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I have a client that owns three rental properties. She has a full-time job as a physician, and she did some side work before her second kid was born. When I did the tax return, she had $45,000 in passive losses from the rentals, and $35,000 in income from her S-Corporation. I called her and found out how many hours she worked in her S-Corporation. She had only worked for three months, which was less than 500/750 hours per year. I changed the nature of the income from the S-Corporation to passive, thereby eating up the passive losses from the rental.

The reality of the situation is that this client doesn't use a property management company on the rentals. I felt it was stretch to say she was a real estate professional, because she is a physician. However, before she got her job with the clinic, she did some side work at a hospital for a few months, but never met the limits of material or active participation.

Let's take another example. I am involved in many businesses, however the job that I spend all my time with is CWSEAPA (my main company). The other businesses are passive income or loss. Why? From experience, the IRS will buy that you have one full time job that you spend all your time working at. The rest would be passive.

Another example is the Uber or Lyft Driver. Most of the drivers have other jobs, and spend less than 15 hours a week on driving. The income is usually passive. As are most of the side jobs that people do to supplement their income.

Explaining to a client that their rental income or loss is passive is no easy feat. For example, most of my clients don't meet the adjusted gross income (AGI) requirements to take the $25,000 deduction allowed for rentals. However, they can take those

through Northwest Plastic Surgery Associates, which is a single member PLLC. Mrs. Hardy is the chief operating officer. Previously, Dr. Hardy performed operations either at his office or at two local hospitals. If the surgery required local anesthesia he performed the operation at his office, but if it required general anesthesia or an overnight stay, he would have to perform the operation at one of the hospitals. The problem with this situation was that the availability of the operating rooms at the hospitals was limited. Hardy struggled to find space at the hospitals to conduct his procedures. Due to this difficulty, Hardy considered opening his own surgery center. He purchased land and developed plans to build this surgery center; however, before construction started, MBJ representatives approached Hardy to ask him about becoming a member. Mr. Hardy concluded that becoming a member/manager of an established surgery center was a better business decision than building his own surgery center due to the cost of construction, staffing, certifying, and operating the center.

MBJ is an LLC formed by a group of practicing physicians in 2004 for the purpose of operating a surgery center. For income tax purposes, it is treated as an LLC, and it hires its own employees. It bills patients directly for facility fees and then distributes each members' share to him or her based on his or her share of the earnings, which is the facility fees less expenses. It uses a third-party accounting firm to prepare the Schedule K-1, Partner's Share of Current Year Income, Deductions, Credits, and Other Items, and all other accounting matters for the members. MBJ does not pay members/managers for the procedures they perform. Doctors receive pay from their own partnership distributions. One advantage of MBJ for the Hardys was that MBJ is equipped for procedures that require general and local anesthesia; but overly complex procedures that require an overnight stay still had to be performed at a hospital.

In 2006 Dr. Hardy purchased a 12.5% interest membership in MBJ for $163,974.

choose the surgery center because it was cheaper.

The Hardys used a partner and tax director at an accounting firm with more than 40 years of experience to prepare and file their tax returns. In 2006 and 2007, the Hardys reported their income from MBJ as nonpassive based on the CPA's professional judgment. They claimed a total disallowed loss. He determined that the income was nonpassive based on MBJ's Schedule K-1 that it distributed to Hardy. The K-1 stated that the income was from a trade or business and included self-employment tax. Dr. Hardy's ownership interest in MBJ was not grouped with his medical practice activity, and the grouping regulations were not considered. In 2008, their CPA determined that the income from MBJ was passive and started to report it accordingly. He determined this because he learned that Dr. Hardy was not involved in any management of MBJ and was not liable for the debts of the company. He did not amend the 2006 and 2007 returns because he believed the difference was immaterial. In 2008 through 2010 the Hardys reported the MBJ income as passive and claimed an allowed loss.

The IRS issued a notice of deficiency for tax years 2008 through 2010. They disallowed the passive activity loss and tacked on a Section 6662(a) accuracy-related penalty. Hardy appealed for redetermination in a timely manner. He challenged the IRS's determination that he could not claim passive activity loss deductions against the income from MBJ and the accuracy-related penalties.

The Tax Court had to decide whether the Hardys properly reported Dr. Hardy's income from MBJ as passive, and if so, whether they could deduct a passive activity loss carryover from previous years. It also had to determine whether the Hardys overpaid their self-employment tax. Finally, it had to decide if they were liable for the accuracy-related penalties.

Typically, in IRC §§ 162[1] 212[2]. The IRS then may determine whether the activity is

"they are involved in the operations of the activity on a regular, continuous, and substantial basis "Dr. Hardy's activity does not meet the material participation test.

In short you have to have documented proof of an activity being active or passive;

[1] (a) In general, There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

[2] In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

[3] a) Disallowance

(2) Persons describedThe following are described in this paragraph:

(A) any individual, estate, or trust,

(B) any closely held C corporation, and

(C) any personal service corporation.

(b) Disallowed loss or credit carried to next year

Except as otherwise provided in this section, any loss or credit from an activity which is disallowed under subsection (a) shall be treated as a deduction or credit allocable to such activity in the next taxable year.