estate industry. The reform act extended “at-risk” limitations to real estate investments, eliminated the special treatment of capital gains, extended the number of years over which property is to be depreciated, and placed the passive classification on income and losses from many real estate investments (Morris 26). Even though the passive activity legislation limited the real estate industry’s options, tax planning strategies can neutralize the effects of the legislation.

Part I (chapters 1-4) of this thesis explains the passive activity legislation. The passive classification was instituted through the Tax Code Section 469. Tax legislation is organized in a hierarchial manner. The tax code is the ultimate authority. Next in line are regulations and then amendments. The tax code, more specifically Section 469 on passive activities, explains the passive classification and the scope of this classification. Regulations give guidance on the meaning and application of the code. Precedents are set by examples issued within the regulations. Amendments make technical changes to the tax code or regulations after the
legislation has been enacted.

Part II (chapters 5-9) describes how the legislation, explained in Part I, affects tax planning strategies for real estate activities. Planning strategies will be described from the point of view of the individual taxpayer. I will, however, note exceptions to the effects if the activities are owned through personal service corporations, closely-held C corporations, pass-through entities such as partnerships.

This thesis will not attempt to analyze real estate activities held by estates and trusts, publicly traded partnerships, or the effect of passive credits on real estate investments. In addition, it will not examine the application of phase-in legislation. This legislation does not apply after 1994, and examination will not aid in the understanding of the current legislation. Nor will information in this thesis apply to activities purchased before August 16, 1986, the effective date of the TRA of 1986.

This thesis is written for individuals with a general business knowledge. It is my goal to provide information that will enable the reader to understand passive activities and their tax consequences, and information that will allow the reader to plan appropriately to maximize their return on real estate investments.
PART I - EXPLANATION OF PASSIVE ACTIVITY LEGISLATION

This passive activity legislation overview will cover the legislation initiated through the TRA of 1986 (section 469 of the Tax Code), two sets of regulations published on February 25, 1988 and May 11, 1989, and the Revenue Reconciliation Act of 1993. This overview is needed to establish a basic knowledge of the definition and scope of passive activities, from which the effects of this legislation on the real estate industry can be discussed.
CHAPTER 1: TAX CODE SECTION 469

GENERAL

Section 469 of the Tax Code is entitled “Passive Activity Losses and Credits Limited.” The explanation of this section will follow the order presented in the tax code. The exceptions to this order will occur when a definition from later in the tax code is useful to prevent repetition. The subsections (noted in the code as a, b, c, etc.) will be identified throughout the explanation to aid in the reader’s interpretation of the Section 469. In this section, the passive activity limitations are defined and explained, as are the separation of income into active, portfolio, and passive classifications.

The IRC begins the passive activity loss limitation section with a bold statement: no taxpayer, for any tax year, is allowed to deduct a passive activity loss. However, any loss disallowed by this passive rule in one year may be carried forward to the next year or any future year in which the loss can be used and the investment is held by the taxpayer (Sec.469b). A taxpayer is considered to be an individual, estate, trust, closely held C corporation (CHC), and a personal service corporation (PSC) (Sec.496a). CHCs and PSC are defined in Sec 496j. A C corporation is considered closely held when a direct or indirect ownership of more than 50% of the corporation’s outstanding stock is held by five or fewer people. A PSC is defined as a corporation that employee-owners control through ownership more than 10% of the value of the corporation’s stock and perform more than 50% of the services rendered.
DEFINITION OF PASSIVE ACTIVITY

Passive activity is defined with three criteria, one general and two specific. In general, any activity that constitutes a trade or business, in which the taxpayer has invested, but does not materially participate in, is a passive activity (Sec.469c1). Material participation is described in Sec 469h as being involved in the operations of the activity in a regular, continuous, and substantial manner. This subsection states that an interest in a limited partnership is not to be treated as material. It also states that CHCs and PSCs can only be considered a material participant if one or more of the owners, who hold more than 50% of the outstanding stock, materially participate in the activity. In addition, the participation of the taxpayer’s spouse may be taken into account when deciding whether or not the taxpayer materially participates in the activity.

The two specific criteria are less detailed. First, any rental activity is considered a passive activity (Sec.469c2). A rental activity is defined in paragraph h of the code: the activity is a rental activity if receipts are primarily for the use of tangible property. Second, any working interest in oil and gas is exempt from the passive activity classification if the activity is held directly or through an entity that does not limit the taxpayer’s liability in relation to the activity (Sec.469c3). The material participation requirement for the general criterion does not apply to the rental or at risk oil and gas property rules (Sec.469c4).
DEFINITION OF PASSIVE ACTIVITY LOSS

Having an understanding about what a passive activity is, we can now look toward what constitutes a passive activity loss. A taxpayer has a passive activity loss for the tax year in which the aggregate losses from all passive activities exceed the aggregate income from passive activities in that year (Sec.469d). Subsection e describes some special rules for determining income and loss from passive activities. Income from interest, dividends, annuities, or royalties is not taken into account because this amount applies to portfolio income, not passive income. Likewise, any expenses, including interest, directly attributable to the portfolio income is also not considered. In addition, for the taxable year any gain from the disposition of property held as an investment, any gain or loss attributable to an investment in working capital, and any earned income is not accounted for when computing passive income or loss (Sec.469e).

The code also indicates special income/loss classification rules for CHCs other than PSCs. These corporations may deduct passive losses against net active income. Net active income includes any income or loss without regard to income or loss from a passive activity, or any item of gross income, gain, expense, or loss attributable to a portfolio investment (Sec.469e2).
TREATMENT OF FORMER PASSIVE ACTIVITIES

In the next subsection, the code deals with the treatment of a former passive activity, with respect to the taxpayer. Any unused passive loss carried forward from a previous year, in which the activity was passive, must be offset against the passive income of the activity in the present year. However, unused deductions must continue to be treated as from a passive activity (Sec.469f).

