

THE REAL ESTATE EXCEPTION TO THE PASSIVE ACTIVITY RULES IN MOWAFI V. COMMISSIONER
AND THE NEW BURDEN SHIFTING STATUTE
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TEXT:

In *Mowafi v. Commissioner*,ⁿ¹ the Tax Court held that the taxpayer did not meet the burden of proof required for the real estate professional exception to the passive activity rules.ⁿ² The court found that the taxpayer's inconsistent testimony combined with logs that were prepared two to three years after the activities supposedly occurred did not establish the requisite proof under section 469(c)(7).ⁿ³ Ultimately, *Mowafi* establishes that it will be very difficult for a taxpayer with a full-time job to qualify for the real estate professional exception.

n1 81 *T.C.M. (CCH)* 1605, 2001 *T.C.M. (RIA)* P2001-111 [hereinafter *Mowafi*].

n2 *I.R.C.* § 469(c)(7).

n3 *Mowafi*, 81 *T.C.M. (CCH)* at 1606, 2001 *T.C.M. (RIA)* P2001-111 at 789.

Part I of this Note summarizes the relevant tax law and the facts of *Mowafi*. Part II analyzes the decision of the Tax Court and demonstrates that the court's holding is consistent with prior case law. Part III discusses section 7491 which shifts the burden of proof to the Service once the taxpayer produces credible evidence concerning any factual issue in dispute,ⁿ⁴ and concludes that the outcome in this case would have been the same under the new burden shifting statute. Part IV explains the tax planning implications of the real estate professional exception. Part V concludes that taxpayers should maintain detailed contemporaneous records to meet the requirements of section 469.

n4 *I.R.C.* § 7491; see also TAX CT. R. 142 (shifting the burden of proof to the Service as required by section 7491).

I. BACKGROUND

A. *Passive Activity Rules*

As defined in section 469, passive activity occurs when a taxpayer conducts any trade or business in which the taxpayer does not materially participate.ⁿ⁵ Generally, passive activity losses can be used only to offset passive income,ⁿ⁶ and any excess losses can be carried forward to a subsequent taxable year.ⁿ⁷ The passive loss rules were enacted as part of the Tax Reform Act of 1986ⁿ⁸ to prevent taxpayers from offsetting non-passive income with passive losses.ⁿ⁹

n5 *I.R.C.* § 469(c)(1). Section 7491 did not become effective until after the taxable years in question.

n6 *I.R.C.* § 469(a)(1).

n7 *I.R.C.* § 469(b).

n8 Pub. L. No. 99-515, § 501, 100 Stat. 2085, 2233 (1987).

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n9 STAFF OF JOINT COMM. ON TAXATION, [100TH] ADD CONGRESSIONAL YEAR CONG.,
GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 209-215 (Comm. Print 1987).

Section 469 states that all rental activity is passive. n10 However, an exception is made for certain taxpayers that materially participate in real estate activity. n11 Passive losses from a real estate activity can offset ordinary income if: (1) over half of all personal services performed by the taxpayer during the year were in real property trades or businesses in which he materially participated, and (2) the taxpayer worked more than 750 hours a year in those real estate activities. n12

n10 *I.R.C. § 469(c)(2)*.

n11 *I.R.C. § 469(c)(7)*.

n12 *I.R.C. § 469(c)(7)(B)*.

B. Burden of Proof

As a general rule, before Congress enacted section 7491, the taxpayer had the burden of proving that he qualified for the real estate professional exception by a preponderance of the evidence. n13 Enacted in 1998, section 7491 shifts the burden of proof to the Service once the taxpayer produces credible evidence with respect to any factual issue relevant to determining the taxpayer's tax liability. n14 Because the audit in *Mowafi* began before July 22, 1998, section 7491 did not apply; n15 thus, the taxpayer had the burden of proving that he met the requirements of the real estate professional exception.

n13 *See Welch v. Helvering, 290 U.S. 111, 115 (1933)*.

n14 *I.R.C. § 7491(a)(1)*.

n15 *I.R.C. § 7491*. The statute became effective on July 22, 1998 and the Service's audit of Mowafi's tax return began before that date. *See* Brief for Appellant at 10-11, *Mowafi, 81 T.C.M. (CCH) 1605, 2001 T.C.M. (RIA) P2001-111* (No. 1663-00).

