Tax Court: Trusts Can Qualify for the Beneficial Real Estate Pro Rule

Many rental real estate owners incur tax losses, often due to depreciation write-offs. However, your ability to actually deduct those losses might be postponed indefinitely by the passive activity loss (PAL) rules. On the other hand, you can currently deduct rental real estate losses if you qualify for a special exception targeted at real estate professionals. Surprisingly enough, in one case, the U.S. Tax Court ruled that trusts can potentially qualify for the exception.

Here are the facts of the case, along with what you need to know if you are in this situation.

Rental Real Estate Passive Activity Losses

For federal income tax purposes, rental real estate losses are usually treated as passive activity losses (PALs). According to the general rule, individual taxpayers and trusts can only deduct PALs to the extent they have passive income from other sources. For example, if you have positive taxable income from other rental properties, that generally counts as passive income. Taxable gains from selling rental properties also generally count as passive income. You can use your PALs to offset passive income from these other sources, which amounts to being able to currently deduct the PALs.

Unfortunately, many rental property owners have little or no passive income in most years. In this scenario, your excess rental real estate PALs for the year (the amount of PALs you cannot currently deduct because you don't have enough passive income from other sources) are suspended and carried forward to future years. You can deduct the suspended PALs in future years when you finally have enough passive income or when you sell the properties that generated the PALs in the first place. *Bottom line:* Suspended PALs often remain suspended for a number of years. This problem applies equally to individual rental property owners and trusts that own rental properties.

Special Exception for Real Estate Professionals

Thankfully, a special exception allows qualifying taxpayers, including trusts, to currently deduct rental real estate losses even though they have little or no passive income. To be eligible for the special exception:

- The taxpayer must spend over 750 hours during the year delivering *personal services* in real estate activities in which the taxpayer *materially participates;* and
- Those hours must be over half the time the taxpayer spends delivering personal services (in other words, working) during the year.

If these hurdles are successfully cleared, the taxpayer qualifies as a real estate professional. The second step is determining if the taxpayer has rental properties in which the taxpayer *materially participates*. If so, those properties are exempt from the PAL rules, and the losses from those properties can generally be deducted in the current year. Note: The taxpayer can elect to combine all rental properties into a single group and treat the combined group as one property for purposes of taking this second step.

The three easiest-to-pass material participation tests for a real estate business activity (including one or more rental properties treated as a single activity for tax purposes) are the following:

1. Spend more than 500 hours on the activity during the year.

2. Spend more than 100 hours on the activity during the year and making sure no other individual spends more time than you.

3. Making sure the time you spend on the activity during the year constitutes substantially all the time spent by all individuals.

You only have to meet one of these requirements to pass the material participation test for an activity.

Facts behind the Tax Court Decision

The Frank Aragona Trust owned several rental real estate properties and was also involved in other real estate business activities such as holding and developing real estate. Frank Aragona set up the trust in 1979 with himself named as the trustee and with his five children named as the beneficiaries. Aragona died in 1981 and the trusteeship was taken over by the five children (one of whom acted as executive trustee) and one independent trustee. Although the trustees formally delegated their powers to the executive trustee, the trustees acted as a management board and made all major decisions regarding the trust's assets.

Three of the children also worked full-time for, and received wages from, Holiday Enterprises LLC (HE), which was wholly owned by the trust and treated as a disregarded entity for tax purposes. HE managed most of the trust's rental real estate properties and had several other employees in addition to the three children. The trust conducted some of its other rental real estate activities directly, some through wholly owned entities, and the rest through entities in which it owned majority interests. The trust conducted its real estate holding and real estate development activities through various other entities in which it owned majority or minority interests.

On its federal income tax returns (Form 1041) for the two years in question, the trust reported losses from its rental properties. They were classified as currently deductible non-passive losses pursuant to the real estate professional exception. After an audit, the IRS claimed the rental real estate losses were passive, because a trust cannot qualify for the real estate professional exception. According to the IRS, a trust cannot perform the requisite personal services. Only an individual can. So the IRS assessed over $700,000 for taxes and penalties. Ouch! The unhappy trustees took the case to the Tax Court.

What the Court Concluded

The Tax Court opined that if trustees are individuals who work in a business owned by a trust as part of their trustee duties, their work can be considered personal services performed by the trust for purposes of qualifying for the real estate professional exception. Having made that intellectual leap, the Tax Court concluded that the trust met the material participation standard for its real estate operations and its rental real estate activities.

More specifically, the court said that the work of the six trustees on behalf of the trust, including work performed as employees of HE, should be considered in determining whether the trust met the material participation standard for its real estate business activities as a whole. When that work was counted (especially the work performed by the three trustees who worked full-time on behalf of the trust), the court concluded that the trust spent over 750 hours during the year delivering personal services in real estate activities in which the trust materially participated, and thereby qualified for the real estate professional exception. As explained earlier, that is only the first step towards gaining an exemption from the PAL rules for rental real estate activities. The second step involves separately meeting the material participation standard for rental real estate activities. Because the IRS failed to raise this second step as an issue, the court basically gave the trust a free pass by concluding that the material participation test had been met for the trust's rental real estate activities. (*Frank Aragona Trust, 142 TC No. 9, 2014)*

While the *Frank Aragona Trust* decision is clearly good news for trusts that own rental real estate, it left a number of open questions.

Exactly whose hours should be counted in attempting to meet the two real estate professional eligibility requirements (the 50% requirement and 750-hour requirement)? Can the work of one trustee cause the trust to meet the requirement, or must the work of all trustees who work on behalf of the trust be aggregated? Can a trust count work performed by its employees and independent contractors as well, as work performed by its trustees in attempting to qualify for the real estate professional exception? The Tax Court implies that it can, without directly answering the question. Hopefully, the IRS will issue guidance to address these uncertainties, but that may not happen. It may take more court decisions.

Your Situation

The *Frank Aragona Trust* decision encourages trusts to be more aggressive in considering whether they might qualify for the taxpayer-friendly real estate professional exception. While some important questions remain unanswered, the old "nothing ventured, nothing gained" adage probably applies here. Consult with your tax advisor.

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