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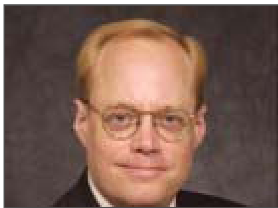

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Why 'Material Participation' Can Be Your Ticket To Tax Deductions

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The tax law distinguishes between passive investments and active businesses. Suppose you have condo you rent out that generates a tax loss every year because the rent you collect doesn't cover your mortgage and real estate taxes. If you depreciate the condo, it will make your tax loss even larger. Can you offset that real estate loss against your salary or business income?

It depends on whether the real estate is active or passive. Using more correct terminology, the question is whether you materially participate in the condo rental business. If you "materially participate" it is active and you can offset your tax loss against your other income. If you don't, you can't and must store up the suspended passive losses until you eventually have passive income, as by selling your condo.

These issues—covered by Section 469 of the tax code—come up frequently for investors in real estate and many other fields. A good recent example involves a cattle ranch. In *Iverson v. Commissioner*, the Tax Court disallowed ranch losses because the taxpayer failed to show he materially participated in the day-to-day management or operation of the ranch. Besides, there was a full-time paid ranch manager who ran it.

How do you "materially participate" to satisfy the IRS?

1. If (based on all of the facts and circumstances) you participate in the activity on a regular, continuous, and substantial basis during the year; or
2. If you participate in the activity for more than 500 hours during the year.

But acting as an investor—reviewing financial statements, finances or operations—doesn't qualify unless you ***also*** handle day-to-day management. Your management activities are not taken into account if another person is paid to manage the activity or if another person spends more time managing it than you do.

You can prove your own involvement by any reasonable means. That includes calendars, appointment books, or narrative summaries identifying work performed and hours spent. Contemporaneous daily time reports or logs aren't required but you somehow must establish it.

How did this ranch owner do? Not well. He had a medical equipment business and worked there full time. When he bought a 14,000 acre cattle ranch, he hired a full-time manager to run it.

Still, he went there 11 times in 2005 (usually with his kids), spending 23 days there. He also hosted employees, clients and potential clients at the ranch. Unfortunately, he kept no day-to-day record of the work he performed.

When he deducted his losses, the IRS objected, saying the activity was passive. The part-time rancher went to Tax Court but couldn't prove he spent 500 hours on ranch activities. To win, keep extensive files, to-do lists, home and mobile phone records, business plans, project descriptions and instructions to employees documenting your active involvement in the regular, continuous and substantial management, and day-to-day activities.

For more, see:

Ships Pilot/Developer Case Shows Importance of Aggregation Election

S Corporation Rental Income Not Passive Except When It Is

Passive Activity Loss Audit Technique Guide

Keep Tax Records In The Vault!

When Tax Refunds Like Steinbrenner's Are Too Good To Be True

What's Your IRS Audit Risk? IRS Audit Risk If You're "Rich"

Avoid IRS Audit Triggers

More IRS Audits Coming Your Way

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