However, *Mowafi* and the other cases discussed in this Note are relevant to understanding section 7491 because they help to interpret the credible evidence requirement of the new burden shifting statute. In addition, Temporary Regulation section 1.469-5T(f)(4) also helps taxpayers to determine what qualifies as credible evidence. The regulation states that a taxpayer can establish his participation in rental activity by any reasonable means, such as identification of services performed over a period of time and the approximate number of hours spent performing such services based on appointment books, calendars, or narrative summaries. n16 Contemporaneous daily time reports, logs, or similar documents are not required if the extent of participation may be established by any reasonable means. n17

n16 Temp. Reg. § 1.469-5T(f)(4).

n17 Temp. Reg. § 1.469-5T(f)(4).

C. Facts of Mowafi

The taxpayer, Mowafi, was the director of research and manager of research and development at GTE Inc. (GTE). n18 He worked at least 40 hours a week for GTE in Waltham, Massachusetts n19 and was promoted to vice president because his supervisor appreciated his long work hours. n20 On weekends, he went to Virginia to spend time with his family, n21 where he was also involved with 17 rental real estate properties. n22 He spent a portion of his personal time maintaining and accounting for these rental properties. n23

n18 *Mowafi, 81 T.C.M. (CCH) at 1605, 2001 T.C.M. (RIA) P2001-111 at 788*.

n19 *Id.*

n20 *Id. at 1605 n.1, 2001 T.C.M. (RIA) P2001-111 at 788 n.1*.

n21 *Id. at 1605, 2001 T.C.M. (RIA) P2001-111 at 788*.

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n22 *Id. at 1605, 2001 T.C.M. (RIA) P2001-111 at 789.*

n23 *Mowafi, 81 T.C.M. (CCH) 1605, 2001 T.C.M. (RIA) P2001-111 at 789.*

On his 1994 and 1995 federal income tax returns, the taxpayer recognized losses attributable to these rental properties of \$ 115,977 and \$ 92,037, respectively. n24 The taxpayer offset his ordinary wage income by these amounts. n25 The Service determined that the taxpayer did not meet the requirements of the real estate professional exception of section 469, characterized them as passive activity losses, and thus denied them as offsets against non-passive ordinary income. n26

n24 *Id.*

n25 *Id.*

n26 *Id. at 1606, 2001 T.C.M. (RIA) P2001-111 at 789.*

II. THE TAX COURT'S DECISION

The taxpayer argued that he met the real estate professional exception; accordingly, he should have been allowed to deduct his real estate losses from his non-passive income. n27 He tried to meet his burden to prove that he met the real estate professional exception with his testimony at trial and logs that he had prepared in response to his audit two to three years after the 1994 and 1995 tax years. n28

n27 *Id.*

n28 *Mowafi, 81 T.C.M. (CCH) at 1606, 2001 T.C.M. (RIA) P2001-111 at 789.*

The court refused to accept the taxpayer's testimony and logs as evidence, because it found the material untrustworthy. n29 The court stated that the logs prepared by the taxpayer were not credible because they were prepared several years after the taxpayer had actually worked on the properties and because by the taxpayer's admission, the logs could have misstated the losses by as much as 20%. n30 The court also stated that the taxpayer prepared the logs post-hoc with an end result in mind--to meet both the 750-hour and the-more-than-half the personal service requirements of section 469. n31

n29 *Id.*

n30 *Id. at 1606, 2001 T.C.M. (RIA) P2001-111 at 790.*

n31 *Id.*

In addition, the court found that some of the hours that the taxpayer reported in his logs as part of his 750-hour requirement were related to personal business activities, instead of rental activities. n32 The court stated that when comparing his logs with his time cards at GTE, the taxpayer claimed to have worked 24 hours in one day, and on one occasion, even more than 24 hours a day. n33 Finally, the court refused to believe the taxpayer had worked only 1,832 hours a year for GTE, spending the remainder of his time on rental activities. n34 It is likely the court refused to believe the taxpayer had worked only 1,832 hours a year because of his title at GTE (director of research and manager of research and development), and because he was promoted to vice president based on his supervisor's appreciation of his long hours. n35

n32 *Id. at 1606-07, 2001 T.C.M. (RIA) P2001-111 at 790.* For example, the taxpayer included in his logs the time he spent preparing his tax return, buying a home in Waltham, and traveling between Virginia and Waltham.

n33 *Mowafi, 81 T.C.M. (CCH) 1607, 2001 T.C.M. (RIA) P2001-111 at 790.*

n34 *Id.*

n35 *See supra* Part I-C.

The Tax Court's holding is consistent with cases that discuss the credibility standards of proof offered by taxpayers to meet the real estate professional exception.

