

Lessons from the Tax Court: Combining passive activities

Generally, you can only deduct losses from passive activities up to the amount of your income from passive activities for the year. But there are certain exceptions to this general rule, including a limited loss allowance of up to \$25,000 for losses from real estate activities if your income is below certain limits. The rental real estate loss allowance is phased out between adjusted gross income (AGI) of \$100,000 and \$150,000.

Fortunately, you can also avoid the passive activity loss (PAL) rules when you “materially participate” in an activity. The IRS has spelled out material participation tests in regulations. For example, you are considered a material participant if you spend more than 500 hours on the activity during the year.

Depending on the situation, you may be able to combine the time spent on multiple business activities for these purposes. But this option isn’t always available.

New case: The taxpayer was a real estate developer in California. He held an interest in one project where he was mainly involved in logistics. In 2007, he spent more than 500 hours on this real estate activity.

To reduce his travel time for business meetings, the taxpayer acquired an airplane and eventually began chartering it out as a separate business. However, his participation in the chartering activity was minimal and constituted fewer than 500 hours for the year. The chartering business showed a loss in 2007.

As you might imagine, it’s easier to pass the material participation tests when multiple activities are combined (i.e., work hours are added together). Whether or not this can be done is based on the following factors:

- Similarities and differences in types of businesses
- The extent of common control
- The extent of common ownership
- Geographical location
- Relationships between or among the activities.

After reviewing the facts, the Tax Court concluded that the two businesses didn’t serve the same clients nor offer a common product or service. In addition, the plane wasn’t utilized by the real estate businesses. Because the businesses were dissimilar, the taxpayer could not combine the hours spent on them for purposes of passing the material participation tests. As a result, the loss from this business was denied under the passive activity rules. (*Brumbaugh TC Memo 2018-40, 4/3/18*)