DISPOSITION OF PASSIVE ACTIVITIES

Subsection g pertains to the disposition of a passive activity. The code separates dispositions of the entire interest of an activity into the following three categories: fully taxable transactions, by death, and installment sales. In the case of a fully taxable disposition, if the entire gain or loss on the disposition is realized, then the sum of the passive losses from the present and previous years and the loss realized upon disposition in excess of the gain for the taxable year for all passive activities is treated as a loss from a non-passive activity (Sec.469g1). Therefore, suspended losses are recognized upon the disposition of the entire activity. This only applies if the sale is to an entity that does not bear a relationship to the taxpayer. In the event that the activity is sold to a related entity, these rules will apply when the activity is acquired by someone who is not related to the taxpayer (Sec.469g2). Dispositions by death are treated as a fully taxable disposition to the extent that the losses are greater than the excess of the basis of the property in the hands of the new owner over the adjusted basis of the property held by the deceased individual immediately prior to death. Losses that do not qualify are not allowed as a deduction in any year (Sec.469g2). Installment sales of an entire activity are to be treated as a
fully taxable transaction in proportion to the percentage of losses attributable to the percentage of sales for that year (Sec.469g3).

RENTAL REAL ESTATE ALLOWANCE FOR INDIVIDUALS

Subsection I describes the specifics of a $25,000 passive loss offset for rental real estate activities. This offset is only allowed for a taxpayer who actively participates in the activity (Sec.469iI). Active participation includes performing or arranging management activities, repairs, and leasing procedures. The taxpayer must hold at least a 10% share of the activity to actively participate. The participation of the taxpayer’s spouse is taken into consideration for active participation. Interests held through limited liability partnerships can not apply this allowance. The active participation requirement does not apply to qualified rehabilitation or low-income housing rental activities (Sec.469i6).

The $25,000 allowance is phased out beginning at $100,000 adjusted gross income (AGI). The allowance is reduced by 50% of AGI, not including passive activity losses, over $100,000. Therefore, the entire allowance is phased out at $150,000. For qualified rehabilitation rental activities the phase out begins at $200,000 (Sec.469i3B). In addition, the phase-out does not apply to low-income housing rental activities (Sec.469i3C).

REGULATORY AUTHORITY

The authority to issue regulations on the Section 469 of the tax code was given to the Secretary of the Treasury Department (TD) through subsection I. It states that “the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of
this section.” The code continues by stating that the TD should issue regulations in these areas: specify what activity, material participation, and active participation mean; include additional items that will not be considered in computing passive income or loss; reclassify passive income as active income in the case of limited partnerships or other types of entities; explain the allocation of interest in passive activities; and explain the differences for filing a joint married return or separate married returns (Sec. 469l).

CONCLUSION

As a result of this reform act, many professionals began to ask for substantive tests in the areas of material and active participation, and for classification of what constitutes a rental activity. One author describes the feeling of taxpayers and their advisors as “essentially impossible.” “Not only are the rules highly complex and in some cases equally uncertain, but any planning can be subverted by open-ended authority invested in the Treasury to issue regulations to attack efforts to minimize the burdens of Section 469” (Westin 139). As a result, most advisors awaited regulations (which confront most of the issues suggested by the IRS) and applied one basic principle -- minimize passive activity losses and maximize passive activity income. This principle’s basic goal will eventually prove to be one of the most effective ways to neutralize the affect of passive legislation.
CHAPTER 2: TEMPORARY REGULATIONS 1988

GENERAL

The Treasury Department (TD) exercised its authority in composing regulations in reference to Section 469 on February 25, 1988. These regulations begin to confront the areas of the passive loss limitation rules that provided taxpayers with little guidance except vague wording and the general intent of Section 469. Regulations were issued in five areas: material participation, a limited partnership’s ability to materially participate, exceptions to the rental activity exclusion, passive income situations reclassified as active income, and passive gain on dispositions reclassified as active gains. These five areas will be discussed in detail in this section.

MATERIAL PARTICIPATION

In the area of material participation, the TD issued a set of seven tests to apply to an individual’s participation in a trade or business activity. Six of the tests rely on substantive information, of which two relate to previous tax years; the final test relates to the facts and circumstances of the situation. The following is a summary of the key elements of the seven material participation tests that must be met for the activity to be reclassified as active (Reg.Sec.1.469-5Ta).

(1) Participation of more than 500 hours during the tax year.

(2) Participation constitutes substantially all of the participation of all individuals, including non-owners, of the activity for the tax year.
(3) Participation of more than 100 hours and that participation is not less than the participation of any other individual, including non-owners, in the activity for the tax year.

(4) The aggregate of all significant participation activities is greater than 500 hours. A significant participation activity is defined as an activity in which the individual participates more than 100 hours, but does not materially participate in when considered alone. (Reg.Sec.1.469-5Tc).

(5) An individual, without regard to this test, has materially participated in any five of the immediately preceding ten tax years for this activity.

(6) In the case of a personal service activity (PSA), if an individual, without regard to this test, has materially participated in the activity for any three tax years previous to the present tax year. PSA’s are defined in Reg.Sec.1.469-5Td as any trade or business where capital is not a material income-producing factor, including the professions in such areas as health, law, engineering, architecture, accounting, actuarial science, performing arts, and consulting.

(7) Participation, based on all facts and circumstances, of the individual is on a regular, continuous, and substantial basis for the tax year.

Reg.Sec.1.469-5Tb describes the allowance of management activities for this test only if no other person receives compensation for management duties in connection with the activity, and if no other person performs more hours of management duties for the activity than the taxpayer. The regulation limits the scope of this test to activities with participation of more than 100 hours.

The TD also excludes some forms of participation from the scope of these tests. Work not customarily done by owners, or work done with the sole purpose of avoiding disallowance is
not included as participation. Work done as an investor, reviewing financial statements, compiling summaries and analysis of financial information for personal use or monitoring operations in a non-management capacity, is also not considered participation (Reg.Sec.469-5Tf).

In addition, the TD sets parameters for methods of proving participation. Reasonable means of proving participation does not mandate maintaining daily time logs. The TD suggests that identification of the type of participation and any estimate of the hours can be based on an appointment book or calendar, and on narrative summaries (Reg.Sec.1.469-5Tf).

Interest in an activity as a limited partner was immediately excluded the from material participation status by Sec.469, but Reg.Sec.1.469-5Te allows for two exceptions to this exclusion. First, if taxpayers, acting as a limited partner in an activity, satisfy the first, fifth or sixth material participation tests (500 hours, or the previous years' tests), they are considered to be a material participant. Second, if the taxpayer is both a general and limited partner in the activity, the entire interest is treated as a non-passive activity. However, the interest in the second exclusion is then subject to the seven material participation tests.