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In *Rapp v. Commissioner*, the taxpayers, a husband and wife, owned and rented a condominium unit managed by a management company. n36 The property was located 225 miles from the taxpayers' principal residence. n37 The taxpayers deducted the condominium's losses against ordinary income. n38 Subsequently, the Service denied the deductions on the grounds that the real estate activity was passive. n39 The taxpayers argued that the rental activity fell within the real estate professional exception because the husband spent a sufficient amount of time repairing the property, participating in the condominium association, and negotiating the management contract with the management company. n40

n36 *Rapp*, 79 T.C.M. (CCH) 175, 1999 T.C.M. (RIA) P99,249 at 1627.

n37 *Id.*

n38 *Id.* at 176, 1999 T.C.M. (RIA) P99,249 at 1628.

n39 *Id.*

n40 *Id.* at 177, 1999 T.C.M. (RIA) P99,249 at 1630.

To carry their burden of proof, the taxpayers offered the testimony of the husband, contemporaneous calendars, and documents prepared after the actual participation in the rental activities. n41 The Tax Court refused to accept the calendars because they contained no information regarding the taxpayers' participation. n42 Also, the court found that the husband's testimony regarding the repairs was unpersuasive as the taxpayers had ordered the management company to make simple repairs such as changing a light bulb. n43 Furthermore, the property manager stated that the wife worked more hours repairing the unit than her husband, while the court found the wife only made decisions on how to decorate the unit and left the actual decorating to the management company. n44 Finally, as in *Mowafi*, the court refused to credit noncontemporaneous documents. Thus, the court held the taxpayer failed to provide sufficient proof to meet the real estate professional exception to section 469. n45

n41 *Rapp*, 79 T.C.M. (CCH) 177, 1999 T.C.M. (RIA) P99,249 at 1630.

n42 *Id.* For example, the calendars did not state exactly which activities the taxpayers conducted for the property.

n43 *Id.* at 178, 1999 T.C.M. (RIA) P99,249 at 1630. A logical inference from the court's analysis is that if the taxpayers ordered the management company to make such simple repairs as changing a light bulb, then they must have also ordered the management company to do the more difficult repairs. Thus, the taxpayers probably spent very little time doing any repairs on the property whatsoever.

n44 *Id.* The court held the husband's testimony was unreliable because at trial he stated he met the requisite hours by making repairs to the property but this was inconsistent with the property manager's testimony that the wife performed more repairs to the property than the husband; the court had already found the wife made very few repairs.

n45 *Id.* at 178, 1999 T.C.M. (RIA) P99,249 at 1630. See also *Goshorn v. Commissioner*, 66 T.C.M. (CCH) 1499, 1993 T.C.M. (RIA) P93,578 [hereinafter *Goshorn*] (holding that taxpayer's testimony alone was insufficient to satisfy his burden of proving the real estate professional exception in a case involving the rental of his yacht).

In *Pohoski v. Commissioner*, n46 the taxpayers owned and rented condominiums in Hawaii. n47 The property was managed by a management company. n48 The taxpayers deducted losses sustained from the property against their ordinary income. n49 The Service disallowed the losses based on the passive activity rules of section 469. n50

n46 *Pohoski*, 75 T.C.M. (CCH) 1574, 1998 T.C.M. (RIA) P98,017 at 91.

n47 *Id.* at 1575, 1998 T.C.M. (RIA) P98,017 at 88.

n48 *Id.*

n49 *Id.* at 1577, 1998 T.C.M. (RIA) P98,017 at 91.

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n50 *Id. at 1577, 1998 T.C.M. (RIA) P98,017 at 92.*

The taxpayers argued that they met the real estate professional exception because they worked a sufficient number of hours on the rental property by answering telephone calls from renters, working with a travel agent to assist in renting the property, setting up a web page, sending e-mails to prospective renters, and making repairs to the condominiums. n51 As proof of these activities, the taxpayers relied on a narrative summary written in a letter that was produced after their actual participation. n52 The taxpayers testified that they maintained contemporaneous records consisting of a calendar stating the names and the arrival and departure dates of tenants and rental rates. n53 The taxpayers also maintained a database containing customer information. n54

n51 *Pohoski, 75 T.C.M. (CCH) 1574, 1577-79, 1998 T.C.M. (RIA) P98,017 at 91-94.*

n52 *Id. at 1578, 1998 T.C.M. (RIA) P98,017 at 92.*

n53 *Id. at 1579, 1998 T.C.M. (RIA) P98,017 at 93.*

n54 *Id. at 1578, 1998 T.C.M. (RIA) P98,017 at 93.*

The Service, citing *Goshorn*, argued that the narrative summary was a "post-event ballpark guesstimate," insufficient to prove participation. n55 The court rejected the Service's argument and held that although the records and the data-base were not introduced as evidence, they provided a sufficient basis for the narrative summary in the letter. n56 The court also noted that the property manager's testimony, combined with the contract between the taxpayers and the property manager, established the participation asserted by the taxpayers. n57 Thus, the court held that the taxpayers fell within the real estate professional exception.

