Introduction to Passive Activity Loss Issues Relating to Real Estate Transactions
A. §469: Passive Activity Loss Limitations

1. §469(a) provides a general rule that passive activity losses are not allowed to offset income from non-passive activities. If the passive activity losses are not deducted in the current tax year, then they are carried forward indefinitely. The passive activity losses can only be offset against passive income.

2. §469(c) generally defines a passive activity as:
   a. Any activity which involves the conduct of a trade or business in which the taxpayer does not materially participate, and
   b. Any rental activity regardless of the level of participation.

3. The law provides a general rule that after the taxpayer has classified all items of passive rental income and loss, the excess passive losses cannot offset income from active and portfolio sources.

4. §469(a)(2) provides that passive loss rules apply to individuals, estates, trusts, closely-held corporations, and personal service corporations.

5. Although passive activity losses cannot be used to offset income from non-passive activities, passive losses are allowed to offset income or net profit from other passive activities.

6. There is an exception to the general rule that excess passive losses cannot offset other sources of income. There is a maximum $25,000 special allowance for rental real estate activities with active participation which allows additional losses even if the losses exceed passive income.

7. Losses associated with passive activities that are disallowed because of the passive loss limitation rules are "suspended" and carried forward indefinitely. They are treated as a passive activity deduction in subsequent years.

8. “Suspended” passive activity losses are also allowed to be deducted in full in the tax year that the entire interest in the passive activity is disposed of and the transaction results in a fully taxable event.
9. **§469(i)** provides special relief and allows taxpayers to offset up to **$25,000** of non-passive income by utilizing losses from rental real estate activities.

10. In order to qualify for the **$25,000 special allowance** for rental real estate the taxpayer must:

   a. be a **natural person** (an individual or his estate for the tax years ending less than two years after the date of his death);
   b. have a **10% ownership interest** in the rental real estate activity at all times during the tax year; and
   c. **actively participate** in the rental real estate activity.

11. The **$25,000 special allowance** is phased out by a reduction equal to **50%** of the taxpayer's **modified adjusted gross income in excess of $100,000**.

   **Tax Professional Note**: Married taxpayers filing **separately** must reduce the allowance from $25,000 to **$12,500** and also reduce the **modified AGI** from $100,000 to **$50,000**. Even after these amounts are reduced the taxpayers must live apart for the **entire** year in order to be eligible for the special allowance of **$12,500**. If they did not live apart for the **entire** year, then the allowance is **zero**.

12. **§469(i)(3)(F)** defines modified adjusted gross income as AGI computed without regard to:

   a. **§86** Taxable social security or railroad retirement benefits income
   b. **§135** U.S. Bond interest exclusion for qualified education
   c. **§137** Employer adoption assistance exclusion
   d. **§164(f)** Deduction for one-half of self-employment tax
   e. **§199** Domestic production activities deduction
   f. **§219** IRA or SEP contributions
   g. **§221** Student loan interest deduction
   h. **§222** Tuition and fees deduction
   i. **§469** Any passive losses
   j. **§469** Any overall loss from a publicly traded partnership (PTP)
   k. **§469** Any real estate losses allowable under the real estate professional rules
EXAMPLE #1: Ennis T. Pea has $35,000 in losses from rental property in which there is active participation in the management of such property. His AGI is $90,000 before the $35,000 loss on the rental property computed as follows:

- **Calculation of Modified AGI:**
  
  Gross income $140,000  
  Less: adjustments ( 50,000)  
  AGI $ 90,000  
  
  Regular AGI before considering passive activities $ 90,000  
  
  Plus: §469(i)(3)(F) modifications 50,000  
  Modified AGI $140,000

- **Calculation of allowable and suspended PAL:**
  
  Total rental loss $35,000  
  AGI phase-out ceiling $150,000  
  Less: modified AGI  (140,000)  
  Excess 10,000  
  Statutory phase-out percentage x 50%  
  Allowable rental real estate PAL  
  in current year ( 5,000)  
  Suspended PAL carried forward $30,000

EXAMPLE #2: In the current tax year Ennis T. Pea had a salary of $120,000 and a $31,000 loss from rental real estate activities in which he actively participated. His current year special real estate allowance and carryforward of PAL is calculated as follows:

Modified AGI..............................................................$120,000  

