A Reminder: Records Matter in Tax Cases.

With the deadline for filing personal income tax returns nearly upon us, a recent district court case from California offers a timely reminder that recordkeeping is important in reducing tax liability.

The case, *Gragg v. United States*, 2014 U.S. Dist. LEXIS 44862 (N.D. Cal. Mar. 31, 2014), involved a married couple whose rental real estate activities ran afoul of the passive activity loss limitations in Section 469 of the Code, which bar the use of losses from passive activity to offset other income. The Graggs had two rental properties, which had generated losses; after an audit, the IRS determined that the rental properties were subject to the passive activity rules and assessed the Graggs with two deficiency assessments of $14,874 and $43,499. 2014 U.S. Dist. LEXIS 44862, slip op. at *8. The Graggs paid the assessment and made a refund claim; once the refund was denied, the filed suit.

Section 469(c)(2) of the Code makes rental activity a per se passive activity; the loss limitations apply, even if the taxpayer materially participates. But there is an exception: if a taxpayer is in a real estate business, then Section 469(c)(7)(A) applies, and the rental activity is not considered per se passive. To fall within the scope of this exemption, a taxpayer has to demonstrate

- first, that over one-half of her personal services rendered in a trade or business were in one or more real property trades or businesses in which she materially participates, and
- second, that she performs more than 750 hours of services in the tax year in real property trades or businesses in which she materially participates.

I.R.C. § 469(c)(7)(B). To meet the “material participation” standard, a taxpayer’s involvement with a trade or business must be “regular,” “continuous,” and “substantial.” I.R.C. § 469(h)(1).

Mrs. Gragg was a real estate broker, and the couple sought to recoup the additional taxes paid on this basis. Initially, they argued that because Mrs. Gragg was a real estate agent, the rental activity was automatically treated as a non-passive activity. The Court rejected that position, relying upon a regulation that specifically precluded someone in a real estate trade or business from grouping rental activity with other activities. *See Gragg,* 2014 U.S. Dist. LEXIS 44862, slip op. at *19 (quoting Treas. Reg. § 1.469-9(e)(i)). The court also noted a series of persuasive Tax Court opinions that were on point.

Left to show that Mrs. Gragg materially participated in the rental real estate activity, the Graggs lacked sufficient evidence to do so. The court concluded that the evidence offered to demonstrate material participation were “unreliable post hoc reconstructions of time spent.” *Id.* slip op. at *27. While the relevant regulations provide for proof of material participation to be shown by reasonable means, the district court followed the approach of the Tax Court to reject estimates constructed after the fact as a reasonable means of demonstrating the material participation standard was met.

The broader lesson: if it isn’t documented, it didn’t happen.

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