n55 *Pohoski, 75 T.C.M. (CCH) 1574, 1578, 1998 T.C.M. (RIA) P98,017 at 92* (quoting *Goshorn, 66 T.C.M. (CCH) 1501, 1993 T.C.M. (RIA) P93,578 at 3020*). *See also supra* footnote 45.

n56 *Id.*

n57 *Id.*

The Tax Court's decision in *Pohoski* can be reconciled with *Mowafi* based on the different proof offered by the taxpayers. While both taxpayers relied on testimony and on documents prepared after the fact, in *Pohoski* the taxpayers testified that they maintained contemporaneous documents and a customer data-base, whereas the taxpayer in *Mowafi* provided no such proof. Also, in *Pohoski*, the testimony of the property manager and the contract between the taxpayers and the property manager objectively established the taxpayers participation.

The Tax Court has ruled consistently on the sufficiency of evidence required in the passive activity cases. In *Mowafi*, the court refused to rely on the taxpayer's testimony or noncontemporaneous logs because the court found them untrustworthy. n58 In *Pohoski* the court held that the taxpayers met their burden of proof because their testimony was supported by contemporaneous evidence.

n58 *See supra* Part II.

III. THE NEW BURDEN SHIFTING STATUTE

Section 7491, n59 the new burden shifting statute, can have an impact on the outcome of tax disputes with the Service by shifting the burden of proof to the Service once the taxpayer has met certain prerequisites. It is important to apply the new statute to *Mowafi* for two reasons: (1) it provides an example of the type of analysis practitioners must perform when applying section 7491, and (2) it emphasizes the key requirement of section 7491--that the taxpayer must provide credible evidence to shift the burden of proof to the Service. If taxpayers cannot provide such evidence, then the statute will not benefit them.

n59 *See I.R.C. § 7491.*

A. Section 7491

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In 1998, Congress enacted section 7491, requiring the burden of proof in a tax liability proceeding to be shifted to the Service once the taxpayer introduces credible evidence and meets additional requirements. To shift the burden of proof the taxpayer must: (1) introduce credible evidence with respect to the issue; (2) comply with substantiation requirements; (3) maintain all required records; and (4) cooperate with reasonable requests by the Service for witnesses, information, documents, meetings, and interviews. n60

n60 *I.R.C. § 7491.*

The most subjective aspect of this test is the first requirement that the taxpayer provide credible evidence. The legislative history of the statute clarifies this requirement:

Credible evidence is the quality of evidence which, after critical analysis, the court would find sufficient upon which to base a decision on the issue if no contrary evidence were submitted. A taxpayer has not produced credible evidence for these purposes if the taxpayer merely makes implausible factual assertions, frivolous claims, or tax protestor-type arguments. The introduction of evidence will not meet this standard if the court is not convinced that it is worthy of belief. n61

n61 S. REP. NO. 105-174, at 46 (1998).

The taxpayer can satisfy requirements (2) and (3) of section 7491 by offering the methods of proof suggested in Temporary Regulation section 1.469-5T n62 and can satisfy the fourth requirement by cooperating with the Service.

n62 Temp. Reg. § 1.469-5T(f)(4).

If the taxpayer meets these four requirements, then the burden shifts to the Service to bring forth evidence to dispute the factual issue. n63 As a result, if the court believes the evidence from both sides is equally balanced, the Service has not sustained its burden and the court will find in favor of the taxpayer for the disputed fact. n64 Thus, to hold the taxpayer liable, the Service must establish the taxpayer's liability by a preponderance of the evidence. n65

n63 *See I.R.C. § 7491.*

n64 *See S. REP. NO. 105-174, at 46 (1998).*

n65 *Id.*

"The purpose of [section 7491] is to reverse existing law, which is that a taxpayer is guilty until proven innocent." n66 If a taxpayer maintains sufficient records as required by the statute and provides those records to the Service, the burden of proof will shift to the Service in all tax cases. n67

n66 144 CONG. REC. 56,54484 (daily ed. May 7, 1998) (statement of Sen. Gramm). Technically there is no guilt or innocence in civil tax litigation and presumably Senator Gramm was speaking metaphorically.

