Qualifying as a real estate professional in the eyes of the IRS is only half the battle when it comes to utilizing your rental real estate losses. This article discusses the second hurdle taxpayers must clear—a hurdle affectionately known as material participation.

According to the IRS Office of Chief Counsel, qualifying as a real estate professional merely allows you the opportunity to apply and meet one of the seven tests for material participation. This means in order for a taxpayer to avoid rental real estate's default classification as a passive activity, taxpayers must first establish that they qualify as real estate professionals. Then the taxpayer must establish that he/she materially participated in the rental real estate activity. Except in limited situations (such as the year a property is disposed), if a taxpayer does not meet both of these requirements, any losses that arise from the rental activity will be considered passive and subject to the passive activity loss limitations.

It is important to understand that like the real estate professional designation, material participation is an annual determination. It is possible that a taxpayer could materially participate in one year and not the next. Of equal importance is that unless a taxpayer makes a grouping election, he/she will need to meet this hurdle for each rental real estate activity.

### Seven Tests for Material Participation

So what does it mean to materially participate in your rental activity? According to the IRC (Internal Revenue Code), a taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the activity's operations “on a basis which is regular, continuous and substantial.” Further regulatory guidance offers seven tests a taxpayer may apply to determine if he/she materially participates:

1. The individual participates in the activity for more than 500 hours during such year;
2. The individual's activity constitutes substantially all of the participation in such activity (including non-owner activity);
3. The individual participates in the activity for more than 100 hours during the taxable year and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual;
4. The activity is a significant participation activity and the individual’s aggregate participation in all significant participation activities during the year exceeds 500 hours;
5. The individual materially participated in the activity for any five taxable years during the ten taxable years that immediately precede the taxable year;
6. The activity is a personal service activity and the individual materially participated in the activity for any three taxable years preceding the taxable year; or,
7. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis.

A closer look at these tests will further narrow the opportunities for a taxpayer to meet the material participation standard as it relates to rental real estate. For example, the definition of a significant participation activity specifically excludes rental or leasing activities. Furthermore, personal service activities are those activities that involve the performance of personal services or other activities that are not capital intensive. Rental activities are certainly capital intensive, so this test is not applicable. Finally, it is tempting for taxpayers to presume they qualify based on all facts and circumstances. However, this test requires that the taxpayer participate for at least 100 hours, no one else performs services in connection with the management of the activity that exceeds the amount of hours performed by the taxpayer, and no one else receives compensation for managing the activity. These three elements may be difficult to substantiate if the taxpayer has not retained the proper support and documentation.

### Qualifying vs. Non-Qualifying Time

Next, you may ask, “What types of participation can be counted toward the remaining tests?” Well, in general, any work done by the taxpayer in connection with an activity that the taxpayer owns an interest in at the time the work is done is treated as participation under the regulations.

You may also ask yourself whether your spouse’s time can be included. His/her time can be included, even when your spouse files a separate return or doesn’t have an ownership interest in the activity. But remember, when...
meeting the real estate professional designation, one spouse must separately satisfy the two statutory tests. Like all good regulations, there are exceptions to the general rule. Non-qualifying time includes:

1. Work not customarily performed by owners
2. Participation as an investor
3. Non-rental real estate activities
4. Certain travel time
5. Participation of children or employees

The purpose of the first category of non-qualifying time is to prevent taxpayers from including time spent performing work where the main purpose is to avoid the disallowance of losses or credits. Time is not precluded from being eligible if the primary intent is not to prevent the disallowance. There are legitimate reasons why the owner may perform some non-customary types of work. For example, it may not be cost effective to hire employees to complete such tasks.

Reviewing financial statements, reporting on or monitoring the finances or operations in a non-managerial capacity are considered investor type activities. Other activities, such as organizing records, paying bills, preparing taxes may also be considered non-qualifying time if the taxpayer is not involved in the day-to-day management of the rental.

The third category is a reminder that only time related to the rental may be included. Take for example, a taxpayer who is a real estate developer who acquires land, constructs, builds, rents and manages buildings. Although the taxpayer’s real estate acquisition and construction activities are taken into consideration in determining whether he is a real estate professional, for determining whether a taxpayer materially participates in a rental real estate activity, the non-rental time in which the taxpayer is involved with construction, acquisition, and development activities is not taken into account.

Travel time is a highly contested area. For purposes of determining whether a taxpayer materially participates in an activity, the services provided by the taxpayer must be integral to operations, and travel is generally not viewed as such. Special scrutiny will likely be paid to this area, especially if other factors indicate the taxpayer is not participating in the activity on a regular, continuous and substantial basis. If you are relying on travel time, make certain you are documenting your traveling time appropriately.

Methods of Proof
A taxpayer’s participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required by the regulations if the extent of participation can be established by other reasonable means. Reasonable means for these purposes may include, but are not limited to, the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

Summary
In summary, qualifying as a real estate professional allows a taxpayer the opportunity to avoid rental real estate’s default classification as a per se passive activity if he/she also meets one of the seven tests for material participation. This means that the taxpayer needs to be involved in the activity’s operations on a basis that is regular, continuous and substantial. Taxpayers are advised to ensure that they are contemporaneously maintaining records to support their involvement, to both mitigate audit risk and enable their tax professionals to determine whether their losses are currently deductible.

These rules are complex and other factors may affect your ability to utilize your rental real estate losses. Boulay believes it is important for our clients to understand how the material participation rules affect the tax treatment of their activities. Please contact us to discuss how these rules may apply to your individual tax situation at 952.893.9320 or learnmore@boulaygroup.com.