Specific examples of material participation in trades or businesses are supplied in Reg.Sec.1.469-5Tk.

**RENTAL ACTIVITY EXCLUSIONS**

The TD issued regulations excluding certain rental activities from the scope of Sec.469. These regulations consist of six tests, which limit the rental classification primarily to traditional real estate investments. The following is a summary of the six tests included in Reg.Sec.1.469-1Te3 stating which rental activities are excluded from the scope of Sec.469:
(1) Any activity in which the average customer-use period is less than or equal to seven days.

(2) Any activity in which the average customer-use period is less than or equal to thirty days and significant personal services are provided. Significant services do not include those necessary for the lawful use of the property, improvements that extend beyond the average customer period, or services usually provided in association with long-term high grade property, e.g., cleaning, repairs, maintaining common areas, garbage or recyclable collection, elevator service, or security.

(3) Any activity in which extraordinary services are provided in connection with making the property available to the customer. The use of the property in this type of activity is usually incidental to the receipt of service. Some examples are hospital rooms and boarding schools.

(4) Any activity in which the rental of property is treated as incidental to a non-rental -- held as and investment or is a trade or business -- activity of the taxpayer. If realized gross rents or gains are less than 2% of the lower of the activity’s unadjusted basis or fair market value, the activity is considered incidental to an investment activity. If the taxpayer owns an interest in the trade or business and the rented property is predominately used in that trade or business, or the 2% qualification stated above is satisfied the activity is considered incidental to a trade or business activity.

(5) Any activity in which the rented property is customarily available during published business hours for non-exclusive use by various customers.

(6) Any activity where the rental property is used by a partnership, S corporation, or any other joint venture in which the taxpayer holds an interest.
Specific examples of activities excluded from the Sec.469 rental classification are given by the TD in Reg.Sec.1.469-ITE3viit.

PASSIVE INCOME RECLASSIFIED AS ACTIVE

The third area covered by the TD is the reclassification of some passive income to active income. Reg.Sec.1.469-2Tf covers four reclassification situations that pertain to this thesis: significant participation income, rental of non-depreciable property, rental activities incidental to development, and property rented to a non-passive activity. These regulations place investors in a no-win situation because their income from the activity is treated as active or portfolio, while their losses from the activity are treated as passive. Therefore, the investor is not allowed to realize the losses, or to match the income against other passive activities. One professional described the situation as a “heads the IRS wins, tails the taxpayer loses” situation (Lipton 366).

The first active income reclassification occurs if the aggregate of income in significant participation activities is greater than the aggregate loss; then the income from these activities is classified as active. This regulation was adopted to prevent taxpayers from diversifying their investment to the extent that all of their activities were treated as significant participation activities. Consequently, the income from the taxpayer’s general business activities could offset the losses of the taxpayer’s passive activities.

Second, net active income from rental of property of which less than 30% of the unadjusted basis held for use by the customer is subject to depreciation should be reclassified as active. This regulation prevents the taxpayer from placing small buildings on land and renting the land as a passive activity instead of an investing activity.
Third, the net income from the rental of property incidental to the development of the property is reclassified as active. Property is considered incidental to development in the following situations: when any gain from sale, exchange or disposition is included for the present tax year; if the use of the property began less than twelve months before the date of disposition; or if the taxpayer materially participated in services that enhanced the value of the property. This regulation insures the separation of developmental activities and rental activities, and disallows the conversion of active development projects to passive activities, which would enable the taxpayer to match gains on the sale of the developed property against suspended or current passive losses.

Fourth, income from property rented to a non-passive activity, which the taxpayer materially participates in, is classified as active income. This regulation disallows the treatment of capital contributions of property or similar items to be treated as rental activities; therefore, the income cannot be classified as passive.

PASSIVE GAIN ON DISPOSAL RECLASSIFICATION

The TD also issued regulations on the reclassification of gains from the disposal of a passive activity. There are two situations in which a gain is reclassified. First, if the item being disposed of was used in a passive activity for less than twelve months, the taxpayer must allocate the gain among the activities the item was used in for the twelve months preceding the date of disposition (Reg.Sec.1.469-2Tc2ii). Second, any gain on the sale of property that was previously used in a non-passive activity and that had a fair market value (FMV) over 120% of the property’s adjusted basis is treated as an active gain. However, the second reclassification is
avoided if the property is used in a passive activity for twenty-four months before disposal or 20% of the time the property was held (Reg.Sec.1.469-2Tc2iii).

CONCLUSION

In general, the first set of regulations clear up many gray areas, such as material participation and the definition of a rental activity. The TD also reclassifies income from activities that were able to manipulate the intent of Sec.469. Although the definition of what constitutes an activity was still unknown, its vast application could change the entire effect of the passive loss limitations.
CHAPTER 3: TEMPORARY REGULATIONS 1989

GENERAL

These regulations define what is meant by the term activity. If one of the goals of the TRA of 1986 was to simplify the tax code, the TD strayed from this goal and created an entangled mess of "undertakings" and aggregated undertakings grouped into activities. I suspect the TD realized that the definition of an activity was extremely complicated and detailed because the first subsection of the regulation contains a brief, concise explanation of the regulations on activities. However, the TD boldly states that this explanation is not to be viewed as tax law, and taxpayers should use it only as a guide through the regulations (Reg.Sec.-1.469-4T(a)). This is the only area in the tax code where I have seen an explanation published by a governmental agency.

UNDERTAKINGS

The TD begins the regulations by defining the term undertaking. An undertaking is the smallest unit that can constitute an activity. Operations are identified as an undertaking through their location and ownership. If either business operations or rental operations are owned by the same interests and are located at the same location, the operations are considered one undertaking. Likewise, if operations are owned by different interests and located at different locations the operations are treated as separate undertakings (Reg.Sec.1.469-4T(c)).