  Less: Amount not subject to phase out rules ........................................ (100,000)  
  Excess subject to phase-out provision .................................................... 20,000  
  Statutory phase-out percentage .................................................................50%  
  Required reduction to special allowance ............................................... $10,000  
  
  Maximum special ....................................................................................... $25,000  
  Less: Required reduction to special allowance ........................................ (10,000)  
  Adjusted special allowance for current year ............................................... $15,000  
  
  Total PAL from rental............................................................................... $31,000  
  Less: Adjusted special allowance in current year..................................... (15,000)  
  Suspended PAL carried forward ............................................................... $16,000
B. Active Participation in Rental Real Estate Activities

1. The difference between active participation and material participation is that active participation can be satisfied without regular, continuous, and substantial involvement in operations as long as the taxpayer participates in the making of management decisions in a significant and bona fide sense.

2. In this context, relevant management decisions include such decisions as approving new tenants, deciding on rental terms, and approving capital or repair expenditures.

3. The $25,000 special allowance is available after all active participation rental losses and gains are netted against each other and applied to other passive income.

4. If a taxpayer has a real estate rental loss in excess of the amount that can be deducted under the real estate rental exception, then that excess is treated as a passive loss.

**EXAMPLE:** Ennis T. Pea has $90,000 of modified AGI before considering rental activities and has $85,000 of losses from a real estate rental activity in which he actively participates. He also actively participates in another real estate rental activity from which he has $25,000 of profits.

He has other passive income of $36,000 from investments in limited partnerships. The net rental loss of $60,000 is offset by the $36,000 of passive income, leaving $24,000 that can be deducted against other income as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rental real estate losses with active participation</td>
<td>$(85,000)</td>
</tr>
<tr>
<td>Rental real estate profits with active participation</td>
<td>25,000</td>
</tr>
<tr>
<td>Net rental real estate active participation</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Other passive activity income</td>
<td>36,000</td>
</tr>
<tr>
<td>Net passive rental losses available</td>
<td>$(24,000)</td>
</tr>
</tbody>
</table>
C. Real Estate Professionals and the Exception to the Annual $25,000 Special Allowance Limitation

1. §469(c)(7)(A) provides special rules for taxpayers in a real property business. This is an exception to the general rule that real estate is a “passive activity.”

2. If the taxpayer qualifies as a “real estate professional” and materially participates in the specific separate rental real estate activity, then the activity is not treated as passive.

3. §469(c)(7)(B) defines a "real estate professional" as a taxpayer who meets both of the following tests:
   a. More than one-half of the personal services performed in a trades or businesses by the taxpayer during the tax year are performed in real property trades or businesses in which the taxpayer materially participates, and
   b. Such taxpayer performs more than 750 hours of services during the taxable year in real estate trades or businesses in which the taxpayer materially participates.

   Tax Professional Note: Any services that are performed as an employee in a real estate trade or business do not count toward the tests unless the taxpayer is an employee who owns 5% or greater of the business.

4. If the taxpayer files a joint return, then the spouse's personal services are not included in determining meeting these qualifications.

5. §469(c)(7)(C) defines a real estate trade or business as any real property trade or business that involves:
   a. Development,
   b. Redevelopment,
   c. Construction,
   d. Reconstruction,
   e. Acquisition,
   f. Conversion,
   g. Rental,
   h. Operation,
   i. Management,
   j. Leasing, or
   k. Brokerage.
EXAMPLE #1: Laura owns a real estate sales office in which she materially participates. She also personally owns 3 rental real estate properties in which she materially participates. The net rental losses for these properties is **$26,000** and her *modified AGI* is **$150,000** before the losses. Because the real estate sales office qualifies as a real estate trade or business the **$26,000** of active real estate losses are fully deductible in the current year against her other sources of income.

EXAMPLE #2: Same details as in Example #1 above except one of the properties that she owns is owned with 2 other investors who are the active participants. Although Laura is a natural person and owns 10% or more of the interest in the rental activity at all times during the tax year she cannot deduct the losses from that specific rental activity since she is not a material participant.

**Tax Professional Note:** Review the court cases in sections N and O in this chapter for tax court cases distinguishing real estate agents who attempt to qualify as real estate professionals. Section N is the *Agarwal* case and Section O is the *Bahas* case.

