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Craig Smalley • May. 28, 2018



In all of my 24 years in practice, I have never seen what I am about to tell you. I have a gynecologist as a client. He is a partner in a partnership, because the bigger the group of physicians, the larger the insurance payouts. At the end of the year, my client gets a K-1 form from the partnership. The K-1 lists him as a limited partner, meaning the income is passive. However, there is the same amount of income in Box 1 of the K-1 that is in the earnings for self-employment.

As odd as that was, my client received a 1099 to his corporation from the same partnership, and a 1099 to him personally. As you can see this makes absolutely no sense. When I bring it up to the client, he is incredulous, stating the insurance

reimbursements are so good, that he doesn't care. Not to mention, that he had two

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jobs, he had maxed out Social Security. The only issue was the 2.9% of Medicare, which I felt was de minimus.

Rental properties are passive income or loss, with a caveat. If you meet certain adjusted gross income (AGI) limitations, you can deduct up to \$25,000 of your losses. However, if your AGI is too high, the the loss that is incurred from the rentals is passive. Only passive income can be used to against passive losses. However, when the property is sold, the accumulated passive losses go against the gain from the sale of the property. To prove whether an activity is passive or non-passive, the US Tax Court has ruled over and over again that the taxpayer must keep contemporaneous records.

I had a client that I met through tax resolution. I do tax resolution a little differently. My first goal is to find out why my client owes the money in the first place. As it turned out, my client owned several failed partnerships that were pizzerias. Each partnership had losses, and my client was audited. She was represented by a non-licensed preparer, that couldn't appeal the decision. The outcome was that the auditor determined that the losses were passive in nature, causing my client to owe \$175,000 in additional taxes. I requested the auditor's notes through a Freedom of Information Act (FOIA), and received them. The representative made no argument to the reclassification of the losses to passive. I asked for, and received, an audit reconsideration.

As the burden of proof was on me, I had the hard task of trying to prove that my client did, in fact, spend more than 750 hours working in these various pizzerias. I did so by presenting the auditor with all of the purchase orders, and checks that my client signed for. She had to be at the restaurant to perform these tasks. After all, I don't know a business owner that clocks in and clocks out. The auditor accepted my evidence, and reduced the amount that she owed to \$15,000.

Then we have a client's tax return that I recently reviewed. He owns a franchise, and

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involved in other businesses, but the income or loss from those businesses are passive. Why? I work about 100 hours a week in my practice. There is no possible way that I can dedicate 750 hours to all of my other businesses. Not to mention, the IRS will go along with the fact that you spend most of your time in one business, and classify the others as passive.

Passive income can only be reduced by passive losses. However, if you have a carryover of passive losses, they can be taken against any passive income that you may have.

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Craig W. Smalley, MST, EA, is the Founder and CEO of [CWSEAPA, PLLC](#). He has been admitted to practice before the Internal Revenue Service as an Enrolled Agent and has a Master's Certificate in Taxation from UCLA. In practice since 1994, Craig is well-versed in U.S Tax Law and U.S. Tax Court cases, and specializes in individual, partnership, and corporate taxation for high-net-worth clients; entity structuring and restructuring; and representation before the IRS regarding negotiations, audits and appeals. Craig is currently a columnist for CPA Practice Advisor and AccountingWEB and has had 12 books published. His articles have been featured in publications including the Wall Street Journal, The New York Times, and Christian Science Monitor, and he has been interviewed and appeared as a featured guest on numerous radio shows and podcasts. Craig can be reached at [craig@craigwsmalleyea.com](mailto:craig@craigwsmalleyea.com).

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