For the use of this test, location is some physical structure or within the close proximity of some structure. However, all facts and circumstances are taken into account. The TD has also provided ten characteristics to take into account when looking at the facts and circumstances in
Reg.Sec.1.469-4Tc3. Operations that are not conducted at a fixed place or that are conducted at the customer's place of business are considered a part of the undertaking the operations are most closely related to. Likewise, operations at a place of business not related to the other operations at that place of business are to be considered part of the undertaking they support (Reg.Sec.1.469-4Tc). Ownership is considered to be any direct ownership or any indirect ownership of at least 10% in a pass-through organization (Reg.Sec.1.469-4Tj).

Subsection d deals with places of business including both trade or business operations and rental operations. Normally, rental operations and trade or business operations are treated as separate undertakings. However, if 80% or more of the operations at a place of business are either trade/business or rental, then both operations should be classified in the area in which 80% of the operations occurs. This rule only applies to operations held by the same interest (Reg.Sec.1.469-4Td).

**ACTIVITY AGGREGATIONS**

After introducing undertakings, the TD explains how undertakings must be grouped into activities. In general, each undertaking is to be treated as a separate activity (Reg.Sec.1.469-4Tf), but this rule is deceiving because exceptions are allowed for similar trades and businesses, vertically integrated businesses, horizontally integrated businesses, personal service undertakings (PSU), rental real estate undertakings. In addition, a non-rental option to separate undertakings is offered. Consequently, there are very few undertakings included under the general activity rule.

Two or more undertakings that are similar and controlled by the same interest must be treated as one activity. Undertakings are similar if more than 50% of the operations are in a
single line of business and the line of business is the same for the above mentioned undertakings (Reg.Sec.1.469-4Tf4).

Vertically integrated undertakings are undertakings that supply or receive goods from one another. The supplier is considered similar to the recipient if the supplier provides more than 50% of its total goods and services to the recipient. Likewise, the recipient is considered similar to the supplier if it receives 50% or more of its total goods and services from the supplier. The regulations for similar trades and businesses then apply (Reg.Sec.1.469-4Tf4iii).

Horizontally integrated activities are those in which the activities constitute a single trade or business, and the activities are controlled by the same interest. These activities are to be treated as one activity. All facts and circumstances are to be taken into account, but the TD lists twelve criteria, which will be given the highest consideration, including location, ownership, operations, and the norm for similar activities (Reg.Sec.1.469-4Tg).

Involvement in two or more PSUs are considered one activity if they contain significant similar or related services. Services are considered similar if the services are in the same field (in the area of consulting, facts and circumstances are applied to test if services are in the same field), are significant professional services, and are the services are related to each other. Professional services are considered significant in a field if they constitute more than 20% of the gross income related to services. Services are considered related if 20% or more of their gross income is derived from common customers. PSUs are undertakings in which 50% or more of their gross income is derived from services in any of the fields described in the 1988 regulations under PSCs (Reg.Sec.1.469-4Th).
RENTAL REAL ESTATE AGGREGATION EXCEPTIONS

The TD includes special regulations for rental real estate property. It defines rental real estate undertakings as those where 85% of the unadjusted basis of the property available to customers is real property (tangible property other than personal property). Under these regulations, multiple undertakings may be treated as a single activity or as separate activities. If the interest in the undertaking is held by a pass-through organization, such as a partnership or S Corporation, then the undertaking must be treated in the same manner as treated in the annual report filed by the pass-through organization. In the case of leased real estate, a single undertaking may be treated as multiple undertakings (i.e., the leased property can be treated as an undertaking separate from the undertaking in which it is used) if it is allowed by state and local law and the interest is held directly or indirectly by a pass-through organization that treats the property in the same manner. The taxpayer must attach a schedule to the tax return to identify any aggregations or separations. In addition, these regulations do not apply to rental real estate if less than 30% of the unadjusted basis is subject to depreciation, or if the property is the taxpayer's personal dwelling (Reg.Sec.1.469-4T(k)).

NON-RENTAL AGGREGATION ELECTION

Finally, the TD allows for an election to treat non-rental undertakings as separate activities if a written request is attached to the tax return, and if any pass-through entity by which the undertaking is held treats the undertaking in the same manner (Reg.Sec.1.469-4T(o)).
CONCLUSION

The general philosophy of the undertaking was a straight-forward concrete idea.

However, the TD clouded the meaning of the undertaking by issuing many exceptions and special situations.
CHAPTER 4: REVENUE RECONCILIATION ACT OF 1993

GENERAL

The Revenue Reconciliation Act of 1993 (RRA of 1993) established an exception to the definition of a passive activity for taxpayers who participate in real property businesses. This exception placed real estate professionals "on a level playing field with other trades and businesses" (Lipton 619). The RRA of 1993 accomplished the level playing field by including an exception for real property professionals similar to the $25,000 allowance given to individuals investing in rental real estate.

PASSIVE RENTAL ACTIVITY REDEFINED

Sec.469c2 of the Tax Code, before the RRA of 1993, said "the term passive activity includes any rental activity." However, when the RRA of 1993 was enacted on January 1, 1994, the code was changed to read, "except as provided in paragraph 7, the term passive activity includes any rental activity." Paragraph 7 is entitled Special Rules For Taxpayers In Real Property Business. This paragraph is to be applied to each interest in rental real estate as a separate activity, unless an election is made to treat all rental real estate interests as one activity (Sec.469c7A). For the purposes of this section, a trade or business qualifies as a real property trade or business if operations are in one of the following real property areas: development or redevelopment, construction or reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage (Sec.469c7C).
TAXPAYER QUALIFICATIONS FOR REAL PROPERTY TRADE OR BUSINESS

A taxpayer is qualified as a real property professional if more than 50% of the taxpayer’s participation in trades or businesses are performed in real property trades or businesses in which the taxpayer materially participates. In addition, the taxpayer must perform a total of at least 750 hours of services in those real property trades or businesses. Unlike other material participation tests, the participation of a spouse, in the case of a joint return, is treated separately from that of the taxpayer. Therefore, either the taxpayer or the spouse must satisfy the requirements independently (Sec.469c7B).

There are two special qualification rules for interests held through corporations. First, real property interests held through CHCs are included in the scope of paragraph 7 if more than 50% of gross receipts of the corporation are derived from real property trades or businesses in which the CHC materially participates. Second, personal services performed as an employee of a PSC cannot be treated as performed in a real property trade or business unless the employee owns at least 5% of the interest of the PSC.

