

**SORRY, YOU CAN'T GET THERE FROM
HERE: THE UNTENABLE GOAL OF USING
SHORT-TERM RENTAL REAL ESTATE TO
ATTAIN REAL ESTATE PROFESSIONAL
STATUS**

*Ausher M. B. Kofsky**

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* Ausher M. B. Kofsky, MBA, CPA, JD, LL.M., Assistant Professor, Western New England University, College of Business. The author wishes to recognize an individual who was originally a co-author on this Article. A sudden government appointment, however, prevented the co-author from continuing and now prevents the Article from listing the co-author's name. The co-author's contributions were, nonetheless, instrumental in the development of the Article, for which the author is highly grateful. The author also wishes to thank the following individuals from Western New England University School of Law for their excellent review and advice regarding the article: William D. Metzger, Professor of Law; Pat Newcombe, Associate Dean for Library & Information Resources; and Sudha N. Setty, Associate Dean for Faculty Development & Intellectual Life and Professor of Law. Additionally, the author is greatly indebted and thankful to his wife and family for their loving support during the creation of the Article.

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I. INTRODUCTION

Is the owner of an inn or a bed and breakfast engaged primarily in the business of managing real property or primarily in the business of providing services to mainly transient customers? What about the owner of a vacation home who rents out the property on a daily or weekly basis during prime tourist season? How would you characterize Conrad Hilton, J. W. Marriott, and Jay Pritzker: as hotel entrepreneurs or as real property moguls? Does it really matter? It does in the complex

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world of passive activity losses.¹

This Article analyzes whether the law allows, and whether public policy should allow, taxpayers to count personal service hours² they provide in connection with short-term rental real estate³ as hours of personal service they provide in association with a real property trade or business. This simple question matters because if a taxpayer has sufficient hours in real property trades or businesses, then subject to other restrictions not at issue here,⁴ the taxpayer may qualify as a real estate professional under I.R.C. § 469(c)(7).⁵ Real estate professional

1. As this Article explains in more detail later, passive activity losses refer generally to losses, as opposed to profits, arising from a trade or business in which the taxpayer does not take an active role. Congress enacted code section, 26 U.S.C. § 469 with the name “Passive activity losses and credits limited” in 1986 to stem taxpayers’ use of tax shelters to lower their tax bill. Profits were not a concern because taxpayers would have to report their share of profits as income. Before the passive activity loss rules, a taxpayer could invest in an activity, often sold by a promoter. Because of accelerated depreciation, credits, and other tax benefits, the activity would generate losses or credits in the early years. Taxpayers could then use their share of the losses or credits to offset other income, such as high salary, commissions, or bonuses. The passive activity loss rules said a taxpayer must play an active role in the venture to be able to deduct the losses. An antonym of active is passive. Thus, the phrase passive activity loss was born. *See infra* Section II(A).

2. By personal service hours, this Article refers to hours of the taxpayer’s own effort, as opposed to hours of hired contractors, employees, or agents. For the reasons stated in the preceding footnote and throughout this Article, the tax code is concerned whether the taxpayer personally served an active participant, as opposed to a passive check writer seeking a deduction.

3. For purposes of this Article, short-term rental real estate means, as Temporary Treasury Regulation § 1.469-1T(e)(3)(ii)(A) defines, a rental property where the guests’ period of use averages seven days or less, such as a bed and breakfast, inn, or hotel. Temporary regulations have a binding effect and receive the same weight as final regulations. *Peterson Marital Trust v. Comm’r*, 102 T.C. 790, 797 (1994), *aff’d*, 78 F.3d 795 (2d Cir. 1996).

4. Section 469(c)(7)(B) contains a two-part test, as follows:

- (i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
- (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

This Article will not discuss: the taxpayer’s other activities for purposes of the one-half of total time under § 469(c)(7)(B)(i) and similarly will not discuss “post-event ballpark guestimates” or other substantiation issues, *see, e.g.*, *Moss v. Comm’r*, 135 T.C. 365, 369 (2010).

5. *See* 26 U.S.C. § 469(c)(7)(B) (2012). Unless otherwise specified, the section refers to the Internal Revenue Code (Title 26 of the United States Code) of 1986, as amended. The title of § 469(c)(7) states “Special rules for taxpayers in real property business,” however, this Article uses the vernacular by referring to those individuals

status is important in turn because professionals usually become eligible to deduct passive activity losses arising from their rental real estate activities. Conversely, taxpayers who are not real estate professionals must usually suspend their losses.⁶

A 2013 case provides an example of the impact of this issue. In *Hoskins v. Commissioner*,⁷ a taxpayer sought to establish real estate professional status to overcome the Commissioner's determination of \$66,110 in deficiencies and penalties over two years.⁸

In *Hoskins*, the taxpayer's extensive real estate activities seemingly fit the profile of a real estate professional.⁹ The taxpayer maintained a Florida real estate sales license; worked "approximately 40 hours per week as an independent contractor assisting other individuals with selling, purchasing, and leasing homes;" "provided maintenance services for bank-owned properties [for] approximately 15 to 20 hours per week;" and owned four properties in Ohio and six properties in Florida.¹⁰ One of the Florida properties in 2006 and two in 2007 were vacation home rentals where the average customer stay was seven days or less.¹¹ The rest of the properties were either not rented or were long-term rentals.¹²

The parties and the court agreed that the short-term rentals "were not rental real estate because the average period of

as real estate professionals.

6. See § 469(c)(7)(A). Section 469(i) provides another exception that is not the focus of this Article. Under § 469(i)(2), a taxpayer may deduct up to \$25,000 of rental real estate losses, but under § 469(i)(3), the loss allowance begins to phase out by fifty-cents on the dollar when a taxpayer's adjusted gross income begins to exceed \$100,000 and therefore, completely phases out for when taxpayer's adjusted gross income hits \$150,000.

7. *Hoskins v. Comm'r*, T.C. Memo. 2013-36, 105 T.C.M. (CCH) 1242 (2013). In an effort to assist the reader, the author cites to both T.C.M. (CCH) and T.C. Memo. when referring to the Tax Court Memorandum decisions for the *Bailey I*, *Mordkin*, *Hoskins*, and *Lapid* decisions throughout this Article. The T.C. Memo. pages cited throughout the Article are reflected in the PDF version of the decisions as found at the U.S. Tax Court website. See *Opinions Search*, U.S. TAX CT., <http://www.ustaxcourt.gov/UstcInOp/asp/HistoricOptions.asp> (last visited Mar. 18, 2014).

8. *Id.* at *2, 105 T.C.M. (CCH) at 1242.

9. *Id.* at *2-6, 105 T.C.M. (CCH) at 1242-43.

10. *Id.* at *3, 105 T.C.M. (CCH) at 1242.

11. *Id.*

12. *Hoskins v. Comm'r*, T.C. Memo. 2013-36, at *3-4, 105 T.C.M. (CCH) 1242, 1242-43 (2013).

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customer use was seven days or less during those periods.”¹³ The court concluded that those short-term rental real estate properties were “a trade or business or an income-producing activity.”¹⁴ Further, the court held that those short-term rental real estate properties were “not rental [real estate] activities for purposes of section 469(c)(2).”¹⁵ Consequently, the court excluded the taxpayer’s hours connected with the short-term rentals when reviewing the taxpayer’s contention that he was a real estate professional.¹⁶ Without those hours, the taxpayer failed to establish real estate professional status and the court sustained the Commissioner’s \$66,110 deficiency determination.¹⁷ This example shows that the characterization of short-term rental real estate can have a significant impact on real estate professional status, which in turn can have a significant financial impact on a taxpayer.¹⁸

Section II of this Article examines scholarly commentary from the tax community on this topic. Next, Section III will review the broader statutory, regulatory, and judicial framework. Section IV analyzes public policy. Finally, Section V concludes that it is clear that taxpayers may not count hours expended in short-term rental real estate as hours expended in a real property trade or business.

To preview an important part of the rationale for the conclusion, taxpayers involved in short-term rental real estate are not involved in a real property trade or business. Instead, according to Congress, they engage in a labor intensive service-oriented business. That is the distinguishing factor.

Consider ownership of a service business such as a

13. *Hoskins v. Comm’r*, T.C. Memo. 2013-36, at *10, 105 T.C.M. (CCH) 1242, 1244 (2013).

14. *Id.* (citing *Bailey v. Comm’r (Bailey I)*, T.C. Memo. 2001-296, 82 T.C.M. (CCH) 868 (2001)).

15. *Id.*

16. *Id.* at *14, 105 T.C.M. (CCH) at 1244-45. Also important for this Article, the court in *Hoskins* went on to analyze whether the taxpayer’s participation in the short-term rental activities was an active or a passive trade or business under the material participation requirements of § 469(c)(1). *Id.* at *11-12, 105 T.C.M. (CCH) at 1244-45. The dichotomy between § 469(c)(1) and § 469(c)(2) is highly significant, which this Article analyzes at length later. *See infra* Section II(A)(2)(a)–(b).

17. *Hoskins v. Comm’r*, T.C. Memo. 2013-36, at *14-17, 105 T.C.M. (CCH) 1242, 1245-46 (2013).