**D. Self-Rental Rule Issues**

1. While the exception to the general rule provides that passive income can offset a passive activity loss (PAL), there is an *exception* for the taxpayer who creates their own passive income generator (PIG).

**EXAMPLE:** Don has **$17,000** of suspended passive activity losses from two rental properties in which he actively participates. At the same time he owns a building which he rents to his corporation at a fair market rent and has net rental income of **$20,000**. At first blush it would appear that the **$17,000** of passive rental losses would be freed up by the $20,000 of commercial rental income. However, because of IRS *Reg. 1.469-2(f)(6)* Don has “self-rental” income because he owns more than 50% of his corporation. As a result the **$17,000** of suspended PALS from the other two properties remains suspended and the **$20,000** is reported as non-passive rental income on Schedule E in the current tax year.
**Tax Professional Note:** Review the *Beecher* case presented in Section P of this chapter.

**E. Disposition of a Passive Activity via Sale**

1. When a taxpayer disposes of the *entire* interest in a passive activity, the actual economic gain or loss on the investment can be determined.

2. Under the passive loss rules, when there is a **fully taxable disposition**, any loss from the activity is recognized and allowed against any other source of income.

3. A **fully taxable disposition** generally includes a sale of the property to a third party at arms' length. Gain recognized upon a transfer of an interest in a passive activity generally is treated as passive and is first offset by the prior **suspended PAL** from that activity.

**EXAMPLE:** Don sold an apartment house with an adjusted basis of $100,000 for **$180,000**. In addition, Don has a suspended **PAL** associated with that specific apartment house of **$60,000**. The **recognized** capital gain of **$80,000**, allowable **suspended PAL** of **$60,000** and the net **recognized** gain, **$20,000**, are calculated and reported as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales price</td>
<td>$180,000</td>
</tr>
<tr>
<td><strong>Less:</strong> Adjusted basis</td>
<td>(100,000)</td>
</tr>
<tr>
<td><em>Recognized</em> capital gain on sale</td>
<td>$ 80,000</td>
</tr>
<tr>
<td><strong>Less:</strong> Allowable suspended <strong>PAL</strong></td>
<td>(60,000)</td>
</tr>
<tr>
<td>Net <strong>recognized</strong> income</td>
<td><strong>$ 20,000</strong></td>
</tr>
</tbody>
</table>

Because the **suspended PAL** retains its character, the **$60,000** allowable suspended **PAL** is now offset against Don's other ordinary income and portfolio income.

**Tax Professional Reminder:** The gain on the sale of the passive activity could include **§1250** unrecaptured depreciation which will be subject to a maximum long-term capital gain rate of **25%** reported on *Schedule D* page 2, line 19.
4. If the current and suspended losses of the disposed passive activity exceed the gain realized on the sale, then any loss from the activity for the tax year and any loss realized on the disposition in excess of net income or gain for the tax year from all passive activities is treated as a loss that is not from a passive activity.

EXAMPLE: Don sold an apartment house with an adjusted basis of $100,000 for $150,000. In addition, Don has current and suspended losses associated with that specific apartment house of $60,000 and has no other passive activities. The recognized capital gain, $50,000, allowable suspended PAL of $60,000, and the net recognized loss, $10,000, are calculated and reported as follows:

Sales price $150,000
Less: Adjusted basis (100,000)

Recognized capital gain $ 50,000 Schedule D

Less: Allowable suspended PAL (60,000) Schedule E

Net recognized loss on sale $ (10,000) Net effect on AGI

Because the suspended PAL retains its character, the $60,000 allowable suspended PAL is now offset against Don's other ordinary income and portfolio income.

F. Disposition of a Passive Activity at Death

1. §469(g)(2) provides that a transfer of a taxpayer's interest in a passive activity by reason of the taxpayer's death results in a suspended PAL being allowed to the decedent to the extent that the PAL exceeds the amount of the step-up in basis allowed under §1014.

2. A suspended PAL is lost to the extent of the amount of the §1014 basis increase. Any excess allowed is reported on the final Form 1040 of the deceased taxpayer.
**EXAMPLE #1:** A taxpayer dies with passive activity property having an adjusted basis of $40,000, suspended PAL of $10,000, and a fair market value at the date of the decedent's death of $75,000. The §1014 step-up in basis is $35,000. The $10,000 suspended PAL is not deductible on the decedent's Final 1040 because the suspended PAL of $10,000 did not exceed the §1014 step-up in basis $35,000.

