

# REPS Workshop, 2021 Tax & Legal Summit

## Steps to Determine if Your Rentals are Non-Passive

### Step 1: Identify and group real property trades or businesses

Real property trades or businesses are defined by IRC. Sec. 469(c)(7)(C). You may “group” all hours in all real property trades or businesses for the purpose of meeting the two statutory tests.

### Step 2: Identify real property trades or businesses in which taxpayer materially participates

You cannot count real property trades or businesses that you do not “materially participate” in. Material participation is defined by Treas. Regs. Sec. 1.469-5T.

### Step 3: Total hours of participation in real property trades or businesses in which taxpayer materially participates

Use a time log or calendar to create contemporaneous records. Don't inflate your time and make sure the time you're logging actually counts!

### Step 4: Apply hours from Step 3 to the two quantitative tests of IRC Sec. 469(c)(7)(B)

The two quantitative tests are “750 hours” and “more time in real estate than any other business.”

### Step 5: Assuming step 4 passes, does taxpayer materially participate in the rental activity?

You must separately show that you materially participated in your rental activity. Note that if “rentals” is one of your real property trades or businesses, the hours logged will count for both REPS for Step 4 and material participation for Step 5.

### Step 6: Does taxpayer need to group rentals into one activity via the -9 election to materially participate?

If you do not make the grouping election (Treas. Regs. Sec. 1.469-9(g)) then you must apply Step 5 to each property separately.

### Step 7: If you meet Steps 1-6, your rental activities are non-passive! Apply non-passive losses to proforma and estimate your taxes.

## How the IRS will Audit REPS

REPS is a highly litigated area... and that's just what we **see** in Tax Court rulings. But to get to Tax Court, you have to be audited first. REPS audits are rampant. We've assisted taxpayers in REPS audits and the top reasons taxpayers lose are: (1) poor record-keeping, or records created only after the audit started; (2) logging time that is not "material participation" time; and (3) uncorroborated about your participation in the rental activity.

### Steps the IRS takes during a REPS audit

#### Pre-frame for the auditors

- Rental activities, by nature, normally do not require significant day-to-day involvement, i.e. they are not time intensive.
- For many taxpayers using any kind of outside management, the only material participation test available is the 500-hour test. In many situations, the other tests will not apply.
- In many circumstances, an individual rental activity will not require 500 hours of participation, nor will the taxpayer have sufficient time available to spend 500 hours on each individual rental real estate activity.
- Qualification as a real estate professional is a determination, not an election. A taxpayer may attempt to manipulate the passive activity rules by inappropriately claiming to be a real estate professional, or conversely, by not claiming to be one (for instance, if certain activities are generating net income).

#### Step 1: Review taxpayer's situation to fully understand income streams

- Check to see if all Schedule E rental real estate losses have been deducted as non-passive, possibly not considering the fact that the taxpayer must materially participate in each rental activity.
- Look at the taxpayer's occupation next to the signature block and Schedule E line 43. To be a real estate professional, the taxpayer must spend the majority of time in real property businesses and/or rental real estate.
- Review the Schedule E activities, Schedule K-1s for Form 1065 and Form 1120S returns, and W-2s for other indications regarding the nature of the taxpayer's activities.
- Review W-2s and other non-passive activities. Does it seem likely that the taxpayer could spend 500 hours on the activity in light of other employment obligations?
- Determine the location of each activity. If located far from the taxpayer's residence, how likely is the taxpayer to have spent substantial time on the activity?

#### Step 2: Identify taxpayer's real estate activities and scrutinize

- Determine who is the real estate professional, husband or wife.
- Identify the real property trades or businesses the taxpayer participates in and assess each for material participation

- Request and closely examine the taxpayer's documentation regarding time.
- To meet the recordkeeping requirements of Reg. § 1.469-5T(f)(4), the taxpayer must establish his participation by reasonable means. Reasonable records may include: (1) An identification of the services provided; AND, (2) The approximate number of hours spent, based on appointment books, calendars, or narrative summaries.
- Scrutinize other activities the taxpayer is engaged in to determine whether time claimed makes sense.
- Look for time spent by others in the activity. Indicators: commissions, management fees, expenses for cleaning, maintenance, repairs, etc.
- Time claimed should be scrutinized for investor-type time and work not customarily performed by an owner, which are specifically excluded in the hourly tests for material participation. See Reg. 1.469-5T(f)(2)(ii).
- If hours provided are suspicious, appear inflated, or there is a credibility issue, be sure to state so in your report with examples.

### **Step 3: Interview taxpayer**

- During the initial interview, question the taxpayer regarding time spent in all activities (personal, business, civic, family, hobbies, etc).
- Ask questions on taxpayer activity time early in the examination. Establish time the taxpayer spends on all activities during the initial interview if possible.
- Questions regarding material participation should be asked as early in the examination process as possible, preferably during the initial interview. The log in the exhibit at the end of the chapter is a good document to give to the taxpayer to establish his services and hours.

### **Indicators that the taxpayer did not materially participate:**

- The taxpayer was not compensated for services. Most individuals do not work significant hours without expecting wage or commissions.
- The taxpayer's residence is hundreds of miles from the activity.
- The taxpayer has a W-2 wage job requiring 40+ hours a week for which he or she receives significant compensation.
- The taxpayer has numerous other investments, rentals, business activities, or hobbies that absorb significant amounts of time.
- There is paid on-site management/foreman/supervisor and/or employees who provide day-to-day oversight and care of the operations.
- The taxpayer is elderly or has health issues.
- The majority of the hours claimed are for work that does not materially impact operations.
- Business operations would continue uninterrupted if the taxpayer did not perform the services claimed.