CONCLUSION

The RRA of 1993 begins to release some of the pressure put on the real estate industry by previous passive activity legislation. The exception included in the definition of rental activity for real estate professionals treats these professionals the same as professionals in any other industry. Therefore, material participation rules are applied to real estate professionals instead of the all-inclusive rental activity definition. After seven years, the IRS is finally beginning to realize that all rental and real estate activities are not tax shelters.
CONCLUSION TO PART I

After examining the TRA of 1986's passive limitation and the regulations that followed, there is a path to follow to separate passive activities from non-passive activities. However, I will attempt to give you some directions because the path has many dangerous curves. The diagram on the following page may aid in your understanding. First, taxpayers must separate their operations into undertakings. Second, the undertakings must be aggregated into activities. The taxpayer must record participation for each activity. Third, material participation rules must be applied to the trade or business activities and to rental activities reclassified trade or business activities by exclusions. Fourth, real property rental activities must be separated from non-real property rental activities. If the real property professional exception applies, real property rental activities should be reclassified as active. Fifth, the taxpayer must calculate passive income or loss from each activity and make sure to omit portfolio and active income and portfolio expenses. Losses up to $25,000 are allowed on real property rental activities. Sixth, the taxpayer must aggregate income and losses from all passive activities. Aggregate passive losses are suspended for future use and aggregate passive gains are fully taxable. The taxpayer must keep a record of suspended losses and the adjusted basis for each activity.
Divide operations into undertakings.

Aggregate undertakings into activities.

Is the activity a rental activity?

- yes
  - Do the rental activity exclusions apply?
    - no
      - Is the activity a real property rental activity?
        - yes
          - Does the taxpayer materially participate as a qualified real property professional in the activity?
            - no
              - The income/loss is treated as active.
            - yes
              - The income/loss from the activity is active.
        - no
          - The income/loss is treated as active.
    - yes
      - Calculate income/loss for the activity.

- no
  - Does the taxpayer materially participate in the activity?
    - yes
      - The income/loss from the activity is active.
    - no
      - Calculate income/loss for the activity.

Aggregate passive losses and income.

Gains are taxable.

Losses are suspended.
PART II - REAL ESTATE TAX PLANNING STRATEGIES

The following tax planning strategies are presented from the individual investor's point of view. Tax planning is important in relation to passive legislation because the tax code and regulations paint a very complicated and confusing picture of what is allowed and not allowed for passive activities. Tax planning strategies will enable readers to see some applications of the passive legislation. In addition, readers should be able to maximize the tax benefits of passive activity investments.

In most cases the strategies follow the basic principle previously stated -- maximize passive income and minimize passive losses. Specific ways to do so are the focus of chapters five and six. Chapter seven presents some strategies to maximize the benefits of disposing of passive activities. Chapters eight and nine address tax planning strategies in the two areas the real estate industry has been given special privilege -- the $25,000 real property rental allowance and the real property trade or business exception.
CHAPTER 5: MAXIMIZING PASSIVE INCOME

GENERAL

When considering tax planning strategies, maximizing passive income is only effective if the taxpayer has passive activities that generate losses. Therefore, the additional passive income will allow recognition of these losses. When using this strategy, the taxpayer must be sure to consult the passive income reclassification discussed in chapter 2. These regulations were issued to keep individuals from changing active income-producing activities into passive activities for the purpose of recognizing passive losses. Additional reclassifications could be issued, so there is a need for continuing research if these income maximization strategies are to be used. The following six strategies are a guide for maximizing passive activity income for individuals.

1) MATERIAL PARTICIPATION: There are many ways to avoid the material participation rules in income-producing passive activities because the rules rely heavily on substantive information. One way is to operate the activity through employees, management corporations, or agents (Westin 161). The additional costs incurred may or may not justify the tax benefit, so the taxpayer must analyze the situation carefully. Another way to avoid material participation is to try to work hours in alternating years. Therefore, one year the taxpayer will materially participate, while the next year the taxpayer will not. This will be helpful in the early years of an investment, but the past years' material participation rules (numbers 5 and 6 in chapter 2) will keep this strategy from being a long-term passive income producer.

2) RENTAL ACTIVITY EXCEPTIONS: The exceptions listed in chapter 2 leave little room for avoidance in this area, but there are two possible strategies. Most of the excluded rental real estate activities are hotels, condominiums, or bed and breakfast inns because their rental
period is seven days or less, or thirty days or less and they provide significant services. The first strategy is to offer reduced rate packages for monthly rental or rentals in excess of seven days. These packages could increase the average rental period outside of the seven day limitation. Furthermore, most rental real estate activities do not provide significant personal services (services in excess of lawful use, improvements, cleaning and maintenance, etc.), so these activities are not affected by the thirty day exception. However, if the activity does provide significant personal services, then renter initiated contracting for these services would be feasible if the process is not inconvenient (Wiesner 37).

3) PREDOMINANT OPERATIONS: The predominant operations classification is useful in producing passive income when passive operations predominate (80% of the gross income for rental and non-rental activities) and the active operations produce income. In these situations the two operations should be operated at the same location to increase the net passive income by the amount of the formerly active operations income. If the active operations produce a loss, passive income is reduced and passive losses are increased. Both of these repercussions are not beneficial, so operations should only be combined if the active portion is a solid income producer (Manson 283).

4) SEGMENTED OPERATIONS: Segmenting operations is especially attractive if the taxpayer has invested in a partnership with divided management. By segmenting, each partner will only materially participate in the segment each manages. The other segments of the original activity will produce passive income for the partners. For example, in an active partnership consisting of four partners, the partners could segment the business and each partner would earn active income from one segment and passive income from the other three segments.
of the business (Bandy 764).

5) INVESTMENTS IN LIMITED PARTNERSHIPS: Limited partnership interests are passive investments unless the taxpayer meets one of the two previous years material participation requirements (listed in chapter 2). The taxpayer should look for an activity that generates a positive cash flow and passive income. This type of activity is generally accomplished in the real estate industry through investments with low interest expense deductions and depreciation deductions. The taxpayer must consider the second income reclassification and make sure the activity's depreciable property is greater than 30% of the adjusted basis of the property. If the depreciable property is less than 30% of the property's adjusted basis, the income will be reclassified as active income (Bandy 764).