Fair market value on date of death ........................................... $75,000

Less: Adjusted basis of passive activity property ............... (40,000)

§1014 Step-up .......................................................................... $35,000

Suspended PAL ...................................................................... $10,000

Less: §1014 Step-up ......................................................... (35,000)

Deductible on final Form 1040 ............................................. $ 0

**EXAMPLE #2:** A taxpayer dies with a passive activity property having an adjusted basis of $40,000, suspended PAL of $10,000, and a fair market value at the date of the decedent's death of $47,000. Since the basis increase under §1014 would be only $7,000, the suspended PAL allowed is limited to $3,000. The $3,000 loss available to the decedent is reported on the decedent's final income tax return.

Fair market value on date of death ........................................ $47,000

Less: Adjusted basis of passive activity property ............... (40,000)

§1014 Step-up in basis ............................................................... $ 7,000

Suspended PAL ...................................................................... (10,000)

Less: §1014 Step-up ................................................................. 7,000

Deductible on final Form 1040 .................................................. $ 3,000

3. The §469(g)(2) provision is an activity by activity test and the determination of how much suspended passive activity loss is allowed as a deduction on the final Form 1040 of the decedent must be individually measured and not a cumulative calculation.
EXAMPLE #3: Based on all the data in Examples #1 and #2 above the calculation would be as follows:

Fair market value on date of death $75,000 $47,000  
Less: Adjusted basis (40,000) (40,000) 
§1014 Step-up $35,000 $7,000  
Suspension PAL $10,000 $10,000 
Less: §1014 Step-up (35,000) (7,000) 
Deductible on final Form 1040 $-0- $3,000

G. Disposition of a Passive Activity by Gift

1. §469(j)(6) provides that in a disposition of a taxpayer's interest in a passive activity by a gift, the suspended PAL is added to the basis of the property to the donee.

EXAMPLE: Don makes a gift of real property with a cost of $60,000 and an adjusted basis of $40,000. There is a suspended PAL of $10,000. The fair market value at the date of the gift is $100,000. Don cannot deduct the suspended PAL in the year of the transfer. Instead, the suspended PAL is transferred with the property and is added to the adjusted basis of the gifted property. The donee's adjusted basis for purposes of sale is $50,000 calculated as follows:

Donor’s basis on date of gift................................................................. $40,000  
Add: Transferred suspended PAL .................................................. 10,000  
Donee’s adjusted basis for sale......................................................... $50,000

Tax Professional Note: This increase to basis is only for the purpose of determining the donee's gain or loss on the sale of the passive activity. The basis for depreciation is a carryover from the donor. Therefore, the donee's basis for purposes of depreciation remains at $60,000. Also, since this is a gift, the donee retains the donor's holding period, accumulated depreciation and method of depreciation.
H. Transfer of a Passive Activity Due To Divorce

1. §1041(a) provides that no gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of) a:
   a. spouse, or
   b. former spouse, but only if the transfer is incident to a divorce.

2. §1041(b) provides that the property acquired by the transferee spouse is deemed to be acquired by gift; therefore the receiving spouse has a carryover basis in the property received.

3. Because of the carryover rule of §1041 and the §469(j)(6) provision of a disposition of a passive activity by gift the recipient spouse receives a carryover basis in a suspended passive loss.

**EXAMPLE**: John and Mary jointly own a rental property that has an accumulated suspended **PAL** of $20,000 on the date of their divorce. Mary transfers her ownership interest to John. The original cost of the property was $150,000 and the accumulated depreciation is $50,000. The FMV on the date of the divorce is $200,000. When Mary transfers the property she does not recognize any gain or loss. When John receives Mary's $1/2 ownership interest he has a carryover of her basis and her method of depreciation. He also receives her $1/2 interest in the **PAL** which is added to his adjusted basis only for purposes of gain or loss on the disposition of the property.