18. *See id.* at *9-18, 105 T.C.M. (CCH) at 1242-46.

barbershop, restaurant, car wash, golf course, or drive-in movie theater. Part of each customer's fee is an offset of the owner's expense of real property taxes and of maintaining the real property. In other words, to a greater or lesser extent, service businesses also manage, operate, or rent real property.

The main difference from rental real estate is the temporal length of the customer's stay. Congress carved out a specific set of rules for hotels and other transient short-term rentals of real estate.¹⁹ In particular, Congress stated that these short-term rentals are service businesses, not rental real estate businesses.²⁰

The United States Department of the Treasury then set the temporal bar at seven days or less for purposes of passive activity losses.²¹ Consequently, for passive activity purposes, owners of short-term rental real estate properties are treated similarly to service business owners. In other words, they are tested on whether they are material participants in the trade or business, not whether they are real estate professionals.²²

In summary, the exception for a real estate professional is simply not available to owners of short-term rental real estate.

19. As noted later in this Article, the 1986 Senate Finance Committee report that explained the then-new passive activity loss rules provided the following clarification: "A passive activity is defined under the bill to include any rental activity, whether or not the taxpayer materially participates. However, operating a hotel or other similar transient lodging, for example, where substantial services are provided, is not a rental activity." S. REP. NO. 99-313, at 720 (1986), *reprinted in* 1986-3 C.B. (Vol. 3) 1, 720.

20. *Id.*

21. Temporary Treasury Regulation § 1.469-1T(e)(3)(ii) provides the seven day rule as follows:

(ii) [A]n activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year —

(A) *The average period of customer use for such property is seven days or less.*

Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(A) (emphasis added). This definition then begs the question, if the activity is not rental real estate, then what is it? For the reasons stated above and discussed throughout this Article, the activity is no longer managing, operating, or renting real estate, but is instead a service-oriented trade or business.

22. Material participant is a term of art. 26 U.S.C. § 469(c)(1) defines a passive activity as "any trade or business . . . in which the taxpayer does not materially participate." Section 469(h)(1) then defines material participation as involvement that is regular, continuous, and substantial in the operations of the activity. In other words, once the taxpayer establishes whether he or she is a material participant in a trade or business, it makes no sense to test whether he or she is a real estate professional.

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Therefore, attempts to use short-term rental real estate as an activity for obtaining real estate professional status are misplaced. The statutory language of § 469 supports this conclusion, as do opinions by the United States Tax Court.²³ Moreover, this conclusion promotes good public policy.

II. BACKGROUND AND SUMMARY OF PRIOR SCHOLARLY COMMENTARY

This Section provides the foundation for the Article. The Section presents a short history of Congress's reasons for restricting passive activity loss deductions, a detailed discussion of the underlying statutory and regulatory framework, and a review of the judicial opinions and subsequent critical commentaries that have brought the issue of the proper classification of short-term rental real estate into the spotlight.

A. HISTORY AND DETAIL OF STATUTORY AND REGULATORY FRAMEWORK FOR PASSIVE ACTIVITY LOSSES

Below is a review of the history of passive activity loss rules and an explanation of the pertinent statutes. Additionally the discussion below reviews the requirements for the real estate professional exception as well as the provisions that govern short-term rentals of real estate.

1. BRIEF HISTORY OF PASSIVE ACTIVITY LOSS RESTRICTIONS

Tax deductions are a “matter of legislative grace.”²⁴ Congress enacted 26 U.S.C. §§ 162 and 212 to serve as two such graces that generally allow taxpayers to deduct trade or business expenses and certain expenses for the production of income, respectively.²⁵

Certain taxpayers abused these graces by investing in businesses that generated deductible losses even where the taxpayer had no active involvement.²⁶ In 1986, however,

23. As of the time of this writing, a search found no pertinent cases for a court other than cases from the United States Tax Court, which are discussed herein.

24. *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

25. For instance, § 162 generally allows a deduction for trade or business expenses that are ordinary, necessary, and reasonable in amount.

26. *See Mordkin v. Comm'r*, T.C. Memo. 1996-187, at *38-39, 71 T.C.M. (CCH) 2796, 2808 (1996).

Congress acted to restrict the deduction of losses related to passive activities, for reasons explained in *Mordkin v. Commissioner*,²⁷ as follows:

Congress added the passive activity loss rules to the Code in 1986 as a response to the prevalent use of tax shelters and as an attempt to foster equity within the tax system. Prior to 1986, taxpayers often reduced their tax liability by investing in business ventures that generated tax losses in excess of economic losses and by using those artificial losses to offset unrelated income (e.g., salary or portfolio income). The passive activity loss rules in section 469 curtail the use of tax shelters by restricting a taxpayer's ability to use the losses sustained in the operation of a trade or business to shelter unrelated income, unless the taxpayer materially participates in the operation of that trade or business.²⁸

This common sense purpose illustrates the need for passive activity loss rules. Trying to stamp out tax shelters, however, is a multifaceted task, which explains in part the complex nature of the passive activity loss rules.

2. MAIN STATUTORY AND REGULATORY PROVISIONS

The material that follows details the main statutory and regulatory structure underpinnings for this Article. Included herein are the Internal Revenue Code and Treasury Regulation requirements and definitions for passive activity losses, the treatment of rentals, the exception for real estate professionals, and the impact of short-tenancy on rentals.

a. General Passive Activity Loss Rules

The pertinent Code sections for the current analysis begin with § 469(a),²⁹ which disallows (suspends) passive activity losses.³⁰ Section 469(d)(1)³¹ goes on to explain that a passive

27. *Mordkin v. Comm'r*, T.C. Memo. 1996-187, at *38-39, 71 T.C.M. (CCH) 2796, 2808 (1996).

28. *Id.* (citations omitted).

29. Disallowance, in general. 26 U.S.C. § 469(a)(1) (2012).

30. *Id.* § 469(a)(1)(A). This disallowance or suspension of passive activity losses is how Congress implemented its goal described above of curbing the use of losses from tax shelters in which taxpayers did not materially participate. *See supra* text accompanying note 28.

31. Passive activity loss and credit defined. § 469(d).

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activity loss is the excess of the aggregate losses from passive activities for the year over the aggregate income from passive activities for the year.³² Section 469(c)(1) defines a passive activity as “any trade or business . . . in which the taxpayer does not materially participate.”³³ Section 469(h)(1) defines material participation as involvement that is regular, continuous, and substantial in the operations of the activity.³⁴

b. Treatment of Rentals

Section 469(c)(2) provides special treatment with respect to rentals.³⁵ That section deems rental activities as per se passive regardless of whether the taxpayer materially participates in the rental activity.³⁶ Temporary Treasury Regulation § 1.469-1T(e)(3) explains that, “except as otherwise provided . . . , an activity is a rental activity . . . if [d]uring such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers.”³⁷ Treasury Regulation § 1.469-9(b)(3) defines rental real estate as “*any* real property used by customers or held for use by customers in a rental activity within the meaning of § 1.469-1T(e)(3).”³⁸

c. Exception for Real Estate Professionals

Effective January 1, 1994, Congress added § 469(c)(7) to serve as an exception to the per se suspension of passive activity losses related to rental activities.³⁹ Section 469(c)(7)(A) provides that rental real estate activities for a taxpayer are no longer per se passive under § 469(c)(2) if the taxpayer is engaged in real

32. 26 U.S.C. § 469(d)(1) (2012).

33. *Id.* § 469(c)(1).

34. *Id.* § 469(h)(1).

35. Section 469(c)(2) provides that “the term ‘passive activity’ includes any rental activity.”

36. *Id.* § 469(c)(2), (4).

37. Temp. Treas. Reg. § 1.469-1T(e)(3)(1)(A) (1988) (as amended by T.D. 8175, 1988-1 C.B. 191, 209); *see also* 26 U.S.C. § 469(j)(8) (2012).

38. Treas. Reg. § 1.469-9(b)(3) (emphasis added).

39. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103–66, § 13143, 107 Stat 312 (codified as amended at 26 U.S.C. § 469). As mentioned earlier, a second exception already existed and remained in force but is not the focus of this Article. Briefly, § 469(i)(1) and (2) allow a deductible loss of up to \$25,000 for rental real estate activities where the individual actively participates in the activity during the year. Section 469(i)(3)(A) begins to phase out the \$25,000 loss allowance when AGI exceeds \$100,000 and completely phases out the loss allowance when AGI is \$150,000 or more.

property trades or businesses under the two-part test of § 469(c)(7)(B) discussed below.⁴⁰ As noted above, a taxpayer who passes the two-part test is called a real estate professional.⁴¹ The purpose of this exception is to allow a taxpayer who is active with real property to deduct his or her losses as being from a trade or business of real estate, despite the activity being involved in rental real estate.⁴²

The two-part test of § 469(c)(7)(B)(i) and (ii) restricts real estate professional status to taxpayers who provide personal services during the year. The taxpayer must materially participate in the activity and the taxpayer must provide: (1) more than one-half of the taxpayer's personal service hours in real property trades or businesses and (2) more than 750 hours in total in real property trades or businesses.⁴³

A central part of the current controversy is that § 469(c)(7)(C) provides such a broad definition of a real property trade or business that the statute's sweep would seemingly incorporate short-term rental real estate. Section 469(c)(7)(C) states: "For purposes of this paragraph, the term 'real property trade or business' means *any* real property development, redevelopment, construction, reconstruction, acquisition, conversion, *rental, operation, management*, leasing, or brokerage trade or business."

d. Impact of Short-Tenancy on Rentals

The countervailing keystone for the current dispute stems from Temporary Treasury Regulation § 1.469-1T(e)(3)(ii)(A), excerpted below. This Regulation entirely removes short-term rental real estate from being a rental activity, as follows:

(3) Rental activity—(i) In general. Except as otherwise provided in this paragraph (e)(3), an activity is a rental

40. See Treas. Reg. § 1.469-9(e)(1).

41. See *supra* note 5.

42. See excerpt from 1993 House Budget Committee Report, H.R. REP. NO. 103-111, at 613-14 (1993), *reprinted in* 1993 U.S.C.C.A.N. 378, 844-45, discussed later in this Article. See *infra* note 124-25 and accompanying text.

