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Electing to aggregate rental activities: Better late than never

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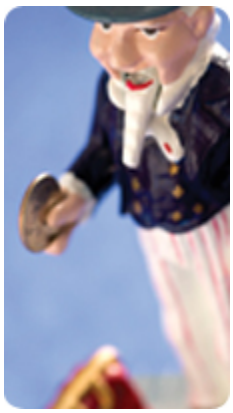

Taxpayers that own several rental properties have to make many decisions when it comes to reporting income or loss from those properties. Among them is whether it would be more beneficial for the income or loss to be characterized as active rather than passive. If the taxpayer wants active characterization applied to income (e.g., to reduce or eliminate liability for the new Sec. 1411 net investment income tax) or loss (e.g., to avoid the Sec. 469 passive loss limitation), it must then decide whether to aggregate the rental activities.

If the taxpayer decides to aggregate the activities, filing the election under Sec. 469(c)(7)(A) to do so is crucial. It may behoove taxpayers to file a late election, as the IRS now allows in certain instances.

REAL ESTATE PROFESSIONALS

For individuals and certain entities, Sec. 469(a) generally disallows for the tax year any passive activity loss, defined as the excess of the aggregate losses from all passive activities for the tax year over the aggregate income from all passive activities for that year. A passive activity is any trade or business in which the taxpayer does not materially participate. Rental activity is treated as a *per se* passive activity unless the taxpayer is a real estate professional.

Under Sec. 469(c)(7)(B), a taxpayer qualifies as a real estate professional, and a rental real estate activity of the taxpayer is not a per se passive activity under Sec. 469(c)(2), if (1) more than one-half of the personal services performed in trades or businesses by the taxpayer during the tax year are performed in real property trades or businesses in which the taxpayer materially participates, and (2) the taxpayer performs more than 750 hours of services during the tax year in real property trades or businesses in which the taxpayer materially participates. In the case of a joint return, these requirements are satisfied if (and only if) either spouse separately satisfies them. (For more on real estate professionals and material participation, see "Higher Stakes for Tax Treatment of Rental Real Estate," *JofA*, Dec. 2013, page 56.)

The default rule is that each property is treated as an independent activity for which the taxpayer must satisfy the material participation requirement, unless the taxpayer elects under Sec. 469(c)(7)(A) to treat all interests in rental real estate as a single rental real estate activity.

For taxpayers with multiple real estate properties, especially those with other jobs outside their rental operations, meeting the material participation requirement for each property separately is usually unrealistic.

MAKING THE SEC. 469(c)(7)(A) ELECTION

A taxpayer makes the election by filing a statement with the taxpayer's original income tax return for the tax year

(Regs. Sec. 1.469-9(g)(3)). This statement should explicitly declare that the taxpayer is a qualifying taxpayer (i.e., the taxpayer meets the requirements to be a real estate professional) for the tax year and is making the election under Sec. 469(c)(7)(A). Once the election is made, it is binding for the tax year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer, even if there are intervening years in which the taxpayer is not a qualifying taxpayer.

A taxpayer can revoke the Sec. 469(c)(7)(A) election only in the tax year in which "a material change in the taxpayer's facts and circumstances occurs or in a subsequent year in which the facts and circumstances remain materially changed from those in the taxable year for which the election was made" (Regs. Sec. 1.469-9(g)(3)). To do so, the taxpayer must file a statement with the original income tax return for the year of revocation containing a declaration that the taxpayer is revoking the election under Sec. 469(c)(7)(A) and an explanation of the nature of the material change.

FILING A LATE ELECTION

The IRS in Rev. Proc. 2011-34 allows certain taxpayers to file an election after filing their original tax return by attaching a statement to their amended return for the most recent tax year and mailing the amended return to the IRS service center where the taxpayer will file its current-year return.

In addition to the information required by Regs. Sec. 1.469-9(g)(3), a taxpayer filing a late amendment must include:

1. An explanation of why the election was not timely made;

2. Designation of the tax year for which the taxpayer seeks to make the late election;

3. Representations that the taxpayer:

- Failed to make an election under Regs. Sec. 1.469-9(g) solely because the taxpayer failed to timely meet the requirements in Regs. Sec. 1.469-9(g);
- Filed consistently with having made an election under Regs. Sec. 1.469-9(g) on any return that would have been affected if the taxpayer had timely made the election.
- Timely filed each return that would have been affected by the election if it had been timely made; and
- Has reasonable cause for failing to meet the requirements in Regs. Sec. 1.469-9(g).

4. A declaration that the representations are made under penalties of perjury; and

5. A statement at the top declaring: "FILED PURSUANT TO REV. PROC. 2011-34." The individual or individuals who sign must have personal knowledge of the facts and circumstances related to the election.

Thus, taxpayers that qualify under Regs. Sec. 1.469-9(c) and have timely filed all previous tax returns and consistently reported the income or loss as aggregated can avail themselves of this revenue procedure, as long as they have reasonable cause for the failure to make the election on the original return. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within six months after its due date, excluding extensions.

REASONABLE CAUSE

"Reasonable cause" generally means the exercise of ordinary business care and prudence (Regs. Sec. 301.6651-1(c)). Absence of fault is a prerequisite, and a taxpayer must prove that failure to file a timely return was not the result of carelessness, reckless indifference, or intentional failure. A likely basis for reasonable cause for failure to timely file a Sec. 469(c)(7)(A) election is reliance on professional advice. Courts generally do not allow this basis for reasonable cause when the dispute relates to a nondelegable duty, such as failure to file a return or pay taxes (see, e.g., *Baccei*, 632 F.3d 1140 (9th Cir. 2011)). However, filing an election is not a nondelegable duty, so taxpayers should be entitled to rely on their accountant to properly file a Sec. 469(c)(7)(A) election. Whether

reasonable cause exists is a question of fact and depends on the particulars of the taxpayer's case.

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