Current Federal Tax Developments

Week of December 5, 2022

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CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF DECEMBER 5, 2022
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IRS RELEASES IRA 2022 GUIDANCE ON PREVAILING WAGE AND APPRENTICESHIP REQUIREMENTS

Notice 2022-61, 11/29/22

The IRS has issued the first guidance related to provisions in the Inflation Reduction Act of 2022 in Notice 2022-61.[1] The Notice provides guidance on the prevailing wage and apprenticeship provisions that provide for increased tax benefits under IRC §§ 30C, 45, 45L, 45Q, 45U, 45V, 45Y, 45Z, 48, 48C, 48E, and 179D. The Notice also establishes the 60-day period applicable under the provisions and guidance on determining the beginning of construction or beginning of installation.

Guidance With Respect to Prevailing Wage Rate Requirements

The Notice provides that the prevailing wage requirements will be satisfied if:

- The taxpayer satisfies the Prevailing Wage Rate Requirements with respect to any laborer or mechanic employed in the construction, alteration, or repair of a facility, property, project, or equipment by the taxpayer or any contractor or subcontractor of the taxpayer; and

- The taxpayer maintains and preserves sufficient records, including books of account or records for work performed by contractors or subcontractors of the taxpayer, to establish that such laborers and mechanics were paid wages not less than such prevailing rates, in accordance with the general recordkeeping requirements under § 6001 and § 1.6001-1, *et seq.*[2]

The prevailing wage is determined using prevailing wage information published by the Department of Labor if it exists. The Notice provides:

> If the Secretary of Labor has published on www.sam.gov a prevailing wage determination for the geographic area and type or types of construction applicable to the facility, including all labor classifications for the construction, alteration, or repair work that will be done on the facility by laborers or mechanics, that wage determination contains the prevailing rates for the laborers or mechanics who perform work on the facility as most recently determined by the Secretary of Labor in accordance with subchapter IV of chapter 31 of title 40, United States Code, as identified in § 45(b)(7)(A).[3]

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[1] Notice 2022-61, November 29, 2022, https://www.federalregister.gov/documents/2022/11/30/2022-26108/prevailing-wage-and-apprenticeship-initial-guidance-under-section-45b6bii-and-other-substantially#h-9 (retrieved December 3, 2022)6

[2] Notice 2022-61, Section 3.01, November 29, 2022

[3] Notice 2022-61, Section 3.02, November 29, 2022

The Notice goes on to describe the procedures to be used if no such determination has been published:

> The following procedures described in section 3.02 of this notice are designed to be used to request an unlisted classification only in the limited circumstance when no labor classification on the applicable prevailing wage determination applies to the planned work.
>
> If the Secretary of Labor has not published a prevailing wage determination for the geographic area and type of construction for the facility on www.sam.gov, or the Secretary of Labor has issued a prevailing wage determination for the geographic area and type of construction, but one or more labor classifications for the construction, alteration, or repair work that will be done on the facility by laborers or mechanics is not listed, then the taxpayer can rely on the procedures established by the Secretary of Labor for purposes of the requirement to pay prevailing rates determined by the Secretary of Labor in accordance with subchapter IV of chapter 31 of title 40, United States Code.[4]

In this case, the Notice provides that the taxpayer must contact the Department of Labor

> To rely on the procedures to request a wage determination or wage rate, and to rely on the wage determination or rate provided in response to the request, the taxpayer must contact the Department of Labor, Wage and Hour Division via email at IRAprevailingwage@dol.gov and provide the Wage and Hour Division with the type of facility, facility location, proposed labor classifications, proposed prevailing wage rates, job descriptions and duties, and any rationale for the proposed classifications. The taxpayer may use these procedures to request a wage determination, or wage rates for the unlisted classifications, applicable to the construction, alteration, or repair of the facility. After review, the Department of Labor, Wage and Hour Division will notify the taxpayer as to the labor classifications and wage rates to be used for the type of work in question in the area in which the facility is located.[5]

The Notice states that the prevailing rate for apprentices may be less than that for journeymen:

> For purposes of the Prevailing Wage Rate Requirements, the prevailing rate for qualified apprentices hired through a registered apprenticeship

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[4] Notice 2022-61, Section 3.02, November 29, 2022
[5] Notice 2022-61, Section 3.02, November 29, 2022

> program may be less than the corresponding prevailing rate for journeyworkers of the same classification, as described in 29 CFR 5.5(a)(4)(i).[6]

Finally, the Notice describes the rule as it impacts §179D:

> For purposes of the Prevailing Wage Requirements for the § 179D deduction, the prevailing wage rate for installation of energy efficient commercial building property, energy efficient building retrofit property, or property installed pursuant to a qualified retrofit plan, is determined with respect to the prevailing wage rate for construction, alteration, or repair of a similar character in the locality in which such property is located, as most recently determined by the Secretary of Labor, in accordance with subchapter IV of chapter 31 of title 40, United States Code.[7]

The following definitions apply for purposes of the prevailing wage rate requirement:

- **Employ** - A taxpayer, contractor, or subcontractor is considered to "employ" an individual if the individual performs services for the taxpayer, contractor, or subcontractor in exchange for remuneration, regardless of whether the individual would be characterized as an employee or an independent contractor for other Federal tax purposes.

- **Wage and wages** - The terms "wage" and "wages" means "wages" as defined under 29 CFR 5.2(p), including any bona fide fringe benefits as defined therein.

- **Laborer or mechanic** - The term "laborer or mechanic" means "laborer or mechanic" as defined under 29 CFR 5.2(m).

- **Construction, alteration or repair** - The term "construction, alteration, or repair" means "construction, prosecution, completion, or repair" as defined under 29 CFR 5.2(j).

- **Prevailing wage** - The term "prevailing wage" means the wage listed for a particular classification of laborer or mechanic on the applicable wage determination for the type of construction and the geographic area or other applicable wage as determined by the Secretary of Labor.

- **Prevailing wage determination** - The term "prevailing wage determination" means a wage determination issued by the Department of Labor and published on www.sam.gov.[8]

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[6] Notice 2022-61, Section 3.02, November 29, 2022
[7] Notice 2022-61, Section 3.02, November 29, 2022
[8] Notice 2022-61, Section 3.03, November 29, 2022

The Notice provides the following three examples of applying these provisions.

EXAMPLE 1

A taxpayer employs laborers and mechanics to construct a facility. The taxpayer also uses a contractor and subcontractor to construct the facility. The Department of Labor has issued a prevailing wage determination that applies to the type of construction that the laborers and mechanics perform for the county in which the facility is located. The taxpayer ensures that the taxpayer, contractor, and subcontractor pay each laborer and mechanic a wage rate equal to the applicable rates for their respective labor classifications listed in this prevailing wage determination. The taxpayer maintains records that are sufficient to establish that the taxpayer and the taxpayer's contractor and subcontractor paid wages not less than such prevailing wage rates. Such records include but are not limited to, identifying the applicable wage determination, the laborers and mechanics who performed construction work on the facility, the classifications of work they performed, their hours worked in each classification, and the wage rates paid for the work. Under these facts, the taxpayer will be considered to have satisfied the Prevailing Wage Rate Requirements with respect to the facility.

EXAMPLE 2

The facts are the same as in Example 1, except that the Department of Labor has not issued an applicable prevailing wage determination for the relevant type of construction and geographic area in which the facility is being constructed. The taxpayer contacts the Department of Labor, Wage and Hour Division under the procedures described in section 3.02 of this notice. After review, the Department of Labor, Wage and Hour Division notifies the taxpayer as to the labor classifications and wage rates to be used for the type of construction work in question in the area in which the facility is located. The taxpayer ensures that the taxpayer, contractor, and subcontractor pay each laborer and mechanic a wage rate equal to the applicable rates for the respective classifications listed in this wage determination.

The taxpayer maintains records, which include the additional prevailing wage rates provided by the Department of Labor to establish that the taxpayer and the taxpayer's contractor and subcontractor paid wages not less than such prevailing wage rates. Under these facts, the taxpayer will be considered to have satisfied the Prevailing Wage Rate Requirements with respect to the facility.

EXAMPLE 3

The facts are the same as in Example 1, except that the Department of Labor has issued a prevailing wage determination that applies to the type of construction that the laborers and mechanics are hired to perform for the county in which the facility is located, but that wage determination does not include a classification of laborer or mechanic that will be used to complete the construction work on the facility (for example, electrician, carpenter, laborer, etc.). The taxpayer contacts the Department of Labor, Wage and Hour Division under the procedures described in section 3.02 of this notice. After review, including confirming that no labor classification on the applicable prevailing wage determination that applies to the work exists, the Department of Labor, Wage and Hour Division notifies the taxpayer as to the wage rate to be paid regarding the additional classification. The taxpayer ensures that the taxpayer, contractor, and subcontractor pay each laborer and mechanic a wage rate equal to the applicable rates for their respective labor classifications listed in the prevailing wage determination, including the additional wage rates provided by the Department of Labor.