43. Not at issue here, but for completeness, 26 U.S.C. § 469(c)(7)(B) provides that for taxpayers filing a joint return, only one spouse needs to satisfy the two requirements. Also not at issue here, § 469(c)(7)(A) provides that the taxpayer must separately determine material participation with respect to each rental property unless the taxpayer makes an election to treat all of his or her interests in rental real estate as a single rental real estate activity. See Treas. Reg. § 1.469-9(e)(1).

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activity for a taxable year if—

....

(ii) Exceptions. For the purposes of this paragraph (e)(3), an activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year—

(A) *The average period of customer use for such property is seven days or less.*⁴⁴

B. THE *BAILEY* OPINION AND THE SUBSEQUENT BLISTERING COMMENTARIES FROM THE TAX COMMUNITY THAT PROMPTED THIS ARTICLE

This Article's particular topic was apparently undiscussed until the United States Tax Court issued an opinion titled *Bailey v. Commissioner* ("*Bailey II*").⁴⁵ In fact, the taxpayer's attorney in *Bailey II* wrote that the matter appeared to be an issue of first impression.⁴⁶

The taxpayer in *Bailey II* owned and operated a short-term rental, a bed and breakfast, as well as four long-term rental properties.⁴⁷ The court in *Bailey II* relied in part on *Bailey v. Commissioner*, T.C. Memo. 2001-296 (*Bailey I*)⁴⁸ for the conclusion that hours expended in short-term rental real estate must be excluded from determining whether a taxpayer is a real

44. Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(A) (emphasis added).

45. *Bailey v. Comm'r (Bailey II)*, No. 28706-09S, 2011 WL 815363 (T.C. Mar. 2, 2011). Under § 7463, currently for disputes involving \$50,000 or less, Congress allows taxpayers to petition the Tax Court to challenge the Commissioner's determinations in a less formal hearing. 26 U.S.C. § 7463(a). In exchange for this convenience, the court's summary opinions are not reviewable by any other court, and the opinions may not be treated as precedent for any other case. *Id.* § 7463(b). This Article includes the summary opinion not for its precedential value, but as context for understanding the commentators' remarks.

46. "Petitioners are unaware of any published case where activities and hours associated with material participation in the operation or management of non-rental real property trades or businesses were counted toward satisfying the 2-prong test of Section 469(c)(7)(B)." Petitioners' Reply to Respondent's Memorandum of Law at 13, *Bailey II*, No. 28706-09S (T.C. Mar. 2, 2011).

47. The four properties were the separate front and back rental real estate properties at Second Street, the existing Boise property, and the new acquisition in Boise. *Bailey II*, 2011 WL 815363, at *1-6.

48. That case had a similar fact pattern and taxpayer surname, see *Bailey v. Commissioner (Bailey I)*, T.C. Memo. 2001-296, 82 T.C.M. (CCH) 868 (2001). However, the *Bailey I* and *II* petitioners were apparently unrelated. See *Bailey II*, 2011 WL 815363, at *10.

estate professional.⁴⁹ Although the court was emphatic in this conclusion, the court did not explain why the taxpayer could not count her hours at the bed and breakfast as hours of operating or renting or managing a real property trade or business to qualify as a real estate professional under § 469(c)(7).⁵⁰

The court in *Bailey II* offered merely a summary opinion.⁵¹ Although *Bailey II* was one in a series of similar decisions from the court,⁵² this particular opinion sparked a sharp negative reaction in the tax community. For instance, three representative scholarly articles contended that the court did not squarely address the issue, its analysis was flawed, or the court outright erred.⁵³

Instead of focusing on any one particular case, however, this Article will review the issue in a broader context. The following Subsection reviews three commentaries that illuminate the underlying issues.

49. *Bailey v. Comm'r (Bailey II)*, No. 28706-09S, 2011 WL 815363, at *10-12 (T.C. Mar. 2, 2011).

50. *See Bailey II*, 2011 WL 815363, at *11-13.

51. *See supra* note 45 for a definition of the precedential value of a summary opinion.

52. *See, e.g.*, *Lapid v. Comm'r*, T.C. Memo. 2004-222, 88 T.C.M. (CCH) 313 (2004); *Bailey v. Comm'r (Bailey I)*, T.C. Memo. 2001-296, 82 T.C.M. (CCH) 868 (2001). For pre-1993 year at issue opinions see *Rapp v. Comm'r*, 78 T.C.M. (CCH) 175 (1999) (involving 1991-1993 tax years); *Madler v. Comm'r*, 75 T.C.M. (CCH) 2025 (1998) (same); *Pohoski v. Comm'r*, 75 T.C.M. (CCH) 1574 (1998) (1993 tax year); *Scheiner v. Comm'r*, 72 T.C.M. (CCH) 1532 (1996) (1991-1992 tax years); *Serenbetz v. Comm'r*, 72 T.C.M. (CCH) 1264 (1996) (same); *Mordkin v. Comm'r*, T.C. Memo. 1996-187, 71 T.C.M. (CCH) 2796 (1996) (1989-1990 tax years); *Chapin v. Comm'r*, 71 T.C.M. (CCH) 2027 (1996) (1987-1991 tax years); *Toups v. Comm'r*, 66 T.C.M. (CCH) 370 (1993) (1989-1990 tax years).

53. *See Tom Daley, Bailey v. Commissioner: Was It 'Real Property Trade or Business'?*, 66 TAX NOTES INT'L 655 (2012); Michael J. Grace, "Bailey v. Commissioner Twice Flawed, but for Other Reasons," 135 TAX NOTES 1528 (2012); Kenneth N. Orbach, *Response to Daley on Bailey*, 136 TAX NOTES 196 (2012).

1. SARDONIC YET INSIGHTFUL ANALYSIS BY MR. DALEY⁵⁴

The first significant commentary was from Tom Daley.⁵⁵ Mr. Daley wrote in response to learning that at a recent meeting of the Passthroughs and Real Estate Committee of the District of Columbia Bar Taxation Section, an IRS Chief Counsel attorney had apparently supported the result in *Bailey II*.⁵⁶ Mr. Daley stated: “One can make an argument that Bailey [II] reached the right result. However, there can be no argument that the court’s reasoning in arriving at that result was incorrect.”⁵⁷

Mr. Daley’s main conclusion was that the court in *Bailey II* “failed to address the real issue in the case: Can the management and operation of real property rented on a short-term basis be a real property trade or business under section 469(c)(7)?”⁵⁸ Specifically, Mr. Daley contended that the court in *Bailey II* “made an unexplained leap from the proposition that a short-term rental is not treated as a rental activity under section 469(c)(2), to the unsupported conclusion that the short-term rental is therefore not a real property trade or business under section 469(c)(7).”⁵⁹

Mr. Daley’s primary contention was that even if § 1.469-1T(e)(3)(ii)(A), Temporary Income Tax Regs., *supra*, excludes short-term rental property from being treated as rental real estate, the activity could still qualify as a real property trade or business under § 469(c)(7)(C). Mr. Daley reasoned that the code section provides a broad definition of the activities that could have easily qualified the taxpayer as a real estate professional, such as operating or managing real property.⁶⁰ Nevertheless, Mr.

54. See Daley, *supra* note 53, at 655-61. A website states the following:

Thomas C. Daley, CPA, JD, a partner in Bowers, Narasky & Daley, LLP, has worked in public accounting for over 25 years. He has taught income taxation at California State University, Hayward and in the graduate tax program at Golden Gate University in San Francisco; and has been a frequent speaker at tax conferences and seminars.

Federal and California Tax Update for Individuals, CALCPA EDUC. FOUND., <http://www.calcpa.org/public/products/ProductDetails.aspx?ProductID=TAXABK11> (last visited Apr. 2, 2014).

55. Daley, *supra* note 53, at 655.

56. *Id.*

57. *Id.*

58. *Id.* at 661.

59. *Id.*

60. Daley, *supra* note 53, at 659; *see also* Motion for Reconsideration of Opinion at 2, *Bailey v. Comm’r*, No. 28706-09S (T.C. Mar. 2, 2011).