## Auditor Interview Sheet: Exhibit 2.4: Real Estate Professionals

**LAW:** Under IRC § 469(c)(7) & Reg. 1.469-9, if the taxpayer spends the majority of his time in real property businesses, meeting the 1/2 personal services and 750-hour tests, rental real estate losses are no longer per se passive. If the taxpayer materially participates in each rental real estate activity, losses are fully deductible. If not, even though the taxpayer is a real estate professional, losses are passive and deductible only up to \$25,000 (if MAGI is less than \$100,000). The IRC § 469(c)(7) does not trigger carryover losses from prior years.

\_\_\_\_\_ Verify that one spouse alone meets BOTH of the following tests.

**FIRST TEST:** Are more than half of personal services in all businesses (T/B) for the year performed in real property T/B and rental real estate?

--Real property T/B = real property development, construction, acquisition, conversion, rental operation, management, leasing or brokerage. Time spent as an employee in real property activities counts only if the taxpayer is more than a 5 percent owner.

**SECOND TEST:** Does taxpayer spend more than 750 hours in real property businesses and rentals in which he materially participates?

\_\_\_\_\_ If answer is **NO** to either of above two tests, **IRC § 469(c)(7) does not apply**, and losses are generally limited to \$25,000.

\_\_\_\_\_ If answer is **YES** to both tests, **apply material participation tests to each rental real estate activity** to determine whether each activity is passive or non-passive. While not seen often, the taxpayer may have made a one-time election to group all rentals as a single activity. Thus material participation is determined based on the grouped rentals. See IRC § 469(c)(7)(A) and Reg. § 1.469-9(g).

### CONCLUSION:

1. Per IRC § 469(c)(7), the following rental real estate activities have been determined to be non-passive and current (but not carryover) losses are fully deductible:  
\_\_\_\_\_ Current losses are entered on Schedule E, but not on FORM 8582.
2. Taxpayer is a real estate professional, but did not materially participate in the following real estate activities: \_\_\_\_\_. He does, however, actively participate, making management decisions. Losses are entered on FORM 8582 line 1a.
3. Taxpayer does not actively participate in the following rental real estate activities: \_\_\_\_\_. Limited partners and Taxpayers who own 2-19 less than 10 percent cannot rise to the active participation standard. Losses are entered on FORM 8582, line 3b (2b for years before 2002).

## **Auditor Interview Sheet: Exhibit 2.5: Real Estate Professional: Interview Half Personal Services Test**

\_\_\_\_\_ Describe the work you perform as a real estate professional. Check occupations by signatures and W-2s.

\_\_\_\_\_ Who is the real estate professional, you or your spouse?

\_\_\_\_\_ Does the spouse claiming to be the real estate professional work full-time or part-time? If the taxpayer has a full-time job working 2080 hours a year in a non-real property business, he must work 2081 on his real property businesses to meet half-personal services test!

\_\_\_\_\_ What percentage of each real property business(es) do you own? Unless taxpayer owns 5 percent or more, time is not counted. See IRC § 469(c)(7)(D)(ii). If, for example, the taxpayer works full-time for a construction company, but does not own any of the company, he is not a real estate professional.

### **750 HOUR TEST**

Time does not count for purposes of the 750 hour test and the half personal services test – unless the taxpayer materially participates in the activity. One spouse ALONE must meet the 750 hour test.

\_\_\_\_\_ Who performs the services, husband or wife? Hours by husband? Hours by wife?

\_\_\_\_\_ Approximately how many hours did you spend working on your rentals in the year under exam? Ask the taxpayer for supporting documentation (appointment books, diaries, calendars, logs, etc.) You may want to give taxpayer a log to be completed for each rental – and for each year under exam. Material participation is a year by year determination. Rentals are generally not time intensive.

\_\_\_\_\_ If non-working spouse claims to be the real estate professional, ask what other commitments he/she may have. Is the spouse a student? Is the spouse providing full-time care to young children?

### **MATERIAL PARTICIPATION IN THE RENTALS**

\_\_\_\_\_ Who monitors the rentals? Who collects the rent? Who does the repairs?

\_\_\_\_\_ Do you have a real estate agent or manager or employee responsible for any of the rentals? Ask for each rental property. Check Schedule E properties for large commissions or management fees. Also, check for large labor expense possibly a hired contractor spent more

time than taxpayer. If there is paid management, it is a strong indicator taxpayer did not materially participate.

\_\_\_\_\_ Is anyone besides you involving with managing or overseeing any the properties? Does a relative or friend manage/monitor the property for free?

\_\_\_\_\_ Does a tenant receive free/reduced rent for managing the rentals – or for caring for the properties?

**Exhibit 4.4: Activity Log**

Business/Property: \_\_\_\_\_ Year: \_\_\_\_\_

Complete the following by day:

Date	Hours Spent	Description of Service Performed. Be as specific as possible.  By each service, enter H or W for husband or wife.	If requested, how could activity be verified?
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**Under penalties of perjury, I declare that I have examined the information contained on this worksheet, including attached worksheets and statements, and to the best of my knowledge and belief, it is true, correct and complete.**

\_\_\_\_\_  
*Signatures (both spouses, if married)* \_\_\_\_\_  
*Date*

Reg. § 1.469-5T(f)(4) provides that reasonable means for proving hours may include a statement of services performed AND approximate hours based on appointment books, calendars, etc. To meet his burden of proof under IRC 7491, the taxpayer must comply with the recordkeeping requirements of the regulations.

## Additional Resources

- [The Code \(Sec. 469\)](#)
- [Material Participation Regs](#)
- [Grouping Regs](#)
- [Our REPS Guide](#)
- [IRS Audit Technique Guide](#)
- [Sample Time Log](#)