The taxpayer maintains records, which include the additional wage rates provided by the Department of Labor to establish that the taxpayer and taxpayer's contractor and subcontractor paid wages not less than prevailing wage rates. Under these facts, the taxpayer will be considered to have satisfied the Prevailing Wage Rate Requirements with respect to the facility.[9]

Guidance With Respect to Apprenticeship Requirements

The Notice provides that a taxpayer must meet the following three tests to comply with the apprenticeship requirements:

- The taxpayer satisfies the *Apprenticeship Labor Hour Requirements*, subject to any applicable *Apprenticeship Ratio Requirements*;
- The taxpayer satisfies the *Apprenticeship Participation Requirements*; and
- The taxpayer complies with the general recordkeeping requirements under § 6001 and § 1.6001-1, including maintaining books of account or records for contractors or subcontractors of the taxpayer, as applicable, in sufficient form to establish that the Apprenticeship Labor Hour and the Apprenticeship Participation Requirements have been satisfied.[10]

The *Apprenticeship Labor Hour Requirements* are described in the Notice as follows:

> Section 45(b)(8)(A)(i) provides that to meet the apprenticeship requirements taxpayers must ensure that, with respect to the construction of any qualified facility, not less than the applicable percentage of the total labor hours of the construction, alteration, or repair work (including such work performed by any contractor or subcontractor) with respect to such facility is, subject to § 45(b)(8)(B), performed by qualified apprentices (Apprenticeship Labor Hour Requirements). Under § 45(b)(8)(A)(ii), for purposes of § 45(b)(8)(A)(i), the applicable percentage is: (i) in the case of a qualified facility the construction of which begins before January 1, 2023, 10 percent, (ii) in the case of a qualified facility the construction of which begins after December 31, 2022, and before January 1, 2024, 12.5 percent, and (iii) in the case of a qualified facility the construction of which begins after December 31, 2023, 15 percent.[11]

[9] Notice 2022-61, Section 3.04, November 29, 2022
[10] Notice 2022-61, Section 4.01, November 29, 2022
[11] Notice 2022-61, Section 2.01(3), November 29, 2022

The *Apprenticeship Ratio Requirements* are described in the Notice as follows:

> Section 45(b)(8)(B) provides that the requirement under § 45(b)(8)(A)(i) is subject to any applicable requirements for apprentice-to-journeyworker ratios of the Department of Labor or the applicable State Apprenticeship Agency (Apprenticeship Ratio Requirements).[12]

The *Apprenticeship Participation Requirements* are described in the Notice as follows:

> Section 45(b)(8)(C) provides that each taxpayer, contractor, or subcontractor who employs 4 or more individuals to perform construction, alteration, or repair work with respect to the construction of a qualified facility must employ 1 or more qualified apprentices to perform such work (Apprenticeship Participation Requirements).[13]

The Notice provides details regarding how a taxpayer can comply with the *Good Faith Effort Exception* to the apprenticeship requirements.

> Under the *Good Faith Effort Exception*, the taxpayer will be considered to have made a good faith effort in requesting qualified apprentices if the taxpayer requests qualified apprentices from a registered apprenticeship program in accordance with usual and customary business practices for registered apprenticeship programs in a particular industry. Pursuant to § 6001 and § 1.6001-1, the taxpayer must maintain sufficient books and records establishing the taxpayer's request of qualified apprentices from a registered apprenticeship program and the program's denial of such request or non-response to such request, as applicable.[14]

The following definitions are provided in the Notice related to the apprenticeship requirements:

- **Employ** - A taxpayer, contractor, or subcontractor is considered to "employ" an individual if the individual performs services for the taxpayer, contractor, or subcontractor in exchange for remuneration, regardless of whether the individual would be characterized as an employee or an independent contractor for other Federal tax purposes.

- **Journeyworker** - The term "journeyworker" means "journeyworker" as defined under 29 CFR 29.2.

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[12] Notice 2022-61, Section 2.01(3), November 29, 2022
[13] Notice 2022-61, Section 2.01(3), November 29, 2022
[14] Notice 2022-61, Section 4.01, November 29, 2022

- **Apprentice-to-journeyworker ratio** - The term "apprentice-to-journeyworker ratio" means the ratio described under 29 CFR 29.5(b)(7).

- **Construction, alteration, or repair** - The term "construction, alteration, or repair" means "construction, prosecution, completion, or repair" as defined under 29 CFR 5.2(j).

- **State Apprenticeship Agency** - The term "State Apprenticeship Agency" means "State Apprenticeship Agency" as defined under 29 CFR 29.2.[15]

The Notice provides the following example dealing with the apprenticeship provisions.