Daley concluded by acknowledging that the court may have been correct in its result.⁶¹

As discussed later, in the view of this Article, Mr. Daley, despite the acerbic tone of his piece, was correct in his conclusion. The court could have done a better job explaining its rationale. Notwithstanding the omission, the court was correct to hold that taxpayers are not entitled to count hours spent with the short-term rental real estate, in that case a bed and breakfast, as hours managing, renting, or operating real property.

2. THE INCOMPLETE ANALYSIS OF MR. GRACE⁶²

A second notable article on the issue was from Michael J. Grace.⁶³ Mr. Grace contended that the court outright erred in *Bailey II* because the court “erroneously concluded that the Baileys failed to qualify for relief under section 469(c)(7) [the exception for real estate professionals].”⁶⁴

Mr. Grace reasoned that “if the Baileys’ short-term rentals constituted trades or businesses for federal tax purposes, then time the taxpayers spent renting out the properties should have counted in determining whether the taxpayers met the threshold qualification tests of section 469(c)(7).”⁶⁵ Mr. Grace emphasized that the definition for a real estate trade or business explicitly included the words any real property rental trade or business.⁶⁶ Mr. Grace stated that the court mistakenly confused the narrower concept of rental activity with the broader concept of rental trade or business.⁶⁷

To support his conclusion, Mr. Grace cited the legislative history of § 469(c)(7), as follows:

The provision treats a taxpayer’s rental real estate activities

61. See Daley, *supra* note 53, at 661.

62. See Grace, *supra* note 53, at 1528-31. A biographical note at the beginning of the article stated that “[d]uring the 1980s [Mr. Grace] worked in the IRS Office of Chief Counsel as the principal author of regulations, rulings, notices, and other administrative pronouncements implementing section 469, which was enacted under the Tax Reform Act of 1986” and that he is currently practicing tax law with Milbank, Tweed, Hadley & McCloy LLP in Washington, D.C. *Id.* at 1528.

63. See *id.* at 1528-31.

64. *Id.* at 1528.

65. *Id.*

66. Grace, *supra* note 53, at 1530.

67. *Id.* at 1529-31.

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in which he materially participates as not subject to limitation under the passive loss rule if the taxpayer meets eligibility requirements relating to real property trades or businesses in which the taxpayer performs services.⁶⁸

Mr. Grace further contended that “[b]oth case law predating the passive activity limitations and regulations interpreting section 469(c)(7) instruct that real property trades or businesses include short-term rentals.”⁶⁹ For case law support, Mr. Grace cited a number of cases⁷⁰ for the following proposition:

Case law predating section 469 concludes that renting out even a single property may qualify as a trade or business for federal tax purposes. If the renting of property constitutes a trade or business, it also should qualify as a real property trade or business under section 469(c)(7)(C). Services a taxpayer renders in renting property should count in the qualifying taxpayer test under section 469(c)(7)(B) whether or not the rental qualifies as a rental activity under section 469. By failing to distinguish trade or business from activity, the court incorrectly concluded that the Baileys could not qualify for the special relief that section 469(c)(7) provides.⁷¹

With respect to supporting regulations, Mr. Grace contended that even if rentals are not a rental activity, the regulations under § 469(c)(7), specifically Treasury Regulation § 1.469-9(b)(1) and (b)(3) still allow the rentals to be treated as a trade or

68. See Grace, *supra* note 53, at 1529 (quoting H.R. REP. NO. 103-111, at 614 (1993)).

69. *Id.* at 1530.

70. *Id.* at 1530 n.17 (citing Fackler v. Comm’r, 45 B.T.A. 708 (1941), *aff’d*, 133 F.2d 509 (6th Cir. 1943); Hazard v. Comm’r, 7 T.C. 372 (1946); Lagreide v. Comm’r, 23 T.C. 508 (1954); Roberts v. Comm’r, 16 T.C.M. (CCH) 625 (1957), *aff’d on other grounds*, 258 F.2d 634 (5th Cir. 1958); Estate of Gibney, 4 T.C.M. (CCH) 878 (1945); Gilford v. Comm’r, 201 F.2d 735 (2d Cir. 1953); Jamison v. Comm’r, 8 T.C. 173 (1947); Bauer v. United States, 168 F. Supp. 539 (Ct. Cl. 1958); Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954), *aff’d per curiam*, 218 F.2d 603 (2d Cir. 1955); Union Nat’l Bank of Troy v. United States, 195 F. Supp. 382 (N.D.N.Y. 1961)) (“The Tax Court in the *Bailey* decisions did not discuss this case law.”).

71. *Id.* at 1530 (footnote omitted). To further emphasize his point, Mr. Grace footnoted to a famous United States Supreme Court tax decision for a plain language definition of a trade or business, as follows: “See *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), in which the Supreme Court concluded that it should defer to the code’s ‘normal focus’ on what it regards ‘as a common-sense concept of what is a trade or business’ for federal tax purposes.” *Id.* at 1530 n.18.

business.⁷² Citing Treasury Regulation § 1.469-9(b)(1), Mr. Grace quoted the following definition:

(1) *Trade or business.*— A trade or business is any trade or business determined by treating the types of activities in section 1.469-4(b)(1) as if they involved the conduct of a trade or business, and *any interest in rental real estate*, including any interest in rental real estate that gives rise to deductions under section 212.⁷³

Additionally, Mr. Grace noted that Treasury Regulation § 1.469-9(b)(3) “confines rental real estate to real property ‘in a rental activity within the meaning of section 1.469-1T(e)(3).’”⁷⁴ Consequently, according to Mr. Grace, “[t]he regulation thus includes within trade or business rentals that are not rental activities.”⁷⁵

Similarly, with respect to short-term rental real estate, Mr. Grace concluded that short-term “rentals should be excluded from rental real estate activities tested for material participation under section 469(c)(7) (step two) because they are not rental activities.”⁷⁶ However, Mr. Grace acknowledged that a short-term rental may qualify as a trade or business activity.⁷⁷

Although it is difficult to conclude against the lead author of the relevant regulations, this Article does in fact reach the opposite conclusion. Yes, short-term rentals do qualify as a trade or business. Yet, similar to a barbershop, grocery store, or movie theater, their short-term tenancy removes them from the realm of being a real property trade or business. Consequently, regardless of the number of hours of personal service, the owners of short-term rental real estate cannot use those hours to qualify as real estate professionals. Instead, as this Article mentioned earlier, owners of short-term rentals may nonetheless qualify as active, non-passive participants in their service businesses if they pass the material participation requirements of § 469(c)(1), as opposed to the real estate professional exception to § 469(c)(2).⁷⁸

72. Grace, *supra* note 53, at 1530.

73. *See id.* (emphasis added).

74. *Id.*

75. *Id.*

76. *Id.* at 1531.

77. Grace, *supra* note 53, at 1531. (“A short-term rental, however, may [nonetheless] qualify as a trade or business activity under section 469.”).

78. *See supra* note 22.

3. PROFESSOR ORBACH PROVIDES A LOGICAL FRAMEWORK BUT ENCOURAGES FURTHER ANALYSIS⁷⁹

A third prominent commentary on the issue was from Professor Kenneth Orbach, who concluded that the court in *Bailey II* had gone astray with its interpretation of the impact of short-term rental real estate.⁸⁰ Professor Orbach contended that proper statutory construction requires first applying the two-prong test of § 469(c)(7)(B), which applies the § 469(c)(7)(C) definition of real property trades or businesses *before* applying § 469(c)(7)(A), which excludes rental real estate activity.⁸¹ Consequently, similar to Mr. Grace, Professor Orbach contended that the court continued to confuse “‘activities’ (section 469(c)(7)(A)) with ‘real property trades or businesses’ (section 469(c)(7)(B)).”⁸²

Although concerned that Treasury Regulation § 1.469-9(b)(3) includes the term activity, Professor Orbach pointed to, as did Mr. Grace, Treasury Regulation § 1.469-9(b)(1) and (b)(3) for support.⁸³ Professor Orbach emphasized that Treasury Regulation § 1.469-9(b)(1) “defines a trade or business . . . to include interests in rental real estate.”⁸⁴ Professor Orbach added that Treasury Regulation § 1.469-9(d)(1) provides “[t]he determination of a taxpayer’s real property trades or businesses” for purposes of paragraph (c), which requires material participation for § 469(c)(7)(B) to apply, of this section is based on “*all of the relevant facts and circumstances.*”⁸⁵

In conclusion, Professor Orbach stated that although a short term rental bed and breakfast was “not a real property rental endeavor, it still may be, say, a real property management or operation endeavor.”⁸⁶

This Article concludes that Professor Orbach was correct to hedge his conclusion. Operating, renting, or managing short-

79. See Orbach, *supra* note 53, at 196-98. A biographical note at the beginning of the article stated that Professor Orbach is a professor at Florida Atlantic University (FAU) in Boca Raton. *Id.* at 196.

80. See *id.* at 197-98.

81. *Id.* at 197.

82. *Id.*

83. Orbach, *supra* note 53, at 198 & n.18.

84. *Id.* at 198.

85. *Id.* at 196 n.3 (emphasis added).

86. *Id.* at 198.

term rental real estate does not create a facts and circumstances test. Instead, the law set a temporal wall that prophylactically excludes short-term rental real estate from being a real property endeavor.