n67 *See id.*

B. *Application to Mowafi*

If the court in *Mowafi* had applied section 7491, it would have reached the same result. The first requirement of section 7491 is that the taxpayer provide credible evidence n68 and it is up to the court to determine if the evidence is credible. n69 In *Mowafi*, the court found the evidence provided by the taxpayer was untrustworthy mainly because the taxpayer conceded that the logs prepared could have inaccurately cited work hours by a margin of 20%, and because the time logged on the rental property was irreconcilable with the taxpayer's other work commitments. n70 This is exactly the type of "implausible factual assertions" that the legislative history states is not credible. n71 Therefore, under section 7491, the taxpayer would have failed to satisfy the first requirement needed to shift the burden of proof to the Service.

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n68 *I.R.C. § 7491.*

n69 S. REP. NO. 105-174, at 46.

n70 *See supra* Part II.

n71 *See supra* Part III-A.

The taxpayer in *Mowafi* would have failed to meet requirements (2) and (3) of section 7491 as well, as they require the taxpayer to maintain sufficient records. The only records supplied by the taxpayer were logs that he had prepared two to three years after his participation. n72 Further, the court found that these logs were untrustworthy. n73 The taxpayer in *Mowafi* would have failed to meet at least three of the four elements required by section 7491. n74 Thus, this new section would have had no effect on the outcome of the case because the burden of proof would have remained on the taxpayer.

n72 *See supra* Part II.

n73 *See supra* Part II.

n74 There were no facts relating to whether or not the taxpayer cooperated with the Service to meet the fourth requirement.

IV. TAX PLANNING IMPLICATIONS

This Part IV synthesizes the tax planning implications from the case law, section 469, Temporary Regulation section 1.469-5T, and the new burden shifting statute.

The main problem relating to the real estate professional exception faced by practitioners is determining the type of records they should advise clients to keep. These records and related evidence should be sufficiently credible to shift the burden of proof to the Service. n75 Temporary Regulation section 1.469-5T states vaguely that a taxpayer can provide any reasonable means to meet the requirements of the real estate professional exception. n76 Although the regulation is not clear on the definition of reasonable means, at least one court has not accepted after the fact testimony to satisfy the requirement. n77

n75 *I.R.C. § 7491.*

n76 *See supra* Part I-B.

n77 *See Goshorn, 66 T.C.M. (CCH) 1499, 1993 T.C.M. (RIA) P93,578.*

The taxpayer should maintain contemporaneous written documents that contain the number of hours spent working on the rental property, appointments concerning the property, and a description of services performed. The documents may be as simple as a calendar or appointment book, or as detailed as daily time reports. n78 If a taxpayer has not maintained contemporaneous records, he or she should prepare them immediately and in as much detail as possible. Such records will probably be more credible if prepared before the commencement of an audit. Also, the taxpayer should try to establish by objective means the credibility of any after-the-fact documentation by maintaining telephone bills and a computer database of tenants, and by testimony on the taxpayer's behalf by someone other than the taxpayer himself. n79

n78 *See supra* Part I-B.

n79 *See Pohoski, 75 T.C.M. (CCH) 1578, 1998 T.C.M. (RIA) P98,017 at 93* (holding the manager's testimony gave credibility to the taxpayer's after the fact documents).

According to section 7491, once the taxpayer hands over such evidence to the Service, the burden shifts from the taxpayer to the Service. n80 As a result, if the Service does not bring forth its own evidence to dispute the taxpayer's evidence, the taxpayer wins. n81 For the Service to prevail, the evidence brought forth by the Service must be more persuasive than the taxpayer's. Under the new burden shifting statute, if the taxpayer maintains sufficiently detailed records, it will be very difficult for the Service to prevail.

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n80 *Id.*

n81 *Id.*

V. CONCLUSION

The Tax Court correctly held that the taxpayer in *Mowafi* did not provide sufficient proof to meet the real estate professional exception of section 469. The court's decision is consistent with its previous decisions in *Rapp v. Commissioner* and *Pohoski v. Commissioner*. Moreover, the new burden shifting statute of section 7491 would not have changed the outcome of the case. Finally, tax practitioners should advise clients to maintain contemporaneous records to satisfy the requirements of section 469 and to shift the burden of proof to the Service under the new section 7491