EXAMPLE

A taxpayer employs workers and qualified apprentices to construct a new facility. Construction of the facility begins in calendar year 2023, and the construction of the facility is completed in calendar year 2023. To satisfy the apprenticeship labor hour requirement, the percentage of total labor hours to be performed by qualified apprentices is 12.5 percent for 2023. The total labor hours, as defined in § 45(b)(8)(E)(i), for the construction of the facility is 10,000 labor hours. The taxpayer employed qualified apprentices that performed a total of 1,150 hours of construction on the facility. On each day that a qualified apprentice performed construction work on the facility for the taxpayer, the applicable requirements for apprentice-to-journeyworker ratios of the Department of Labor or the applicable State Apprenticeship Agency were met.

The taxpayer also hired a contractor to assist with construction of the facility for 1,000 labor hours of the 10,000 total labor hours. The contractor employed qualified apprentices that performed a total of 100 hours of construction on the facility. On each day that a qualified apprentice performed construction work on the facility for the contractor, the applicable requirements for apprentice-to-journeyworker ratios of the Department of Labor or the applicable State Apprenticeship Agency were met.

The taxpayer ensured that the taxpayer and the contractor each employed 1 or more qualified apprentices because the taxpayer and contractor each employed 4 or more individuals to perform construction work on the qualified facility.

The taxpayer maintained sufficient records to establish that the taxpayer and the contractor hired by the taxpayer satisfied the Apprenticeship Labor Hour Requirement of 1,250 total labor hours for the facility (12.5% of 10,000 labor hours), and the Apprenticeship Ratio and Apprenticeship Participation Requirements. Under these facts, the taxpayer will be considered to have satisfied the Apprenticeship Labor Hour, Apprenticeship Ratio, and Apprenticeship Participation Requirements of the statute with respect to the facility.[16]

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[15] Notice 2022-61, Section 4.02, November 29, 2022
[16] Notice 2022-61, Section 4.03, November 29, 2022

Determining When Construction or Installation Begins

The Notice references various previous IRS guidance for different provisions found in the Inflation Reduction Act of 2022. The Notice begins this section with the following cross-reference:

> To determine when construction begins for purposes of §§ 30C, 45V, 45Y, and 48E, principles similar to those under Notice 2013-29 regarding the Physical Work Test and Five Percent Safe Harbor apply, and taxpayers satisfying either test will be considered to have begun construction. In addition, principles similar to those provided in the IRS Notices regarding the Continuity Requirement for purposes of §§ 30C, 45V, 45Y, and 48E apply. Whether a taxpayer meets the Continuity Requirement under either test is determined by the relevant facts and circumstances.[17]

This Notice describes the *Physical Work Test* as follows:

> Under the *Physical Work Test*, construction of a facility begins when physical work of a significant nature begins, provided that the taxpayer maintains a continuous program of construction. This test focuses on the nature of the work performed, not the amount or the costs. Assuming the work performed is of a significant nature, there is no fixed minimum amount of work or monetary or percentage threshold required to satisfy the Physical Work Test. Physical work of significant nature does not include preliminary activities, even if the cost of those preliminary activities is properly included in the depreciable basis of the facility. For purposes of the Physical Work Test, preliminary activities include, but are not limited to, planning or designing, securing financing, exploring, researching, obtaining permits, licensing, conducting surveys, environmental and engineering studies, or clearing a site.
>
> Work performed by the taxpayer and work performed for the taxpayer by other persons under a binding written contract that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in the taxpayer's trade or business (or for the taxpayer's production of income) is taken into account in determining whether construction has begun. Both on-site and off-site work (performed either by the taxpayer or by another person under a binding written contract) may be taken into account for purposes of demonstrating that physical work of a significant nature has begun. Physical work of a significant nature does not include work (performed either by the taxpayer or by another person under a binding written

[17] Notice 2022-61, Section 5, November 29, 2022

> contract) to produce property that is either in existing inventory or is normally held in inventory by a vendor.[18]

The Notice also describes the *Five Percent Safe Harbor* as follows:

> Under the Five Percent Safe Harbor, construction of a facility will be considered as having begun if: (i) a taxpayer pays or incurs (within the meaning of § 1.461-1(a)(1) and (2)) five percent or more of the total cost of the facility, and (ii) thereafter, the taxpayer makes continuous efforts to advance towards completion of the facility. All costs properly included in the depreciable basis of the facility are taken into account to determine whether the Five Percent Safe Harbor has been met. For property that is manufactured, constructed, or produced for the taxpayer by another person under a binding written contract with the taxpayer, costs incurred with respect to the property by the other person before the property is provided to the taxpayer are deemed incurred by the taxpayer when the costs are incurred by the other person under the principles of § 461.[19]