III. ANALYSIS

This Section provides the heart of this Article. The analysis reviews the pertinent case law, revisits the prior commentators' remarks, examines the intent behind the administrative and legislative enactments, applies regulatory and statutory construction, and provides this current author's explanation of the matter. The Section ends by noting that other sections of the Code make a similar distinction for short-term rental properties in contrast to longer term rental units.

A. CASE LAW IS UNWAVERING IN ITS TREATMENT OF SHORT-TERM RENTALS

This Subsection examines the case law history on this topic. The history spans thirty years since the enactment of the passive activity loss rules, or twenty years since the enactment of the real estate professional exception. In that time, the court has, without exception, ruled that the business of managing or operating short-term rentals is an active trade or business under § 162 or § 212. Therefore, the business is subject to the passive activity loss rules of § 469(c)(1) and is not a business of managing real property.

1. CASES IDENTIFIED BY MR. GRACE

As noted above, in contending that the *Bailey* cases erred, Mr. Grace cited a number of cases to illustrate his point that “[c]ase law predating section 469 concludes that renting out even a single property may qualify as a trade or business for federal tax purposes.”⁸⁷ Mr. Grace is correct on that point. The difficulty with those cases, however, is that the trade or business aspect of short-term rentals is not in dispute here. The real issue is the consequences of the short-term aspect of the rental property. Accordingly, the cases that Mr. Grace cited are not helpful in the sense that they do not explain the impact of a short-term rental period.

87. *See supra* notes 69–70 and accompanying text.

2. CASE LAW INVOLVING SHORT-TERM RENTAL REAL ESTATE

Likewise, the three commentators did not address any of the longstanding string of cases where the United States Tax Court focused on the short-term rental of real estate. These cases show that far from being unusual, errant, or rulings of first impression, the two *Bailey* cases were simply two in a long series of unwavering opinions.

Specifically, the judicial history shows that the court has consistently held that efforts associated with short-term rental property are not a rental activity under § 469(j)(8), subject to the passive activity loss rules for rental real estate in § 469(c)(2). As explained below, the court has ruled, without exception, that such ventures are an active trade or business under § 162 or § 212, subject to the passive activity loss rules of § 469(c)(1). The implication is that in the court's view, the characterization prevents taxpayers from using short-term rental real estate to qualify for the real estate professional exception of § 469(c)(7)(B) because the taxpayers are not involved in a real property trade or business.

Below is a summary of those cases, separated into two subcategories: before and after application of the real estate professional exception.

a. Cases Involving Short-Term Rentals *Before* Application of the Real Estate Professional Exception

The first set of cases is interrelated as follows. They represent all the cases that the author could find on the issue of passive activity losses as applied to short-term rental properties for tax years 1986 through 1993.⁸⁸ Those were the years from the

88. Because the tax years involved did not yet have available the exception for real estate professionals, this Article provides only a limited synopsis of each case. *Patterson v. Comm'r*, No. 9268-00S, 2002 WL 1825331 (T.C. May 23, 2002) (involving a North Carolina condominium unit rented out for periods averaging less than seven days in 1994 and specifically averaging 5.6 days in 1996, and although taking place during post-enactment years, neglecting to address the real estate professional exception of § 467(c)(7)); *Barniskis v. Comm'r*, 78 T.C.M. (CCH) 226 (1999) (involving a condominium unit in Minnesota in which the average customer stay at the taxpayers' unit was less than seven days); *Rapp v. Comm'r*, 78 T.C.M. (CCH) 175 (1999) (same); *Madler v. Comm'r*, 75 T.C.M. (CCH) 2025 (1998) (involving a condominium unit in Texas with an unspecified customer rental duration but analyzing the losses under scenarios of more and less than seven days); *Pohoski v. Comm'r*, 75 T.C.M. (CCH) 1574 (1998) (involving two long-term condominium rentals

enactment of the original passive activity loss rules until the effective date of the real estate professional exception.

Notwithstanding the dates, the importance of these cases is their illustration that since the inception of the passive activity loss rules in 1986, the court has consistently applied the seven-day rule of § 1.469-1T(e)(3)(ii)(A), Temporary Income Tax Regs., 53 Fed. Reg. 5702 (Feb. 25, 1988). Under this application, the court has ruled without exception that short-term rentals are not subject to the rental real estate provisions of § 469(c)(2). Instead the court has held that short-term rentals are subject to the passive activity loss restrictions of § 469(c)(1). Below is language from the most recent of the cases, which is similar to language across all the opinions:

A passive activity is any activity involving the conduct of a trade or business in which the taxpayer does not materially participate. As a general rule, any “rental activity” is passive whether or not the taxpayer materially participates in the activity. Under the regulations, the definition of rental activity does not include an activity with respect to which the average period of customer use of the property is 7 days or less.⁸⁹

Consequently, the significance of this first set of cases is that since 1986, the court has consistently separated the treatment of short-term rental real estate from the treatment of long-term rental real estate. Short-term rental properties fall under the

in Camarillo, California, and two short-term rental condominium units in Hawaii, both of which units customers rented for average stays of 6.5 days); *Scheiner v. Comm’r*, 72 T.C.M. (CCH) 1532 (1996) (involving a condominium unit in Maryland, where the customers’ average rental period of the taxpayer’s unit was three to four days); *Serenbetz v. Comm’r*, 72 T.C.M. (CCH) 1264 (1996) (involving a fifty-unit development located in Vermont rented out for periods averaging less than seven days); *Mordkin v. Comm’r*, T.C. Memo. 1996-187, 71 T.C.M. (CCH) 2796 (1996) (involving two Colorado condominium units, which customers rented for periods averaging less than seven days); *Chapin v. Comm’r*, 71 T.C.M. (CCH) 2027 (1996) (involving a Maryland condominium that the taxpayers rented to customers for an average period of seven days or less; the taxpayers also owned five other rental properties that they generally leased for one year terms); *Toups v. Comm’r*, 66 T.C.M. (CCH) 370 (1993) (involving facts where the guests rented the taxpayers’ Georgia cottage for rental periods averaging less than seven days during each year 1988-1990; the taxpayers also owned a 50-100% interest in a commercial office building in their hometown, Baton Rouge, Louisiana).

89. See *Patterson v. Comm’r*, No. 9268-00S, 2002 WL 1825331, at *2 (T.C. May 23, 2002) (citing 26 U.S.C. § 469(c)(1)-(2), (4); Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(A)).

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jurisdiction of § 469(c)(1), which as the court noted above makes them a trade or business under § 162 or § 212. In contrast, rentals of long-term properties fall under the jurisdiction of § 469(c)(2).

As stated repeatedly in this Article, the significance of the disparate treatment is that under § 469(c)(1), taxpayers could deduct their passive losses if they established that they were material participants. Section 469(c)(2), on the other hand, provided no such outlet. Accordingly, that is why Congress later discovered that the law needed a separate exception for real estate professionals under § 469(c)(7).

b. Cases Involving Short-term Rentals *After* Enactment of the Real Estate Professional Exception

One could theorize that the enactment of the real estate professional exception, effective beginning in 1994, changed the rules of the game. This second set of cases, however, shows that post-enactment, the court has remained just as emphatic on the implication of short-term rentals.

These cases all involved situations where the taxpayers concurrently operated a mix of short-term and long-term rental properties and petitioned the court for relief as a real estate professional, which the Commissioner had disallowed.⁹⁰ Below is a summary of each case, again listed by most recent publication date first.

i. *Hoskins v. Commissioner*⁹¹

The taxpayers in *Hoskins* owned four properties in Ohio and six properties in Florida.⁹² In 2006, one of the Florida properties was short-term rental property, rented to customers for average periods that did not exceed seven days; in 2007, two of the Florida properties were short-term.⁹³

In deciding whether to include hours expended on the short-

90. *Hoskins v. Comm'r*, T.C. Memo. 2013-36, 105 T.C.M. (CCH) 1242 (2013); *Bailey v. Comm'r (Bailey II)*, No. 28706-09S, 2011 WL 815363 (T.C. Mar. 2, 2011); *Lapid v. Comm'r*, T.C. Memo. 2004-222, 88 T.C.M. (CCH) 313 (2004); *Bailey v. Comm'r (Bailey I)*, T.C. Memo. 2001-296, 82 T.C.M. (CCH) 868 (2001).

91. *Hoskins*, T.C. Memo. 2013-36, 105 T.C.M. (CCH) 1242.

92. *Id.* at *3, 105 T.C.M. (CCH) at 1242.