6) BURNED-OUT TAX SHELTERS: Many taxpayers have tax shelters they invested in during the mid 1980s that no longer shelter their income. However, common practice in tax shelters was to accelerate deductions or defer income to later years. If these investments are passive activities, they are now producing passive income that can be matched against otherwise suspended passive losses. Even if the shelter is not producing income yet, the taxpayer should consider the value of additional passive income compared to the future passive losses before selling (Bandy 762).
CONCLUSION

Maximizing passive activities is very useful when the taxpayer has passive loss-producing activities. However, it is also one of the riskiest of tax planning strategies because the TD was given full authority to reclassify any passive income to active income if the income producing activity is used for the sole purpose of recognizing passive losses. Reclassification presents a no-win situation of increased passive losses and decreased passive income, so extreme caution should be use in this area of tax planning strategies.
CHAPTER 6: MINIMIZE PASSIVE ACTIVITY LOSSES

GENERAL

The tax planning strategy of minimizing passive activity losses is one of the most risk-free planning opportunities because the philosophy generally agrees with the philosophy of the TRA of 1986. Therefore, the TD has not targeted loss minimizing with regulations outside of tax code Sec.469. However, taxpayers who expect to be in a higher tax bracket in the future may want to suspend their losses to receive a greater benefit in future years. The first three planning strategies are parallel to the first three strategies presented in the previous chapter, and the final three strategies are independent of the situations already discussed.

1) MATERIAL PARTICIPATION: The taxpayer benefits from material participation in passive activities that produce a loss. Material participation allows non-rental activities to be treated as non-passive activities and the loss restrictions are lifted. To fulfill the material participation tests, the taxpayer must perform work generally done by an owner (Bandy 759). In addition, if the taxpayer materially participates under the significant participation rule (chapter 2), the activities must produce a small loss because income is reclassified as active if the income exceeds the loss in significant participation activities. Consequently, all of the significant participation income is active and all of the significant participation losses are considered passive -- a no-win situation.

2) RENTAL ACTIVITY EXCEPTION: If a rental activity produces a loss, the taxpayer should attempt to obtain one of the six rental activity exceptions. Techniques such as special weekend rates can be used to reduce the average rental period to less than seven days. Or
significant personal services could be added to the operations of those rental activities that have a rental period above seven days but under thirty days. Both of these situations would allow the losses to be treated as active if the taxpayer materially participates in the activity (Wiesner 37).

3) **PREDOMINANT OPERATIONS:** The predominant operations classification is beneficial in minimizing passive losses when active trade or business operations predominate (80% of gross income of all rental or non-rental operations) and passive operations produce a loss. In these situations the operations should be conducted at the same location so they can be considered the same activity. The operations are considered active and the passive losses can be offset by the active income of the activity. However, if the passive operations produce income, the taxpayer must reduce the amount of income that could be offset by passive losses when the operations are aggregated. Therefore, if the passive activity produces both income and losses in various years, the taxpayer should avoid the use of the predominant operations aggregation (Manson 283).

4) **INTEREST EXPENSE REDUCTION:** Many rental real estate activities consist of highly leveraged equities and large interest expenses. These interest expense deductions are now limited because of the suspended loss rules. One method of reducing interest expense is to sell some of the rental property. By selling, the taxpayer activates suspended losses, which reduces taxable income. The taxpayer can use the amount left after paying for the related financing to reduce financing on other activities. The sale must be an arms-length transaction because related party transactions do not activate suspended losses. Another method of reducing passive interest expense is to borrow money secured by the taxpayer's first or second residence because interest on this type of borrowing is deductible as qualified residence interest (QRI). QRI is allowed to
the extent of the total debt secured by the taxpayer's residences other than acquisition indebtedness, and the total amount cannot exceed $100,000 or the fair market value (FMV) of the residence on the date of the loan less acquisition indebtedness (Bandy 760). Reg.Sec.1.469-2Td3iiiA specifically classifies QRI as active. Consequently, the QRI can be deducted from the taxpayer's taxable income and the excess tax savings can be used to reduce the debt on other activities.

5) EXPENSE ALLOCATION: General and administrative expenses and compensation paid to officers that is directly attributable to portfolio investments (undeveloped land, or property held for investments) may be allocated to portfolio income (Reg.Sec.1.469-2Td4). The TD does not give a special method of allocation, so the reasonable method most favorable to allocating expenses to the portfolio income should be used. Items commonly allocated are legal fees, overhead costs, accounting expenses, and joint costs. By allocating as many expenses to the portfolio income as possible, the taxpayer will be able to reduce passive losses (Bandy 761).

6) TRANSACTION TIMING: Timing the recognition of revenues and expenses can be a beneficial tax planning strategy for rental real estate operations. In a year that an activity produces a loss, the taxpayer should accelerate the recognition of income through anticipatory sales and defer expenses (maintenance, supplies) into the next year. These accelerations and deferrals will decrease the amount of passive loss for the activity in the present year, but the accelerations and deferrals will have opposite effects in the following year (Westin 161).
CONCLUSION

Planning strategies for minimizing passive activity losses have few specific regulations, but the benefits of these strategies should be weighed against the additional time, money, and services that must be provided to avoid restriction of losses. If the additional investment in the operations is useful, the taxpayer will substantially decrease taxable income.
CHAPTER 7: DISPOSAL OF PASSIVE ACTIVITIES

GENERAL

Disposal of a passive activity can be profitable if done correctly. Passive activity rules on dispositions and the taxpayer's future operations must be regarded, or recognition of additional taxable income or permanent suspension of losses could occur. In all disposals the taxpayer must sell the entire interest in the activity and be aware of the gain reclassifications discussed in chapter two -- prior active interest and appreciated property (Bomyea 542). Discussed below are three questions the taxpayer should consider before disposing of a passive activity and four planning strategies that deal with disposal.