The Notice references the *Continuity Safe Harbor* of Notice 2016-31:

> Similar principles to those under section 3 of Notice 2016-31 regarding the Continuity Safe Harbor also apply for purposes of §§ 30C, 45V, 45Y, and 48E. Taxpayers may rely on the Continuity Safe Harbor provided the facility is placed in service no more than four calendar years after the calendar year during which construction began.[20]

The Notice describes these referenced continuity requirements as follows:

> The IRS Notices, as clarified and modified by Notice 2021-41, provide that for purposes of the Physical Work Test and Five Percent Safe Harbor, taxpayers must demonstrate either continuous construction or continuous efforts (Continuity Requirement) regardless of whether the Physical Work Test or the Five Percent Safe Harbor was used to establish the beginning of construction. Whether a taxpayer meets the Continuity Requirement under either test is determined by the relevant facts and circumstances. The IRS will closely scrutinize a facility and may determine that the beginning of construction is not satisfied with respect to a facility if a taxpayer does not meet the Continuity Requirement.

[18] Notice 2022-61, Section 2.02(2)(i), November 29, 2022
[19] Notice 2022-61, Section 2.02(2)(ii), November 29, 2022
[20] Notice 2022-61, Section 5, November 29, 2022

> The IRS Notices, as subsequently modified and clarified, also provide for a "Continuity Safe Harbor" under which a taxpayer will be deemed to satisfy the Continuity Requirement provided a qualified facility is placed in service no more than four calendar years after the calendar year during which construction of the qualified facility began for purposes of §§ 45 [14] and 48,[15] and no more than six calendar years after the calendar year during which construction of the qualified facility or carbon capture equipment began for purposes of § 45Q.[16] Certain offshore projects and projects built on federal land under §§ 45 and 48 satisfy the Continuity Requirement if such a project is placed into service no more than 10 calendar years after the calendar year during which construction of the project began.[21]

The Notice provides the following information regarding IRC §179D issues in this area:

> For purposes of § 179D, the IRS will accept that installation has begun if a taxpayer generally satisfies principles similar to the two tests described in section 2.02 of this notice, above, regarding the beginning of construction under Notice 2013-29 (Physical Work Test and Five Percent Safe Harbor). The relevant facts and circumstances will ultimately be determinative of whether a taxpayer has begun installation.[22]

Finally, the Notice closes out the guidance on when construction or installation begins for IRC §§ 45, 45Q, and 48.

> For purposes of §§ 45, 45Q, and 48, the IRS Notices will continue to apply under each respective Code section, including application of the Physical Work Test and Five Percent Safe Harbor, and the rules regarding the Continuity Requirement and Continuity Safe Harbors.[23]

Date That is 60 Days after Guidance Published

A key date for the application of these provisions is 60 days after guidance is published. The information accompanying this Notice in the *Federal Register* provides the following information that sets that 60th day:

> January 30, 2023 is the date that is 60 days after the Secretary of the Treasury or her delegate (Secretary) publishes the guidance described in 26 U.S.C. 30C(g)(1)(C)(i), 45(b)(6)(B)(ii), 45Q(h)(2),

[21] Notice 2022-61, Section 2.03, November 29, 2022
[22] Notice 2022-61, Section 5, November 29, 2022
[23] Notice 2022-61, Section 5, November 29, 2022

> 45V(e)(2)(A)(i), 45Y(a)(2)(B)(ii), 48(a)(9)(B)(ii), 48E(a)(2)(A)(ii)(II) and (a)(2)(B)(ii)(II), and 179D(b)(3)(B)(i).[24]

TAXPAYERS DENIED DEDUCTIONS FOR PARTNERSHIP LOSSES FOR A MULTITUDE OF REASONS

Dunn v. Commissioner, TC Memo 2022-112, 11/29/22

In the case of *Dunn v. Commissioner*, TC Memo 2022-112,[25] the taxpayers lost deductions for claimed depreciation on an automobile and losses from a partnership they wholly owned that held real estate.