93. *Id.* at *3-4, 105 T.C.M. (CCH) at 1242-43.

term rentals in computing the real estate professional exception, the court cited § 1.469-1T(e)(3)(ii)(A), Temporary Income Regulation, 53 Fed.Reg. 5702 (Feb. 25, 1988), for the principle that an “activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year * * * [t]he average period of customer use for such property is seven days or less.”⁹⁴ As a consequence, the court noted that the parties agreed that the short-term properties “were not rental real estate because the average period of customer use was seven days or less during those periods.”⁹⁵ In conclusion, the court concluded: “Thus, these properties are not rental activities for purposes of section 469(c)(2) and are considered a trade or business or an income-producing activity.”⁹⁶ The court reiterated that short-term rental properties were simply “not rental real estate.”⁹⁷

ii. *Bailey v. Commissioner (Bailey II)*⁹⁸

In *Bailey II*, the taxpayer owned five rental properties that were situated at four locations.⁹⁹ Four of the properties were long-term rentals and one was a 1200 square-foot garage that the taxpayer had converted into a bed and breakfast.¹⁰⁰ Guests, on average, rented rooms in the bed and breakfast for three days at a time.¹⁰¹

The taxpayer spent 1003 hours in total on all of the rental real estate activities, of which 324 hours the taxpayer devoted to the bed and breakfast.¹⁰² In other words, without the bed and breakfast, the taxpayer expended only 679 hours on the other rental real estate activities, which is below the 750-hour requirement of § 469(c)(7)(B)(ii) to qualify as a real estate

94. *Hoskins v. Comm’r*, T.C. Memo. 2013-36, at *10, 105 T.C.M. (CCH) 1242, 1244 (2013) (alteration in original).

95. *Id.* at *10, 105 T.C.M. (CCH) at 1244.

96. *Id.* (citing *Bailey v. Comm’r (Bailey I)*, T.C. Memo. 2001-296, 82 T.C.M. (CCH) 868 (2001)).

97. *Id.*

98. *Bailey v. Comm’r (Bailey II)*, No. 28706-09S, 2011 WL 815363 (T.C. Mar. 2, 2011).

99. *Id.* at *1-6.

100. *Id.* Actually, the bed and breakfast included just coffeemakers for guests, no breakfast. *Id.* at *1.

101. *Id.* at *1.

102. *Bailey v. Comm’r (Bailey II)*, No. 28706-09S, 2011 WL 815363, at *6 (T.C. Mar. 2, 2011).

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professional.¹⁰³

The court explained its ultimate holding as follows:

We reiterate the holding in [Bailey I] that a rental property with average use of less than 7 days is not an activity that a taxpayer can include in computing the more than 750 hours of services that a taxpayer needs to qualify as a real estate professional under section 469(c)(7)(B)(ii).

The rationale for segregating petitioner's hours is consistent with the disparate reporting of the activities. The Inn activity is reported on Schedule C because managing a property with a short rental period is akin to running a business. The other rental real estate activities are reported on Schedule E as a separate and distinct activity and generally fall within the purview of section 212.

The statute's legislative history reinforces this rationale, though not as petitioner suggests. A 1986 Senate Finance Committee report, in explaining the then-new passive activity loss rules, provided the following clarification:

"A passive activity is defined under the bill to include any rental activity, whether or not the taxpayer materially participates. However, operating a hotel or similar transient lodging, for example, where substantial services are provided, is not a rental activity."¹⁰⁴

Thus, in summary, the court held that a taxpayer may not aggregate hours spent on a short-term occupancy rental property with long-term occupancy properties to attain real estate professional status because a short-term rental is not a real estate activity. The taxpayer was not operating, renting, or managing real property. Instead, the taxpayer was conducting a service business of providing transient lodging, similar to running a hotel.

iii. *Lapid v. Commissioner*¹⁰⁵

In *Lapid*, the taxpayers owned four units located within two

103. *Bailey v. Comm'r (Bailey II)*, No. 28706-09S, 2011 WL 815363, at *9 (T.C. Mar. 2, 2011).

104. *Id.* at *12-13 (quoting S. REP. NO. 99-313, at 720 (1986), *reprinted in* 1986-3 C.B. (Vol. 3) 1, 720).

105. *Lapid v. Comm'r*, T.C. Memo. 2004-222, 88 T.C.M (CCH) 313 (2004).

different condominium hotels—a Day’s Inn and a Howard Johnson—near Orlando, Florida.¹⁰⁶ During 1999 and 2000, the taxpayers rented the hotel condos to customers for periods averaging less than seven days.¹⁰⁷ Also during this time, the taxpayers owned a rental unit in another Florida condominium and a house in Henderson, Nevada, both of which properties the taxpayers rented to longer term tenants.¹⁰⁸

In its analysis, the Court included the following footnote:

The regulations make clear that taxpayers generally cannot combine trade or business activities with rental activities. As the hotel condos are trade or business activities and the nonhotel properties are rental activities, we cannot combine them to measure whether Mrs. Lapid spent the time required to claim the benefit of the safe harbors listed in the regulation.¹⁰⁹

Similarly, for purposes of deciding real estate professional status, the court treated the short-term rental property as distinct from the longer-term rentals, as follows:

The nonhotel condo and Nevada house are both rental activities rather than a trade or business, so we must analyze whether they are passive activities under section 469(c)(2). The material participation standard ordinarily does not apply to rental activities. But it does become relevant when petitioners argue that one of them is a “real estate professional.”¹¹⁰

The court then went on to exclude the taxpayer’s four short-term rental properties from its real estate professional analysis.¹¹¹ Consequently, the taxpayer did not have the 750

106. Lapid v. Comm’r, T.C. Memo. 2004-222, at *2-3, 88 T.C.M (CCH) 313, 313 (2004) (“Condominium hotels look like any other hotel. Guests check in, get a room, have full run of the hotel, and then check out. The hotels have people manning the front desk and others working as housekeepers and janitors. The major difference between condominium and regular hotels is that each room in a condo hotel is owned by an investor who typically is not affiliated with the hotel’s management company. The brand name on the hotel (e.g., Day’s Inn, Howard Johnson), is the management company’s, not the investor’s, so guests have no idea who owns their rooms.”).

107. *Id.* at *6, 88 T.C.M (CCH) at 313-14.

108. *Id.* at *3, 88 T.C.M (CCH) at 313.

109. *Id.* at *7-8 n.2, 88 T.C.M (CCH) at 313 n.2 (citing Treas. Reg. § 1.469-4(d)(1)).

110. *Id.* at *4, 88 T.C.M (CCH) at 315 (citation omitted).

111. Lapid v. Comm’r, T.C. Memo. 2004-222, at *4, 88 T.C.M (CCH) 313, 314-15

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hours in real estate trades or businesses that § 469(c)(7)(B)(ii) requires to be a real estate professional under § 469(c)(7).¹¹²

*iv. Bailey v. Commissioner (Bailey I)*¹¹³

In *Bailey I*, the taxpayer jointly owned five real estate properties in three locations.¹¹⁴ Four of the properties were long-term rentals, and the fifth was a single-family house rented to customers for periods averaging less than four days.¹¹⁵

The court sustained the Commissioner's disallowance of the taxpayer's rental losses.¹¹⁶ The court held that: (1) the taxpayer did not materially participate in the short-term rental property; and (2) agreed with the Commissioner that the short-term rental property, rented on average for less than seven days, required the taxpayer to exclude those hours from the calculation of 750 hours of personal services in real property trades or businesses that is necessary under § 469(c)(7)(B) to qualify as a real estate professional.¹¹⁷

The following excerpts show the court's decisiveness on this issue:

Petitioners argue that the Lake Arrowhead [short-term rental] property is rental real estate that should be included in determining whether petitioner is a real estate professional. We disagree.

Petitioner's activities that are related to the Lake Arrowhead property are disregarded for purposes of determining whether she was a real estate professional, because the Lake Arrowhead property is not "rental real estate" as defined in section 1.469-9(b)(3), Income Tax Regs. Section 1.469-9(b)(3), Income Tax Regs., defines "rental real estate" as "any real property used by customers or held for use by customers in a rental activity within the meaning of section 1.469-1T(e)(3)." Section 1.469-1T(e)(3), Temporary Income Tax Regs., 53

(2004).

112. *Lapid v. Comm'r*, T.C. Memo. 2004-222, at *5, 88 T.C.M. (CCH) 313, 315 (2004).

113. *Bailey v. Comm'r (Bailey I)*, T.C. Memo. 2001-296, 82 T.C.M. (CCH) 868 (2001).

114. *Id.* at *2, 82 T.C.M. (CCH) at 869.

115. *Id.* at *3-7, 82 T.C.M. (CCH) at 869-70.

116. *Id.* at *20-21, 82 T.C.M. (CCH) at 874.

117. *Id.* at *12-21, 82 T.C.M. (CCH) at 871-74.

Fed.Reg. 5702 (Feb. 25, 1988), states that, except as otherwise provided, an activity is a “rental activity” for a taxable year, if “during such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers”. As provided in section 1.469-1T(e)(3)(ii)(A), Temporary Income Tax Regs., an “activity involving the use of tangible property is not a rental activity for a taxable year if for such taxable year * * * [the] average period of customer use for such property is seven days or less”.