QUESTIONS TO ASK BEFORE DISPOSING OF AN ACTIVITY

There are three important questions to ask before a taxpayer disposes of a passive activity. First, are the suspended losses for the activity equal to or greater than the amount of gain that is to be recognized on the sale? If the gain exceeds the suspended losses, the taxpayer will increase taxable income. The activity should be kept until the losses are at least equal to the gain recognized on the sale (Mason 284). Second, should the taxpayer use the installment method to match a gain against passive losses in future years? If the passive activity has been profitable and is sold at a gain, the installment method could be used to maximize the matching of passive income and passive losses over the next few years (Mason 284). Third, will the taxpayer be in a higher tax bracket in the near future? If a higher tax bracket is anticipated, the taxpayer should refrain from disposing the activity in order to receive a greater benefit from the recognition of suspended losses in a future disposition will be subject to a higher income tax rate.
(Westin 163). Asking these questions before disposal will reduce the taxpayer’s income tax liability.

**DISPOSAL OF ONE ACTIVITY AND PURCHASE ANOTHER**

The disposal of the first activity will trigger the suspended losses that have accumulated, and the taxpayer can buy another passive activity. This strategy enables the taxpayer to recognize the losses at the time tax savings are most needed. However, wash sales rules prevent the recognition of losses if the taxpayer buys a substantially identical property within thirty days of the sale (Bandy 766).

**FRAGMENTED RENTAL REAL ESTATE ACTIVITIES**

Activities classified as rental real estate activities are not subject to special aggregation rules. These activities should be fragmented as much as possible to ensure the recognition of suspended losses as soon as the activity is sold. The taxpayer can only recognize a gain on the sale of a building if each building is treated as a separate activity. Additional record keeping costs must be weighed against the probability of future suspended losses and the amount of the suspended losses if the activities are not fragmented (Gans 17).

**CONCLUSION**

The disposition of a passive activity is a simple transaction. It can be a profitable transaction if the taxpayer takes time to calculate when the recognition of suspended losses produces the greatest benefit.
CHAPTER 8: $25,000 RENTAL REAL ESTATE ALLOWANCE

GENERAL

Sec.469 of the tax code allows individuals to recognize up to $25,000 of passive losses from rental real estate activities. The tax planning strategies for the allowance are easy -- invest in rental real estate properties. However, the allowance is phased out beginning at $100,000 of adjusted gross income ($200,000 for qualified low-income or rehabilitation housing). The tax effects of the phase out are astonishing. Patrick McKeown, a professor of management science at the University of Georgia, and Paul Streer, a CPA and associate professor of accounting at the University of Georgia, wrote an article explaining these astonishing effects entitled "Preserving the Benefit Of the Rental Real Estate Activity Loss Exception." The article presents an equation that computes the actual tax rate for phased-out portions of the allowance and tax planning strategies to avoid the phase-out. Many authors recognize the allowance as an obvious benefit for investments in rental real estate, but McKeown and Streer are two of the few authors who acknowledge the phase out of the allowance as equally important. This chapter is a summary of the example given (adjusted for tax rate increases) and the strategies presented in their article.

ACTUAL PHASE-OUT TAX RATE EXAMPLE

In 1994, a married couple filing a joint return is subject to marginal tax rate of 31% on taxable income from $91,850 to $140,000. Assume that the couple also produces rental real estate losses in excess of $25,000 and has adjusted gross income of $130,000. After combining the effects of the 31% marginal tax rate and the phase-out rules, the couples' actual federal income tax rate is 46.5%. This is computed as follows:
(1) \[ T = t + 0.31(AGI - $91,850 - D - LL) \]

where:

- \( T \) = Total federal income tax liability for the current year.
- \( t \) = Taxes due on the first $91,850 of income.
- \( AGI \) = Adjusted gross income, as defined for the purpose of the phase out rule ($>100,000)
- \( D \) = Total dollar amount of itemized deductions and exemptions.
- \( LL \) = Loss limitation, as defined by the lessor of:
  - (a) Actual Rental loss
  - (b) $25,000 - 0.5(AGI - $100,000)

Equation (1) is based on the following assumptions:

- (a) Adjusted gross income is greater than $100,000 but less than $150,000.
- (b) The rental real estate activity will not be disposed of in the foreseeable future. Consequently, the present value of the loss carryforward is approximately zero and is disregarded.
- (c) The impact changes in AGI has on itemized deductions will be minimal and is disregarded.
- (d) The taxpayers are not subject to the individual alternative minimum tax for the computation year. However, if they were, the results shown here would affect the 26% alternative minimum tax rate in exactly the same manner as they do the 31% regular tax rate (McKeown 216).

If the tax liability of a couple is compared at two levels of income, $1,000 apart, the actual marginal tax rate for the couple can be easily computed.
Example: Assume that taxpayer and spouse have AGI of $130,000 in 1994 with real estate rental losses of $20,000. They file jointly, have two children, and claim personal and dependency exemptions of $9,800 (4 * $2,450). Their itemized deductions are $10,000. Based on the foregoing information and using equations (1) and (2) given earlier, the federal income tax liability of the family is computed as follows:

\[ T = t + 0.31(AGI - 91,850 - D - LL) \]

where

\[
\begin{align*}
t &= 20,778 \\
AGI &= 130,000 \\
D &= 19,800
\end{align*}
\]

and

\[
\begin{align*}
LL &= \text{the lesser of $20,000 or $25,000} - 0.5(130,000 - 100,000) \\
    &= 10,000
\end{align*}
\]

therefore

\[
\begin{align*}
T &= 20,778 + 0.31(130,000 - 91,850 - 19,800 - 10,000) \\
    &= 23,366.50
\end{align*}
\]

Now assume all of the same information stated above, except let AGI = $131,000.

\[
\begin{align*}
LL &= \text{the lesser of $20,000 or $25,000} - 0.5(131,000 - 100,000) \\
    &= 9,500
\end{align*}
\]

therefore

\[
\begin{align*}
T &= 20,778 + 0.31(131,000 - 91,850 - 19,800 - 9,500) \\
    &= 23,831.50
\end{align*}
\]

The difference in the tax liabilities for the family at $130,000 and $131,000 ($23,831.50 - $23,366.50) is $465. Therefore, the marginal tax rate is 46.5% ($465/$1,000). If the real estate rental activity loss is at least $25,000, the marginal tax rate between $100,000 and $150,000 will be 46.5% (McKeown 217). However, the rate will fluctuate if the taxpayer recognizes less than $25,000 of real estate rental activity losses in a year. The fluctuation occurs when the total rental
activity losses for the year are less than the $25,000, net of the amount phased out by excess AGI (e.g., A taxpayer has $10,000 of rental real estate losses and $110,000 of AGI. The $10,000 would not be limited because the phase-out will still allow $20,000 of rental real estate losses). In addition, the incremental tax rate is 36% (the rate is increased at $140,000) when AGI exceeds the phase-out amount of $150,000 (McKeown 218). The income tax rate increase at $140,000 does not affect the equation because a married taxpayer with AGI as high as $149,999 (the highest amount at which the allowance applies) would be taxed at the 31% level because the standard deduction of $6,350 and the personal exemptions of $4,900 would decrease AGI below $140,000.