Facts of the Case

The opinion begins by describing the LLC taxed as a partnership held by Heather and Edison Dunn:

> Petitioners formed Magnet Development, LLC (Magnet), in February 2007 to manage investments in real estate. On March 14, 2008, Magnet purchased a 21-unit apartment building in Hephzibah, Georgia (Hephzibah building). Petitioners lived approximately 150 miles from the Hephzibah building. To assist in managing the Hephzibah building Magnet employed Ebony Calhoun from January 5 to July 27, 2013, to collect rents, show apartments, and clean vacant apartments. In addition Magnet hired Augusta Partners Property Management, LLC (Augusta Partners), to rent, lease, operate, and manage the Hephzibah building pursuant to a contract with an effective date of January 2, 2014. Petitioners owned additional properties in Athens and Snellville, Georgia, in their individual names and which they managed on their own.
>
> …
>
> Petitioners each owned 50% of Magnet, which was treated as a non-TEFRA partnership for federal income tax purposes. Magnet timely filed Forms 1065, U.S. Return of Partnership Income, for the years in issue. Magnet reported income and claimed expense deductions for the Athens and Snellville properties on its Forms 8825, Rental Real Estate Income and Expenses of a Partnership or an S Corporation. It [*3] also

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[24] *Federal Register*, Vol. 87, No. 229, November 30, 2022, p. 73580, https://www.govinfo.gov/content/pkg/FR-2022-11-30/pdf/2022-26108.pdf (retrieved December 3, 2022)

[25] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/couple-liable-for-penalties%3b-deductions-disallowed/7ff38 (retrieved December 3, 2022)

> claimed depreciation deductions at 100% business use of a 2013 Ford Explorer that petitioner wife purchased in May 2013. It reported net losses for both years in issue.[26]

The Court noted that the taxpayers, despite each having full-time employment, were arguing they were real estate professionals:

> During the years in issue petitioner husband was employed as a full-time technology support specialist with Gwinnett County Public Schools, and petitioner wife was employed as a full-time computer specialist with Huron Consulting Services, LLC. In addition they attempted to work as full-time real estate professionals. In order to substantiate their real estate activities, petitioners kept two separate logs with respect to the hours they claim to have spent working on the Hephzibah building, the Athens property, and the Snellville property in 2013 and 2014. One log relates to activity conducted at the Hephzibah building in 2014. This log provides the date along with a two- or three-word description of the job completed; it does not list the hours spent working. The second log relates to activity conducted at all three properties in 2013 and 2014. This log provides the date, name of the property, hours worked, and a vague description of the work performed; it does not specify the tasks each petitioner individually performed.[27]

The couple claimed the entire amount of losses reported by the partnership on their individual income tax returns:

> Petitioners filed a joint individual income tax return for each year in issue; however, they did not make an election to group their rental real estate activities as one activity for purposes of section 469(c)(7)(A) for either year. They claimed flowthrough losses from Magnet of $85,260 and $48,740 for taxable years 2013 and 2014, respectively. Petitioners also claimed a loss deduction of $7,028 on their Schedule E, Supplemental Income and Loss, for 2014.[28]

The IRS examined the taxpayers' return and, as you might expect given these facts, asserted the taxpayers had claimed losses they were not entitled to:

> On June 8, 2016, the examiner's group manager signed a Civil Penalty Approval Form with respect to the examination of Magnet approving accuracy-related penalties pursuant to section 6662(a) on the individual shareholders' returns for 2013 and 2014. On September 19,

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[26] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[27] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[28] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

> 2016, the group manager signed a second Civil Penalty Approval Form approving accuracy-related penalties against petitioners for the same period. On February 1, 2017, respondent issued petitioners a notice of deficiency for the years in issue.[29]

Automobile Expenses Had a Number of Problems

The Court first deals with the automobile depreciation deduction claimed on the partnership return. The Court notes:

> For property used in a trade or business or held for the production of income, a depreciation deduction is allowed for reasonable exhaustion or wear and tear. § 167(a). Magnet claimed depreciation deductions for petitioner wife's Ford Explorer for the years in issue.[30]

The opinion immediately comments on the fact that the partnership did not actually own the vehicle in question:

> Petitioners failed to explain why Magnet should be entitled to deductions for property it did not own.[31]

The Court notes that detailed documentation requirements apply to any claimed deduction for vehicles:

> To substantiate entitlement to a depreciation deduction, a taxpayer must establish the property's depreciable basis by showing the cost of the property, its useful life, and the previously allowed depreciation. *Cluck v. Commissioner*, 105 T.C. 324, 337 (1995). To be entitled to a deduction for an automobile, a taxpayer must establish that the automobile was used at least partially for business, and the deductions will be allowed only to the extent of its business use. In addition, a claimed deduction with respect to any "listed property" — a category including "any passenger automobile" — is subject to the heightened substantiation requirements under section 274(d). See § 280F(d)(4) (defining "listed property").[32]