- It is important to note that his basis does not increase for purposes of calculating depreciation.
<table>
<thead>
<tr>
<th></th>
<th>Mary</th>
<th>John</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cost</strong></td>
<td>$75,000</td>
<td>$75,000</td>
<td>$150,000</td>
</tr>
<tr>
<td><strong>Less: Depreciation</strong></td>
<td>(25,000)</td>
<td>(25,000)</td>
<td>(50,000)</td>
</tr>
<tr>
<td><strong>Adjusted basis</strong></td>
<td>$50,000</td>
<td>$50,000</td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Suspended PAL</strong></td>
<td>($10,000)</td>
<td>($10,000)</td>
<td>($20,000)</td>
</tr>
</tbody>
</table>

Original ½ Cost – John ............................................................... $75,000
Original ½ Cost – Mary .............................................................. 75,000

Basis for depreciation .............................................................. $150,000

Less: Depreciation ½ John ......................................................... (25,000)
Depreciation ½ Mary ................................................................. (25,000)

Adjusted basis to John before Mary’s PAL .................................... $100,000
Add: ½ Mary’s suspended PAL ..................................................... 10,000
Adjusted basis for disposition by John ......................................... $110,000

John’s suspended PAL (retains character) ...................................... ($10,000)

I. Disposition of a Passive Activity via Installment Sale

1. §469(g)(3) provides that an installment sale of a taxpayer's *entire* interest in a passive activity triggers the recognition of the suspended losses.

2. The losses are allowed in each year of the installment obligation in the ratio that the gain recognized in each year bears to the total gain on the sale.

**EXAMPLE:** Don sold his *entire* interest in a passive activity for $100,000. His adjusted basis in the property was $60,000.

Sale price $100,000

Less: Adjusted basis (60,000)

Gross profit $40,000

If Don uses the installment method, then his gross profit ratio is 40% ($40,000/$100,000).

Gross profit $40,000 = 40%
Selling price $100,000
If Don received a $20,000 down payment, then he would recognize a gain of $8,000 (40% of $20,000). If the activity had a suspended loss of $25,000, then Don would deduct $5,000 [($8,000 ÷ $40,000) x $25,000] of the suspended loss in the first year.

\[
\text{PAL} \quad \frac{$25,000}{\text{Total gain}} \times \frac{$8,000}{\text{Current year gain}} = \frac{$5,000}{\text{Total gain}} $40,000
\]

**TAX PROFESSIONAL ALERT**: If the property had been depreciable real estate and §1250 unrecaptured depreciation must be recognized as part of the sale, then the regulations require that §1250 gain is recognized before the §1231 gain. Therefore, if in the above example there was $20,000 of §1250 unrecaptured depreciation, then all of the $8,000 recognized gain would be taxed as §1250 gain which has a maximum capital gain rate of 25% instead of 15% or 20%. Therefore as the installment note proceeds are received the next $12,000 of gain recognized would also be §1250 unrecaptured depreciation. The §1231 gain at 15% or 20% is not recognized until all §1250 gain is included in gross income by the taxpayer.

**J. Sale of a Passive Activity to a Related Party**

1. While the law provides a general rule that the disposition of a passive activity in a fully taxable event will allow the use of the PAL, there is also an exception to the release of the PAL if the property is sold to a related party.

2. In this event the seller keeps the suspended PAL suspended until the activity is either:
   a. Disposed of in a taxable event by the related party to a nonrelated party, or
   b. The taxpayer has other sources of passive income.

3. For purposes of this test a related party is defined under the provisions of §267(b) which includes ancestors, descendants, brothers, sisters and spouse. It also includes an entity in which the taxpayer has a greater than 50% ownership interest.
EXAMPLE: Don sells a rental property in which he has a suspended PAL of $40,000 to his daughter. Don recognizes a $50,000 long-term capital gain on the property of which $37,000 is §1250 unrecaptured depreciation. Because his daughter is a related party, Don must recognize his gains without the allowance of the $40,000 PAL in the year of sale. If the daughter does not sell the property until after Don’s death, then the PAL is lost at the time of death. As a result Don can only use his losses if he has other passive income from other activities during his lifetime.

K. Passive Activity Changes to Active Participation

1. §469(f) provides that if a former passive activity changes to active, then the suspended PAL is allowed to the extent of income from the now active investment.