STRATEGIES TO REDUCE AGI

The phase-out's incremental tax rate can be avoided in two ways: by shifting income from the current year into the next year and by shifting expenses from the next into the current year. The technique of shifting income/loss into/from the next year is most effective if the next year's income level is low enough so that the total shifted income plus the following year's AGI does not trigger the phase-out, or if there is no rental real estate loss in the following tax year (McKeown 219). McKeown and Steer present seven strategies:

1. Delay the sale of appreciated property that will produce recognized gains and/or accelerate the sale of depreciated property that will produce recognized losses.
2. Transfer cash and other liquid investments into certificates of deposit that mature in the subsequent taxable year, the earnings from which are subject to a substantial penalty upon early withdrawal. The presence of the restriction causes the interest to be taxed in the next year. The purchase of Treasury bills that mature in the next year will also accomplish this objective.
3. Use income producing liquid assets to purchase state and United States savings
bonds. The interest will not be taxed until the bonds are redeemed unless the irrevocable election to accrue such interest currently has been made.
4. Use income producing liquid assets to purchase state and local debt obligations that are exempt from the federal income tax.
5. Delay salary or bonus payments, if feasible.
6. In the case of a self-employed taxpayer, increase contributions to pension, profit-sharing or annuity plans keeping in mind the overall percentage limits that apply.
7. Accelerate the trade or business expenses of a sole proprietorship, partnership or S corporation in order to reduce the taxpayer's taxable income or share thereof (McKeown 219).

STRATEGIES TO INCREASE AGI

Another strategy to avoid the phase-out of the rental real estate allowance is to shift income from the following tax year into the current tax year. This approach should only be used when enough income cannot be shifted out of the present period to avoid the phase-out. Shifting income into the current year should preserve the rental real estate loss allowance for the following year. The taxpayer will be accelerating the payment of income taxes by one year, but the present value of the benefits obtained often outweigh the present value of the costs associated with shifting income into the present period (McKeown 219). McKeown and Steer list the following six actions that shift income into the current period:

1. Delay sales of depreciated property that will produce recognized losses and/or sell appreciated property that will produce recognized gains.
2. Elect out of installment sale treatment if installment sales producing a recognized gain have taken place during the year.
3. Refrain from investing in certificates of deposit or Treasury bills that will delay the reporting of interest income until the following year.
4. Insure that all salary and bonus payments are made before year-end.
5. If the taxpayer is self employed, have (them) delay some or all of his normal contributions to pensions, profit-sharing or annuity plans until the following tax year without running afoul of the applicable overall percentage limitations that apply.
6. Delay the payment of trade or business expenses and expedite billing and collection procedures of a sole proprietorship, partnership or S corporation in order to increase the taxpayer's taxable income or share thereof (McKeown 219).

CONCLUSION

The phase-out example given at the beginning of the chapter is an ideal way to look at the benefits of tax planning. By following the planning strategies identified in the example, taxpayers can save themselves up to 15.5% of taxes on income between $100,000 and $150,000. Application of the rental real estate allowance and the tax planning strategies associated with the allowance will produce great benefits.
CHAPTER 10: REAL PROPERTY TRADE/BUSINESS PROFESSIONALS

GENERAL

The exception to the rental activity definition for real property trade or business professionals instituted by the RRA of 1993 was great news. These professionals can now treat all of their losses and gains as active. Therefore, the real estate industry finally received recognition as a non-tax shelter trade or business. However, this exception includes an all-or-nothing aggregation rule. The decision to elect to aggregate or not to aggregate is an important decision because it may be binding for all future tax years (Schachat 106).

AGGREGATE

In general, the taxpayer will want to aggregate all real property trades or businesses. By aggregating the activities, most taxpayers should easily satisfy the material participation tests for real property professionals described in chapter 4. Without the aggregation, the taxpayer would have to treat each activity as a separate activity in satisfying the material participation test. In most cases aggregation is the only way material participation can be achieved and the only way to activate the real property professional classification (Lipton 616).
DO NOT AGGREGATE

Situations in which the taxpayer should not aggregate real property trade or business activities are beyond the scope of this thesis. However, one example is of these situations occurs when the taxpayer has passive losses in non-real property activities and passive income in real property activities, the taxpayer will want to preserve the passive income so that passive losses are not suspended (Schachat 106).

CONCLUSION

The real property professional classification provides the greatest opportunity for individuals who invest heavily in real property activities, but the classification only applies when the individual aggregates real property activities. By aggregating the taxpayer is losing some of the benefits of the open aggregation requirements and the planning strategies for fragmentation discussed in chapter 7. However, the ability to match real property rental losses against all of the taxpayer’s other real property business activities is definitely worth the decreased freedom.
CONCLUSION TO PART II

Tax planning strategies are important to any investor. When considering real estate activities and the passive legislation, good tax planning is one of the few ways real estate investors can receive some benefit from or at least decrease the effects of the passive activity legislation. Although tax planning should be considered carefully, each taxpayer's situation must be looked at separately because all of the previous strategies are limited in their application to certain situations. Phillip Weisnser and Sherri Nadeau said it best in their *Journal of Accountancy* article entitled "The Passive Activity Loss Rules: Coping With An Upside-Down World."

In short, making passive income investments or restructuring a client's business operations should not be done solely to create passive income or non-passive losses. The transaction should make sense economically without regard to the supposed tax benefits (Wiesner 39).


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