The Court concludes that the taxpayers didn't come close to substantiating the claimed depreciation:

> Petitioners failed to substantiate the cost of the Ford Explorer, when it was placed in service, the business percentage use of the vehicle, and the previously allowed depreciation. Accordingly, we sustain the

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[29] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[30] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[31] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[32] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

> disallowance of a deduction for depreciation for both 2013 and 2014.[33]

Partnership Didn't Own Two Properties

The Ford Explorer wasn't the only item that the couple attempted to report on the partnership return that wasn't owned by the partnership. As the Court noted:

> For 2013 and 2014 Magnet reported income, expenses, and resulting losses of $3,662 and $5,100 for 2013 and 2014, respectively, for the properties in Athens and Snellville. However, petitioners owned these properties in their individual capacities, not Magnet. Petitioners did not provide any evidence to show that Magnet was entitled to deduct these losses. Accordingly, petitioners are not entitled to deduct them as flowthrough losses.[34]

In a footnote the Court noted the taxpayers failed to argue that, if the properties weren't partnership property, they should be able to report the loss on their own return—and why it wouldn't have mattered if they had made that argument:

> Nor have petitioners claimed that they should be allowed to deduct Schedule E losses in those amounts; and even if they had, for the reasons set forth below they would not be entitled to them.[35]

Lack of Documentation of Basis for Partnership Interests

Things don't get better for the taxpayers when the Court turns to the partnership losses. The Court begins by noting that no losses could have been allowed, regardless of other issues the Court will discuss, because the taxpayers provided no evidence of their basis in their partnership interests:

> Pursuant to section 704(d) "[a] partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred." Petitioners formed Magnet on February 8, 2007, and they provided no evidence showing their basis for 2013 or 2014. Because there is no evidence of petitioners' adjusted bases, they are not entitled to deduct losses from Magnet for 2013 and 2014.[36]

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[33] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[34] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[35] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[36] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

Also Missing Documentation of At Risk Amount

The Court continued pointing out the many ways the taxpayers were going to be unable to claim any losses, this time pointing out that they did not show they had enough at risk to claim any losses from the partnership.

> Pursuant to section 465(a) taxpayers are entitled to losses from rental real estate only to the extent of the aggregate amount with respect to which the taxpayer is at risk for such activity at the close of the year. Amounts considered at risk include (1) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity and (2) borrowed funds that the taxpayer is personally liable for or has pledged property for the borrowed amount. § 465(b). Petitioners failed to show that any amounts in respect of their rental real estate activities were at risk.[37]

Passive Activity Loss Problem

The final area the Tax Court decision looks at that would also deny any deduction relates to the passive loss rules of IRC §469.

The opinion first provides the basic rules applicable to passive activities:

> Taxpayers may deduct costs for certain business and investment expenses under section 162. If the taxpayer is an individual, section 469 generally disallows any passive activity loss deduction for the taxable year and treats it as a deduction or credit for the next taxable year. § 469(a) and (b). A passive activity loss is defined as the excess of the aggregate losses from all passive activities for the taxable year over the aggregate income from all passive activities for that year. § 469(d)(1).
>
> A passive activity is any trade or business in which the taxpayer does not materially participate. § 469(c)(1). A taxpayer is treated as materially participating in an activity only if his or her involvement in the operations of the activity is regular, continuous, and substantial. § 469(h)(1).[38]

The opinion then notes that, under the law, a rental activity generally is considered a passive activity:

> Rental activity is generally treated as a per se passive activity regardless of whether the taxpayer materially participates. § 469(c)(2). A taxpayer

[37] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[38] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

> who actively participates in a rental real estate activity can deduct a maximum loss of up to $25,000 per year (subject to phaseout limitations) related to the activity. § 469(i)(1)–(3).[39]

However, a provision enacted after the Tax Reform Act of 1986 brought the passive activity rules into the law carved out an exception to this default passive treatment for a taxpayer who qualifies as a real estate professional:

> Section 469(c)(7) provides an exception to the general rule that a rental activity is per se passive. The rental activities of a taxpayer in a real property trade or business (a real estate professional) are not subject to the per se rule of section 469(c)(2). § 469(c)(7); see *Kosonen v. Commissioner*, T.C. Memo. 2000-107, slip op. at 9; Treas. Reg. § 1.469-9(b)(6), (c)(1).[40]

To be a real estate professional, the taxpayer must satisfy two tests for the tax year:

