Milbank Tax Attorney Comments on IRS Revenue Procedure Allowing Late Aggregation Elections under Passive Activity Limitations

Michael J. Grace, JD, Managing Director-TAARS®, on June 2, 2011 commented in a major tax publication on recently issued IRS Revenue Procedure 2011-34. The Revenue Procedure allows some "real estate professionals" to make late elections to treat all interests in rental real estate as one rental real estate activity under the passive activity loss and credit limitations, Internal Revenue Code Section 469. Michael observed that the Revenue Procedure technically does not provide a "safe harbor." He also cautioned that taxpayers before making such elections should analyze the relative advantages and disadvantages.

Pertinent Rules

Tax Limitation Generally. Section 469, "Passive Activity Losses and Credits Limited", was added to the Internal Revenue Code by the Tax Reform Act of 1986. Intended to curtail abusive tax shelters, Section 469 disallows passive activity losses and passive activity credits of individuals, estates, trusts, closely held C corporations, and personal service corporations. Those taxpayers generally may not deduct net losses (deductions exceeding gross income) from passive activities. Disallowed net losses carry forward indefinitely until the taxpayer can use them subject to these limitations.

Passive Activities. In general, there are two categories of "passive" activities: (i) any rental activity, and (ii) any trade or business activity in which a taxpayer does not "materially participate." Under IRC Section 469(h)(1), a taxpayer in order to satisfy the material participation requirement must participate in an activity regularly, continuously, and substantially. Regulations prescribe seven alternative "tests" for satisfying this standard. For example, a taxpayer may materially participate in an activity by participating in it more than 500 hours during a taxable year. See Treas. Reg. Sections 1.469-5 and 1.469-5T.

Real Estate Professional Exception. Under a statutory amendment enacted in 1993 (Section 469 (c) (7)), rental real estate activities of certain persons in the "real property business" (also referred to as "real estate professionals" or "qualifying taxpayers") are not automatically passive activities. Instead, any rental real estate activity of a qualifying taxpayer ("QTP") is either active or passive depending on whether the taxpayer materially participates in it. If an activity is "active," then the QTP may deduct net losses from the activity without limitation by Section 469. However, net income from such an activity may not be sheltered by passive losses.

A QTP is a taxpayer who during a taxable year performs (i) more than one half of all personal services and (ii) more than 750 hours of services in real property trades or businesses in which the taxpayer materially participates.

Aggregation Election. In general, the limitations on passive activity losses and credits apply to a QTP as if each interest in rental real estate were a separate activity. However, a QTP may elect to treat all interests in rental real estate as one activity (described below, for shorthand purposes, as an "aggregation election"). Whether or not a particular QTP may benefit from making this election depends on various factors including the numbers and types of rental real estate interests and the extent to which the QTP is involved in them.

A taxpayer may make an aggregation election (subject to statutes of limitation) in any year in which he or she is a qualifying QTP. Failing to make the election one year does not preclude a taxpayer from electing in a later year. Once made, however, an aggregation election generally binds a taxpayer for all future years. A taxpayer may revoke the election only if a "material change" occurs in the taxpayer's facts and circumstances. See Treas. Reg. Section 1.469-9(g).

The Regulations interpreting Section 469(c)(7) specify that a QTP must make an aggregation election with the *original* income tax return for a particular taxable year. Before Revenue Procedure 2011-34, a QTP who missed this deadline but wanted to make a late election could obtain permission, if at all, only by requesting from the IRS a private letter ruling ("LTR"). The IRS has granted some of these ruling requests and denied others. In order to seek a LTR, a taxpayer generally must pay the IRS a user fee and, if professionally advised, professional fees. Letter rulings also require some time to obtain from the IRS.

Revenue Procedure 2011-34

Revenue Procedure 2011-34, 2011-24 I.R.B., will interest a QTP who wants to make an aggregation election to take effect for a particular tax year but who missed the deadline of electing on the income tax return *originally* filed for that year. The Revenue Procedure specifies conditions a QTP must satisfy to receive an extension of time to make an aggregation election without an LTR. A QTP who satisfies the Revenue Procedure's conditions for eligibility may make a late election by amending the federal income tax return for the most recent tax year. A QTP who does not satisfy these conditions may, as before Rev. Proc. 2011-34, seek from the IRS a LTR.

Grace's Observations

Federal Tax Weekly for June 2, 2011, published by CCH, a Wolters Kluwer business, quoted Michael Grace as follows:

"Although technically not providing a safe harbor, Revenue Procedure 2011-34 will enable some qualifying real estate professionals to make late elections to aggregate all their rental real estate interests into one activity." Michael Grace, JD, Milbank, Tweed, Hadley & McCloy LLP, Washington, DC, told CCH, "Whether electing late or otherwise, a qualifying taxpayer first should carefully analyze the advantages and disadvantages of making such an election, because once made the election may be revoked only in restrictive circumstances described in Reg. Section 1.469-9(g)(3)."

For various reasons, the Revenue Procedure technically does not provide a "safe harbor," i.e., absolute assurance that the IRS will respect a late election. The conditions for eligibility (see Section 4.01 of the Revenue Procedure) include that the taxpayer had "reasonable cause" for not electing on time (i.e., not making the election with an originally filed income tax return). The IRS later may determine that the taxpayer lacked reasonable cause. In addition, the IRS may decide for a variety of reasons not to respect the election or its intended consequences. See Rev. Proc. 2011-34, Section 5.

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