

Establishing Credibility: Recent Cases Highlight the Plight of Real Estate Professionals

By Robert S. Barnett, CPA, JD, MS (Taxation) & Rebecca K. Richards

As evidenced by a line of recent cases, the IRS has been aggressive in pursuing taxpayers claiming to be real estate professionals. When faced with taxpayers attempting to deduct losses attributable to their rental real estate activities, the courts have been adamant in requiring adequate, credible proof that the statutory requirements have been satisfied. Otherwise, the losses are deferred as passive activity losses.

Section 469 of the Internal Revenue Code generally disallows any deduction for losses sustained from passive activities. Passive activity loss is the amount by which the taxpayer's aggregate losses from passive activities exceed the aggregate income from passive activities. These losses must be carried forward to be applied against passive activity income in subsequent tax years. A passive activity is defined as any trade or business in which the taxpayer does not materially participate. The Code classifies rental activity as "per se passive" regardless of material participation, subject to limited exceptions. One such exception, contained in Section 469(c)(7), provides that a taxpayer's rental real estate activities will not be considered per se passive if the taxpayer qualifies as a real estate professional.

To qualify as a real estate professional, the taxpayer's must prove (i) 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 (ii) 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. For spouses filing jointly, the test is satisfied if either spouse qualifies as a real estate professional.

Material participation is defined by Section 469(h) as regular, continuous, and substantial involvement. Treas. Reg. § 1.469-5T contains seven objective tests that can be used to prove material participation. The regulation provides that proof of participation "may be established by any reasonable means," including, but not limited to, logs, appointment books, time records, or other documents identifying the services performed and the number of hours expended.

Recent cases have focused on the lack of credibility in holding that the taxpayer did not qualify as a real estate professional. Treasury Regulations do not have specific recordkeeping requirements and provide only general guidance. Treas. Reg. § 1.469-5T. The Tax Court has consistently held that a "post-event ballpark guesstimate" is insufficient proof of the hours spent on a particular activity. *Hudzik v. Com'r*, TC Sum. Op. 2013-4; *Fowler v. Com'r*, TC Memo 2002-223; *Moss v. Com'r*, 135 T.C. 365 (2010); *Goshorn v. Com'r*, TC Memo 1993-578. "[T]he credibility of a taxpayer's records is diminished where the number of hours reported appears excessive in relation to the task described." *Jafarpour v. Com'r*, TC Memo 2012-165; *Hill v. Com'r*, TC 2010-200.

In order to successfully claim real estate professional status, the taxpayer must maintain and present sufficient, credible evidence to support the statutory requirements. The only evidence offered in



Robert S. Barnett,
 CPA, JD, MS



Rebecca K. Richards

Hoskins v. Com'r, TC Memo 2013-36, was the taxpayer's testimony regarding the hours spent at each of his rental properties. The taxpayer admitted that he had not maintained an appointment book, record, or log and had only his subjective recollections of the hours devoted to each of property. The court refused to accept "unverified, undocumented testimony" and emphasized the lack of "contemporaneous verification" to substantiate the taxpayer's claims.

The taxpayer in *Hudzik v. Com'r*, TC Sum. Op. 2013-4, offered a general log of time spent at her two rental properties claiming she qualified as a real estate professional. The court disregarded the logs as not credible and denied her claim. The logs did not indicate when they were created, failed to specify the types of services performed at each property, did not break down the hours spent at each property, and provided no "underlying documentary evidence to substantiate the hours reflected in the logs." Further, the number of hours allegedly devoted to the rentals was suspect when compared to the hours devoted to the taxpayer's full-time job.

In *Jafarpour v. Com'r*, TC Memo 2012-165, the Tax Court similarly scrutinized the offered evidence to determine that the taxpayer's appointment book and real estate log were not credible. Notes were frequently illegible and ambiguous, and the taxpayer was unable to accurately document the time spent at her chiropractic office. This lack of proof was fatal to the claim of a real estate professional because she was unable to prove more than one-half of her time was spent in real property trades or businesses.

As to the real estate log, the court found it to be "tainted with incredulity" and the number of hours to be "excessive in relation to the task described." The taxpayer allegedly devoted an entire hour to "receiving and reading a nine-sentence email" and reported two nineteen-hour days visiting and researching rental properties. The log did not appear to be contemporaneous, as the services performed were written in ink, while the total hours were written in pencil on the side of the page.

It is critical for taxpayers wishing to qualify as real estate professional to maintain detailed, accurate records. Separate records should be maintained as to each of the taxpayer's rental properties and should identify the type of service and the hours devoted to that service. Although contemporaneous records are not statutorily required, the cases frequently stress their importance in establishing credibility. Therefore, maintenance of contemporaneous logs or records is highly recommended. In addition, clients should retain all email correspondence, notes of meetings and consultations, and records of banking, maintenance, leases, and repairs for each rental property. The cases highlight the IRS' rigorous review of real estate professionals and the court's careful analysis and examination of both the type of evidence offered and the substance contained therein.

Robert S. Barnett is a partner at Capell Barnett Matalon & Schoenfeld LLP in Jericho, New York, where he heads the Tax and Estate Planning Departments. Rebecca K. Richards is a law clerk at the firm.