> A taxpayer qualifies as a real estate professional if: (1) more than one-half of the personal services performed in trades and businesses by the taxpayer during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates and (2) the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. § 469(c)(7)(B). Section 469(c)(7)(C) provides that "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." In the case of a joint return the above requirements are satisfied if either spouse separately satisfied these requirements. § 469(c)(7)(B)[41]

But being a real estate professional by itself does not make a taxpayers' rental real estate activities nonpassive. Rather, the taxpayer now is permitted to show material participation and only then will the activity or activities be treated as non-passive:

> Rather, the rental activities of a real estate professional are subject to the material participation requirements of section 469(c)(1). See Treas. Reg. § 1.469-9(e)(1).[42]

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[39] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[40] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[41] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[42] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

A taxpayer thus must meet the requirements to show material participation in the activity or activities to be able to treat the losses as not subject to the §469 limits:

> A taxpayer is considered to have materially participated in an activity if one of the seven tests listed in the regulations is satisfied. Temp. Treas. Reg. § 1.469-5T(a). A taxpayer may establish hours of participation by any reasonable means. *Id.* para. (f)(4). Contemporaneous daily reports are not required if the taxpayer can establish participation by other reasonable means. *Id*. Reasonable means include "appointment books, calendars, or narrative summaries" that identify the services performed and "the approximate number of hours spent performing such services." Id. We have noted previously that we are not required to accept a postevent "ballpark guesstimate" or the unverified, undocumented testimony of taxpayers. See, e.g., *Moss v. Commissioner*, 135 T.C. 365, 369 (2010).[43]

For a married couple filing a joint return, the hours tests are different for qualifying as materially participating in the activity vs. qualifying as a real estate professional:

> If a taxpayer is married, activity by the taxpayer's spouse counts in determining "material participation" by the taxpayer. See § 469(h)(5); Temp. Treas. Reg. § 1.469-5T(f)(3). Spousal attribution may not be used for the purpose of satisfying the 750-hour annual service requirement. See *Oderio v. Commissioner*, T.C. Memo. 2014-39, at *6.[44]

The Court then takes note of the records the taxpayers did present to document the hours they had been involved in the rentals:

> In 2013 and 2014 both petitioners worked full-time jobs unrelated to real estate. They provided logs that purported to show their collective rental real estate activities during that time. The logs show 767 hours worked in 2013 and 407 hours worked in 2014; however, the logs do not specify which petitioner worked these hours. Moreover, the hours recorded in the logs are inflated because petitioners included not only hours spent performing activities related to rental real estate, but also the hours they spent physically present at the properties.[45]

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[43] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[44] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[45] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

The Court first points out that the taxpayers had failed to show either of them had met the requirements to be a real estate professional for either year:

> Petitioners contend that they both spent more than one-half of the personal services they performed in a trade or business in a real property trades or business. We disagree. Both petitioners had full-time jobs unrelated to real estate. The evidence does not support the conclusion that half of their time was spent performing services in real property trades or businesses.
>
> Petitioners further contend that they met the 750-hour requirement. To meet this requirement only one spouse needs to have reached the 750-hour mark. See § 469(c)(7)(B). Petitioners have not shown that either of them met the material participation requirements; therefore, neither petitioner qualifies as a real estate professional.[46]

The Court also notes that the taxpayers did not show material participation in their rental activities. By failing to make the election to treat all rentals as a single activity, the taxpayers were faced with showing material participation separately for each rental:

> A taxpayer's material participation in a rental real estate activity is considered separately with respect to each rental property unless the taxpayer makes an election to treat all interests in rental real estate as a single rental real estate activity. § 469(c)(7)(A); Treas. Reg. § 1.469-9(e)(1). A taxpayer makes the election by "filing a statement with the taxpayer's original income tax return for the taxable year." Treas. Reg. § 1.469-9(g)(3). There is no evidence that petitioners made an election for either 2013 or 2014 to treat all their rental real estate activities as one activity.[47]

The Court then points out that the taxpayers had not met the requirements that would have been necessary to show material participation in their rental activities:

> Nor have they shown that they met one of the seven requirements of Temporary Treasury Regulation § 1.469-5T(a). The logs provide vague and misleading estimates of time spent on the rental properties. We cannot conclude from the logs that either petitioner performed more than 500 hours during the taxable year and that their participation in the activities was not less than the participation of any other individual (including individuals who are not owners of interests in the activities) for such year. See *id.* subpara. (1). Even if we were to find that petitioners met the 100-hour requirement described in Temporary Treasury Regulation § 1.469-5T(a)(3), they have not

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[46] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022
[47] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

shown that either Ms. Calhoun or Augusta Partners worked less than 100 hours.[48]

[48] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022