2. If any of the suspended PAL remains, then it continues to be treated as a loss from a passive activity.

3. The excess suspended PAL can be deducted from passive income or carried over to the next tax year and deducted to the extent of income from the now active business in the succeeding year(s). The activity must continue to be the same activity.

EXAMPLE: Don owns 3 separate rental real estate activities. He actively participates in 2 of the activities but not the 3rd activity. The 3rd activity has a suspended passive loss of $15,000 at the end of 2014. On January 1, 2015 he changes from not active to an active participant and incurs another $4,000 PAL in 2015 for a total loss of $19,000. He is eligible to deduct up to $25,000 of PAL under the general rule. However, for the current year his PAL deduction will be limited to $4,000. His suspended PAL of $15,000 remains suspended until he has passive income from any passive activity in a future period.
L. § 1031 Deferred Like-Kind Exchange Transactions and the Treatment of a Suspended PAL

1. In a deferred like-kind exchange transaction, the taxpayer keeps the suspended losses, which generally become deductible when the acquired property is sold.

2. Since the activities of the old and new properties are both like-kind properties the suspended losses cannot be used and therefore stay suspended at the time of the exchange.

**EXAMPLE: In a §1031 exchange, a taxpayer exchanges a duplex (rental activity) for an apartment house. The suspended PAL from the duplex is deductible against future taxable income from the apartment house. The same rental activity exists for the apartment house because the apartment house is used in a rental activity.**

M. Utilizing Passive Losses

1. A taxpayer who has a suspended passive activity loss (PAL) should adopt a strategy of generating passive activity income that can be sheltered by the existing passive loss. One planning approach is to acquire an interest in any passive activity that is generating income. This is referred to as a "passive income generator" (PIG).

2. As a result, the PAL can offset income from the PIG. From a tax perspective, it would be unwise to buy a loss-generating passive activity (PAL) unless one has other passive income (PIG) to shelter, or the activity is rental real estate that can qualify for the $25,000 exception.

3. A taxpayer with an existing suspended PAL might consider buying a rental property. If a large down payment is made or there is no debt at all, then a passive net income could be realized to offset the PAL.

4. Future gain realized upon the sale of the rental property could be sheltered by existing suspended passive losses.
5. Taxpayers with passive losses should consider all other trades or businesses in which they have an interest. If they show that they do not materially participate in the activity, then the activity becomes a passive activity.

**Tax Professional Note:** Any income generated could be sheltered by existing passive losses and suspended losses. Family partnerships in which certain members do not materially participate would qualify. The silent partner in any general partnership engaged in a trade or business would also qualify.

**Tax Professional Research Recommendation:** For more information refer to IRS Publication 925 Passive Activity and Risk Rules and **IRS Form 8582**.

**N. Tax Court Rules Real Estate Agent Equals Real Estate Professional (Shri and Sudha Agarwal vs Commissioner T.C. Summary Opinion 2009-29)**

**Docket No. 12670-072. Filed March 2, 2009**

This case was heard pursuant to the provisions of §7463 in effect when the petition was filed. Pursuant to §7463(b), the decision to be entered is not reviewable by any other court, and this opinion shall not be treated as precedent for any other case.

**Facts**

1. The IRS determined deficiencies of $15,066 and $6,649 in taxpayers’ 2001 and 2002 Federal income taxes, respectively. The IRS also determined accuracy-related penalties under §6662(a) of $3,013.20 and $1,329.80 for 2001 and 2002, respectively.

2. The issue for decision was whether the taxpayers were entitled to deduct losses of $40,104 and $19,656 for 2001 and 2002, respectively, as qualifying taxpayers in real property trades or businesses on **Schedule E**.

**Background of the Case**

1. During 2001 and 2002 Shri Agarwal (Mr. Agarwal) worked full time as an engineer. During 2001 and 2002 Sudha Agarwal (Mrs. Agarwal) worked full time as a real estate agent at “Century 21 Albert Foulad Realty” (brokerage firm). The brokerage firm is a licensed broker under California law. The brokerage firm is franchised by a broker, Albert Foulad.
2. During 2001 and 2002 Mrs. Agarwal was licensed as a real estate agent under California law; she was not licensed as a broker. She worked for a brokerage firm pursuant to an “Independent Contractor Agreement (Between Broker and Associate Licensee)”.