The average period of customer use for the Lake Arrowhead property was less than 7 days during 1996 and 1997. Thus, the rental of the Lake Arrowhead property is not a “rental activity” as defined in section 1.469-1T(e)(3)(ii)(A), Temporary Income Tax Regs., not “rental real estate” under section 1.469-9(b)(3), Income Tax Regs., and not included in the election under section 469(c)(7) to treat all interests in rental real estate as a single rental real estate activity.¹¹⁸

In a later part of the opinion, the court revisited the issue of short-term versus long-term rental property by stating the following:

Petitioners argue that they properly filed an election pursuant to section 469(c)(7)(A)(ii) to treat all of their interests in rental real estate as a single rental real estate activity and that their activities related to the rental of their Lake Arrowhead property should be considered in aggregate with their other rental properties. As previously explained, petitioners’ argument fails because the election to treat all rental properties as one activity is limited to the purpose of determining whether a taxpayer is a real estate professional under section 469(c)(7). Here, the average period of use of the Lake Arrowhead property was less than 7 days in 1996 and 1997; thus, the rental of the Lake Arrowhead property is not a rental activity as defined in section 469(j)(8) and is not a passive activity under section 469(c)(2).¹¹⁹

118. *Bailey v. Comm’r (Bailey D)*, T.C. Memo. 2001-296, at *10-11, 82 T.C.M. (CCH) 868, 871-72 (2001) (alteration in original) (citations omitted) (noting that in *Scheiner v. Commissioner*, 72 T.C.M. (CCH) 1532 (1996), the “average period of customer use [was] less than 7 days” and “the condominium hotel activity was not rental activity under section 469(j)(8) and not considered a passive activity under section 469(c)(2)”).

119. *Id.* at *15, 82 T.C.M. (CCH) at 873 (citing *Scheiner*, 72 T.C.M. (CCH) 1532 (1996); *Mordkin v. Comm’r*, T.C. Memo. 1996-187, 71 T.C.M. (CCH) 2796 (1996)).

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Thus, in this earliest case, as with all the subsequent ones, the court held emphatically that hours that a taxpayer spends on short-term rental real estate are not counted as time spent on a real property trade or business for the computation of hours that a taxpayer needs to attain real estate professional status under § 469(c)(7).

Unfortunately, the court did not explicitly state the reason for its steadfastness in any of the above cases. A close examination below of the statutes and regulations furnish the explanation to fill in the court's silence.

3. GROUPING OF ACTIVE TRADES OR BUSINESSES WITH RENTAL REAL ESTATE

Before providing further analysis on the relevant statutes and regulations, this Subsection notes a case that drives home the point that once a business falls within the jurisdiction of § 469(c)(1), as with short-term rental real estate at issue here, the taxpayer cannot combine that business with long-term rental real estate. In *Carlos v. Commissioner*, the court held emphatically that allowing taxpayers to group non-passive activities with passive activities would effectively subvert the intent of Congress.¹²⁰ The court ruled that to allow such a grouping would enable taxpayers to shelter their active income with passive activity losses, in direct contravention of Congress's intent in enacting the passive activity loss restrictions of § 469(a).¹²¹

B. REVISITING THE COMMENTATORS' REMARKS

Professor Orbach concluded his remarks by stating that he was "not free from doubt" and that he looked forward to other analyses of the issue.¹²² Mr. Grace, though maintaining that the court erred twice, noted that "[e]very word in the code has meaning, although often subject to competing interpretations."¹²³ Mr. Daley observed the following:

One could argue that Pamela [Bailey] was primarily renting beds (that is, personal property) to the Inn's guests, rather than a roof over their heads. Or that in renting out her

120. *Carlos v. Comm'r*, 123 T.C. 275, 283 (2004).

121. *Id.*

122. Orbach, *supra* note 53, at 198.

123. Grace, *supra* note 53, at 1531.

vacation home on a weekly basis, Judy [Bailey] was primarily providing lodging services, rather than renting real property. Supporting that position would require a careful analysis of the statutory definition of a real property trade or business and an exploration of the statute's intended reach.¹²⁴

The commentators' doubts were prescient. Case law, as detailed above, is emphatic that short-term rentals are simply not includible for determining real estate professional status. Administrative and statutory analysis, discussed below, confirms that the Tax Court's position has been correct all along, both before and after the enactment of the real estate profession exception. Specifically, Congress never intended and was correct not to extend the expansive definition of real property to managing, renting, or operating short-term rental real estate.

C. ADMINISTRATIVE AND LEGISLATIVE HISTORIES

Examining the legislative history of the real estate professional exception of § 469(c)(7), one can see how a reader might initially conclude that the Tax Court repeatedly erred by excluding short-term rentals after the statute's enactment. The 1993 House Budget Committee Report provided the following reasons for adding the real estate professional exception:

REASONS FOR CHANGE

The committee considers it unfair that a person who performs personal services in a real estate trade or business in which he materially participates may not offset losses from rental real estate activities against income from nonrental real estate activities or against other types of income such as portfolio investment income. The committee bill modifies the passive loss rule to alleviate this unfairness.

EXPLANATION OF PROVISION

The provision treats a taxpayer's rental real estate activities in which he materially participates as not subject to limitation under the passive loss rule if the taxpayer meets eligibility requirements relating to real property trades or businesses in which the taxpayer performs services. Whether a taxpayer materially participates in his rental real estate activities is determined as if each interest of the taxpayer in

124. Daley, *supra* note 53, at 661.

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rental real estate is a separate activity, unless the taxpayer elects to treat all interests in rental real estate as one activity. The provision applies to individuals and closely held C corporations.

Real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

An individual taxpayer meets the eligibility requirements if more than half of the personal services the taxpayer performs in a trade or business are in real property trades or businesses in which he materially participates.¹²⁵

As the prior commentators noted the above expansive definition of a real property trade or business, which Congress codified as § 469(c)(7)(C), is seemingly broad enough to easily encompass operating or managing an inn or a bed and breakfast, or a hotel. That is, however, not the end of the story. Why, in the twenty years since the 1994 effective date, has the Tax Court continuously ruled the other way? The regulatory and statutory history and construction of § 469, detailed below, provide the answer.

As noted at the outset of this Article, Congress's intent behind the passive activity loss rules was to curb abusive tax shelters. As Congress explained below, taxpayers materially participating in a short-term rental real estate are engaged primarily in a service business, not primarily in a real property business. That makes them *not* the main target of the passive investor tax shelters that Congress sought to curb.

The 1986 Senate report bears out the difference between long-term real property rentals and service oriented short-term rentals, as follows:

[Long term] [r]ental activities generally require less on-going management activity, in proportion to capital invested, than business activities involving the production or sale of goods and services. . . . The extensive use of rental activities for tax shelter purposes under present law, combined with the reduced level of personal involvement necessary to conduct

125. H.R. REP. NO. 103-111, at 613-14 (1993), *reprinted in* 1993 U.S.C.A.N. 378, 844-45.

such activities, make clear that the effectiveness of the basic passive loss provision could be seriously compromised if material participation were sufficient to avoid the limitations in the case of rental activities.¹²⁶

In other words, unlike long-term rental activities, a labor intensive business such as a hotel that provides services to mainly transient tenants was not the focus of Congress's tax shelter ire.

Likewise, the preamble to Treasury Decision 8175 serves a clarifying function. The Secretary explained: "The rationale for the 'seven-day rule' is that a customer's use of property for seven days or less generally will require the person furnishing the property *to provide services significant enough to justify the conclusion that the person is engaged in a service business rather than a rental activity.*"¹²⁷

Thus, the above two 1986 legislative and administrative histories answer the core question here: Operating a short-term tenancy rental property such as a hotel, bed and breakfast, or inn is primarily a service business, not a real property business. In other words, the taxpayer is not primarily engaged in managing, renting, or operating real property.

D. REGULATORY AND STATUTORY CONSTRUCTION

Another way to view the result is to look at the impact of Temporary Treasury Regulation § 1.469-1T(e)(3)(ii)(A). For real estate endeavors involving rentals averaging seven days or less, the regulation transforms the enterprise from a rental activity subject to § 469(c)(2) into a trade or business tested under the material participation requirements of § 469(c)(1). The statutory relocation is decisive here because Congress hinged the entire structure of the real estate professional exception of § 469(c)(7) on providing an exception to § 469(c)(2). Because an activity is not a § 469(c)(2) rental activity, it makes no sense to see if the activity fits the exception to § 469(c)(2).

Section 469(c)(7)(A) supplies the hinge. Section 469(c)(7)(A) states that if a taxpayer is a real estate professional by successfully satisfying the two-prong test of § 469(c)(7)(B), then

126. S. REP. NO. 99-313, at 718 (1986).

127. T.D. 8175, 1988-1 C.B. 191, 192 (emphasis added).

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the passive loss restriction of § 469(c)(2) shall not apply to the taxpayer for that year.

Consequently, the expansive definition of § 469(c)(7)(C) is meaningless for short-term rental real estate because Temporary Treasury Regulation § 1.469-1T(e)(3)(ii)(A) preemptively relocates the endeavor to § 469(c)(1).¹²⁸ Therefore, the Regulation renders null the possibility for short-term rental property to be an exception to § 469(c)(2). Instead, the Regulation firmly places the endeavor as a trade or business subject only to the passive activity loss material participation rules of § 469(c)(1).

E. AUTHOR'S EXPLANATION

The expansive definition of § 469(c)(7)(C) seems robust enough to readily include operating or managing an inn, bed and breakfast, or a hotel.¹²⁹ That code section and its 1993 legislative history, however, are simply inapplicable here because Congress enacted the new law only for taxpayers working in a trade or business founded primarily in real property.

