REAL ESTATE PROFESSIONALS: SURVIVING THE AUDIT

The IRS and New York State have been aggressive in auditing real estate professionals. In order to survive the audit and prove that the statutory requirements have been met, it is critical that taxpayers establish credibility by maintaining detailed, accurate records. If the claim is denied, the losses attributable to rental real estate activities are deferred as passive activity losses.

Section 469 of the Internal Revenue Code defines a passive activity as any trade or business in which the taxpayer does not materially participate. Losses sustained from passive activities are generally not deductible and must be carried forward to be applied against passive activity income in subsequent tax years. Passive activity loss is the amount by which the taxpayer's aggregate losses from passive activities exceed the aggregate income from passive activities. Rental activities are "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.

The real estate professional test requires that the taxpayer 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.

Section 469(h) defines material participation as regular, continuous, and substantial involvement. Treas. Reg. § 1.469-5T contains seven objective tests that can be used to prove material participation. 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.

There are no specific recordkeeping requirements in the regulations, but 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.

To survive the audit, the taxpayer must present sufficient, credible evidence to support the statutory requirements. The taxpayer's mere testimony as to the hours spent at each property was held to be insufficient in Hoskins v. Com'r, TC Memo 2013-36. In Hoskins, the taxpayer did not maintain an appointment book, record, or log. The court denied real estate professional status, noting the lack of "contemporaneous verification."

In Hudzik v. Com'r, TC Sum. Op. 2013-4, a general log of time spent at two rental properties was similarly disregarded. The logs were not credible as they did not contain enough detail and were uncorroborated by additional documentation. Further, the hours reported in the logs were suspect based on the time devoted to the taxpayer's full-time job. This discrepancy was fatal to the taxpayer's claim that she spent more than one-half of her time in real property trades or businesses. Confirmation from an employer that the taxpayer had flexibility to spend time away from the office may substantiate claims of the hours devoted to rental properties.

Poor legibility, ambiguity, implausibility, and a lack of contemporaneous records were decisive in denying real estate professional status in Jafarpour v. Com'r, TC Memo 2012-165. Notes in an appointment book were illegible and ambiguous, while time at the taxpayer's chiropractic office was inaccurately calculated. The court was particularly skeptical of an hour spent "reading a nine-sentence email" and two nineteen-hour days visiting and researching rental properties.

To survive the audit, the taxpayer must provide detailed, accurate records as to each rental property. The records should identify the type of service and the hours devoted to that service. Prudence suggests maintaining contemporaneous records, as the cases frequently stress their importance in establishing credibility. Retention of email correspondence, notes of meetings and consultations, and records of banking, maintenance, leases, and repairs for each rental property may assist in corroborating the taxpayer's claim. Obtaining affidavits from co-workers or employers may corroborate the taxpayer's claim that more than one-half of his or her time was spent in real property trades or businesses. For taxpayers claiming real estate professional status, establishing and maintaining credibility is vital, particularly in light of the aggressive auditing by the IRS and New York State.

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