3. The contract provided that she was an independent contractor, not an employee of the brokerage firm. Consistent with Mrs. Agarwal’s independent contractor status, the brokerage firm issued a Form 1099 to her for each year, and it did not pay her a salary; rather, she received commissions. The contract also required Mrs. Agarwal to sell, exchange, lease, or rent properties and solicit additional listings, clients, and customers diligently and with her best efforts.

4. During 2001 and 2002 the taxpayers owned two rental properties. Together they spent approximately 170 hours managing the “Wanda Property” and approximately 170 hours managing the “Mohave Property” during 2001 and 2002. They were the only persons who managed their rental properties. Mrs. Agarwal spent a total of 1,400 and 1,600 hours managing the rental properties and selling real estate in 2001 and 2002, respectively.

5. For 2001 Mrs. Agarwal reported commissions of $13,912 as gross receipts on her Schedule C. She also reported total expense of $14,084 for a $172 loss with respect to her Schedule C real estate business.

6. For 2002 she reported commissions of $14,119 as gross receipts on Schedule C and total expenses of $13,401 for a profit of $718.

7. For 2001 taxpayers reported total rents of $36,367 on Schedule E. They also reported total expenses of $76,472 for a loss of $40,105. For 2002 they reported total rents of $45,521 on Schedule E and total expenses of $65,177 for a $19,656 loss.
8. In the notice of deficiency issued the IRS disallowed the **Schedule E** losses for each year because:

   a. Passive losses are allowed only to the extent that they qualify for the special allowance for rental real estate; and

   b. Taxpayer’s losses were in excess of their passive income, the special allowance and the phase-in rule.

**Taxpayers’ Losses and Application of §469**

1. **§469(a)** generally disallows any passive activity loss. **§469(d)(1)** provides that a passive activity loss is defined as the excess of the aggregate losses over the aggregate income from all passive activities.

2. **§469(c)(1)(6)** provides that a passive activity is any trade or business or an activity engaged in for the production of income in which the taxpayer does not materially participate.

3. **§469(b)** provides that material participation means that the taxpayer is involved in the activity’s operations on a regular, continuous and substantial basis. (See also **§1.469-5T(a)**, (Feb. 25, 1988) an individual is treated as materially participating if the individual satisfies any one of the seven enumerated tests).

4. **§469(c)(2)** provides a general rule that a rental activity is treated as a passive activity regardless of whether the taxpayer materially participates. But under **§469(c)(7)**, rental activities of a qualifying taxpayer in a real property trade or business are not passive activities under **§469(c)(2)**. Kosonen v. Commissioner, T.C. Memo. 2000-107. Rather, the qualifying taxpayer’s rental activities are treated as a trade or business subject to the material participation requirements of **§469(c)(1)** Fowler v. Commissioner, T.C. Memo. 2002-223; **§1.469-9(e)(1)**.

5. **§469(h)(5)** provides that in determining whether a taxpayer materially participates, the participation of the taxpayer’s spouse is taken into account.
6. §469(c)(7)(B)(i) and (ii) provide that a taxpayer may qualify for the real property trade or business exception if:

a. *More than one-half* of the personal services performed in trades or businesses by the taxpayer during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates; and

b. 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) provides that in the case of a joint return, either spouse must satisfy both requirements.

7. §469(c)(7)(C) defines the term “real property trade or business” as “any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.”

The Parties’ Arguments

1. Taxpayers argued that real estate agents should be considered real estate professionals because real estate agents are engaged in a real property brokerage business in that real estate agents “bring together buyers and sellers.”

2. In reply, the IRS argued that Mrs. Agarwal was a licensed real estate agent, not a licensed real estate broker. Therefore, under California law, according to the IRS, Mrs. Agarwal could not be engaged in a brokerage trade or business, and therefore, she was not engaged in a real property trade or business as defined by §469(c)(7)(C).

Brokerage Defined

a. “Statutory words are uniformly presumed, unless the contrary appears, to be used in their ordinary and usual sense, and with the meaning commonly attributed to them.” Caminetti v. United States, 242 U.S. 470, 485-486 (1917).

b. In addition, a statutory term is construed “in its context and in light of the terms surrounding it.” Leocal v. Ashcraft, 543 U.S. 1, 9 (2004); see also Jarecki v. G. D. Searle & Co., 367 U.S. 303, 307 (1961) (“a word is known by the company it keeps”).