An example of the target recipient would be an active owner of a large apartment complex where tenants typically sign leases for one-year or more. Because the business involves rental property, the owner needed the real estate professional exception of § 469(c)(7) to deduct his or her losses. An active operator of a hotel, bed and breakfast, or an inn, on the other hand, did not need the real estate professional exception because he or she could already deduct his or her losses through the material participation test of § 469(c)(1).¹³⁰

128. In other words, the seven day temporal rule of Temporary Treasury Regulation § 1.469-1T(e)(3)(ii)(A) places short-term rental real estate into the category of a trade or business. Consequently, the owner is then subject to the material participation requirement of 26 U.S.C. § 469(c)(1) and not the real estate professional requirements of § 469(c)(7).

129. The expansive definition of § 469(c)(7)(C) would seem to include all real property activities, as follows: "For purposes of this paragraph, the term 'real property trade or business' means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." As this Article points out, however, many businesses involve real estate, such as a car wash, grocery store, or barber shop, but they are not a real property trade or business. It is the temporal distinction, average customer rental for seven days or less, that is the decisive difference. See Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(A).

130. Section 469(c)(1)(B) defines "passive activity" as any activity where "the taxpayer does not materially participate." Treas. Reg. § 1.469-5T(a) in turn then

Yet another way to view the issue is through the lens of a common first year law school property law concept. The ownership of real property invokes a number of rights akin to owning a bundle of sticks.¹³¹ The highest form of real property ownership is a fee simple estate where the owner owns all the rights in a property.¹³² The owner may fragment those rights into various pieces, such as temporal grants of use, mortgages, and leases.¹³³ Applying the analogy to the current issue, renting real property to customers for a short time involves numerous real property issues, but certainly does not involve all the issues or rights faced by business owners. Extending the analogy further, the brief temporal nature of short-term tenancy invokes only a fraction of the owner's or the business's bundle of duties. Consequently, short-term rental properties exist primarily as a service business and not as a real property trade or business.

Thus, as detailed above, the Code and regulations exclude short-term rental property from being a real property trade or business because it is principally a service business rather than a real property business. Consequently, the short duration endeavor had already become a per se non-real property trade or business. The Tax Court has been correct these past twenty or thirty years, though perhaps the court did not fully explain its rationale.

F. SIMILAR STATUTES SUPPORT THE COURT'S VIEW

This Subsection explores other sections of the Code to support the above findings. As detailed below, at least three other pertinent sections of the Code, § 48(a)(3)(B), § 280A(f)(1), and § 168(e)(2)(A)(ii)(I), treat a property differently if it is used as a hotel, inn, or similar transient housing, than if the same property were used as a long-term rental. Congress's distinction in these other Code sections helps to corroborate that across

provides seven tests to determine if the taxpayer was a material participant, for example, the taxpayers worked in the activity for 500 hours or more during the year. See Treas. Reg. § 1.469-5T(a)(1). In other words, owners of a trade or business have their own separate hours tests, and accordingly, do not need real estate professional status to deduct their losses.

131. See Robert C. Ellickson, *Two Cheers for the Bundle-of-Sticks Metaphor, Three Cheers for Merrill and Smith*, 8 ECON. J. WATCH 215, 215-16 (2011), available at http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=4601&context=fss_papers.

132. *Id.* at 216.

133. *Id.* at 216-17.

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different content areas Congress nonetheless consistently intended a separate treatment for short-term rental properties.

For instance, in § 50(b)(2)(B), Congress provided that “property used by a *hotel or motel*” is eligible to be treated as section 38 property for the investment credit purposes.¹³⁴ Similarly, when comparing § 280A(f)(1)(A) to § 280A(f)(1)(B), Congress made a distinction for short-term rentals when defining a dwelling unit.¹³⁵ Specifically, under § 280A(f)(1)(A) a dwelling unit includes an apartment, condominium, or similar property.¹³⁶ In contrast, in § 280A(f)(1)(B), Congress specifically provided that a dwelling unit does not include any portion of a unit that was “used exclusively as a *hotel, motel, inn, or similar [commercial] establishment.*”¹³⁷

Section 168(e)(2)(A)(ii)(I) provides another example of Congress’s separate treatment for hotel-type property. The section requires different depreciable lives for residential (27.5 years) versus nonresidential property (thirty-nine years) depending solely on whether the tenants are short-term transient dwellers or long term tenants, as follows:

(2) Residential rental or nonresidential real property. —

(A) Residential rental property. —

(i) Residential rental property.—The term “residential rental property” means any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units.

(ii) Definitions.—For purposes of clause (i)—

(I) *the term “dwelling unit” means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis.*¹³⁸

Consequently, the exact same building structure, for

134. 26 I.R.C. § 50(b)(2)(B) (2012) (emphasis added).

135. Compare 26 I.R.C. § 280A(f)(1)(A), with § 280A(f)(1)(B).

136. § 280A(f)(1)(A).

137. 26 I.R.C. § 280A(f)(1)(B) (emphasis added).

138. 26 U.S.C. § 168(e)(2)(A) (emphasis added).

instance a detached home or a condominium unit, could have either of two different depreciation lives depending solely on the length of the occupant's stay. The above definition shows that with respect to depreciation, similar to real estate rentals, Congress has made a distinction between short-term transient rental dwellings and long-term rental units.

Congress has been making a similar distinction for depreciation at least since 1969. For example, in enacting the Tax Reform Act of 1969,¹³⁹ Congress sought to encourage the rehabilitation of buildings for low-cost rental by allowing taxpayers to depreciate rehabilitation additions and improvements over a rapid depreciation timetable of sixty months.¹⁴⁰ Congress made clear, however, that “[t]he 60-month rule does *not apply to hotels, motels, inns, or to other establishments where more than one-half of the units are used on a transient basis.*”¹⁴¹

Thus, the above Code sections show that Congress has been consistently making a distinction for real property that is used as a hotel, inn, or similar transient occupancy endeavors.

IV. DID CONGRESS GET IT RIGHT?

Was Congress correct to have the tax code exclude short-term rental real estate from the computation of hours for determining who is a real estate professional? The answer is yes—Congress enacted the proper public policy. The main point of real estate professional status is to bring parity of relief to people whose primary job is working in long-term rental real estate. If a taxpayer is operating a bed and breakfast, an inn, or a hotel, that taxpayer is working hard to provide services. The taxpayer might be washing sheets, preparing meals, or operating the front desk. Labor intensive activities are the hallmark of a service business. The material participation tests of § 469(c)(1) are therefore sufficient to test whether, for instance, a hotel operator may deduct his or her losses or whether the losses should be suspended because the taxpayer's involvement is passive. Thus, hotel operators were not harmed by the passive activity loss rules of 1986, because they could still deduct their

139. Pub. L. No. 91-172, 83 Stat. 487.

140. H.R. REP. NO. 91-413, pt. 1, at 167 (1969), *reprinted in* 1969 U.S.C.C.A.N. 1645, 1819-20.

141. *Id.* (emphasis added).

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losses as long as they established that they were a material participant.

In contrast, for taxpayers with long-term rental tenants, such as apartment owners with leases averaging a year or more, the owner's activity is typically less labor intensive. Therefore, these taxpayers were uniquely harmed by the passive activity loss rules of 1986, which suspended their losses because their properties were rentals, not businesses. Accordingly, since 1994, when Congress made effective the real estate professional status, long-term rental owners could again deduct their losses if they showed that their efforts were substantial, thus putting them in parity with short-term rental owners such as hotel operators.

Therefore, since 1994, the law has become balanced, parallel, and equitable. Accordingly, this author sees no need to recommend a change in public policy because the law appears to be correct in its present form.

V. CONCLUSION

Mr. Daley stated that "the real issue" is whether "the management and operation of real property rented on a short-term basis [is] a real property trade or business under section 469(c)(7)."¹⁴²

The answer to his question is an emphatic no! Operation, rental, or management of a short-term tenancy rental business is fundamentally a service business and not a business founded primarily in the management or operation of real property. The Tax Court has been correct all along for the past twenty to thirty years.

If the Tax Court's explanation has been cryptic, a summary of the rationale is that temporary Treasury Regulation § 1.469-1T(e)(3)(ii)(A) prophylactically establishes that a short-term rental endeavor is a service-based trade or business under § 469(c)(1)(A), subject solely to the material participation test of § 469(c)(1)(B). Section 469(c)(2) is simply no longer part of the equation. Consequently, the expansive definition of a real property trade or business under § 469(c)(7)(C) is meaningless for short-term rental real estate because the endeavor is no longer a business that deals principally with real property. Congress's

142. Daley, *supra* note 53, at 661.

decision to set the bar at seven days provides an arbitrary but concrete cut off measure.

Thus, the Code and pertinent regulations render null the possibility for short-term rental property to be an exception to § 469(c)(2). Instead, the law squarely places the endeavor as a trade or business subject only to the passive loss rules of § 469(c)(1).

In other words, short-term rental real estate does not fit the definition of a real property trade or business under § 469(c)(7)(C) because the short duration transforms the focus of the business from operating or managing real property to a business that renders a service to transient occupants. Therefore, a taxpayer cannot use short-term real estate to help establish the hours necessary to qualify as a real estate professional.

Thus, despite vigorous commentaries from the tax community, attempts to use short-term rental property to attain real estate professional status are an untenable goal. Consequently, a taxpayer simply cannot use short-term rental real estate to get there, a deduction, from here, having nondeductible passive activity losses.