2. The Court concluded that Congress is presumed to have defined the term “brokerage” in its common or ordinary meaning. The Court further concluded that for purpose of §469, the “business” of a real estate broker includes, but is not limited to:

a. Selling, exchanging, purchasing, renting, or leasing real property;

b. Offering to do those activities;

c. Negotiating the terms of a real estate contract;

d. Listing real property for sale, lease, or exchange; or

e. Procuring prospective sellers, purchasers, lessors, or lessees.

Application of the Definition to Mrs. Agarwal’s Activities

1. The Courts stated that as is relevant here, California law defines the term “real estate broker” as a person who does, or negotiates to do, any one of the enumerated activities for compensation. Cal. Bus. & Prof. §10131 (West 2008).

2. Similarly, California law also defines the term “real estate salesman” as a person who is employed by a broker and who does any one of the enumerated activities. Cal. Bus. & Prof. §10131 (West 2008).

3. But whether Mrs. Agarwal is characterized a broker or a salesperson for State law purposes is irrelevant for Federal income tax purposes because the test is whether she was engaged in “brokerage” within the meaning of §469. Consistent with her real estate salesman’s license and pursuant to her contract with the brokerage firm, Mrs. Agarwal was engaged in “brokerage”; i.e., she sold, exchanged, leased, or rented real property and solicited listings. Therefore, Mrs. Agarwal was engaged in a “brokerage” trade or business within the meaning of §469(c)(7)(C).

4. Because Mrs. Agarwal owned an interest in a rental property, performed more than one-half of her personal services in real property trades or businesses in which she materially participated, and performed more than 750 hours of services in real property trades or businesses in which she materially participated, she is a qualifying taxpayer. §469(c)(7) and §1.469-9(b)(6), (c)(1).
5. Because Mrs. Agarwal is a qualifying taxpayer and she materially participated with respect to each property, the taxpayers are entitled to deduct their 2001 and 2002 Schedule E losses. (§469(c)(7) and §1.469-9(e)(1), (3), (4) Example (1), §1.469-5T(a), supra (defining material participation); see also Fowler v. Commissioner, T.C. Memo. 2002-223; Shaw v. Commissioner, T.C. Memo. 2002-35.

Accuracy Related Penalty

1. §6664(c)(1) provides an exception to the §6662(a) penalty: no penalty is imposed with respect to any portion of an underpayment if it is shown that there was reasonable cause and the taxpayer acted in good faith.

2. §1.6664-4(b)(1) incorporates a facts and circumstances test to determine whether the taxpayer acted with reasonable cause and in good faith.

3. The most important factor is the extent of the taxpayer’s effort to assess the proper tax liability. “Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge, and education of the taxpayer.”


Tax Court Summary Opinion Passive Activities: Real Estate Agent

A licensed real estate agent did not qualify for the exception to the passive activity loss rules for taxpayers in a real property business as provided in §469(c)(7). Therefore, she and her husband were not entitled to passive activity deductions during the years at issue for three rental properties they jointly owned and managed. She did not establish that she worked for more than 750 hours each year with respect to the properties. The hours she worked at a real estate corporation did not qualify as hours worked in a real property trade or business. In addition, she did not meet the 5-percent ownership requirement of §469(c)(7)(D)(ii).
Pursuant to §7643(b), This Opinion May Not Be Treated As Precedent for Any Other Case.

This case was heard pursuant to the provisions of §7463. Pursuant to §7463(b), the decision to be entered is not reviewable by any other court, and this opinion shall not be treated as precedent for any other case.

The IRS determined:

- A deficiency in petitioners’ Federal income tax of $9,560 and §6662(a) penalty of $1,912 for 2006.
- The sole issue for decision was whether taxpayers were entitled to claimed losses of $36,617 for 2006 and $10,874 for 2007 from rental real estate property. Resolution of this issue depends upon whether §469(c)(7) applies to the rental real estate activities of Mrs. Bahas.

Background of Case

1. During 2006 and 2007 Mrs. Bahas was a licensed real estate agent, and Mr. Bahas designed computer networks as a technical applications manager. Mrs. Bahas worked full-time for Snyder & Snyder Real Estate, Inc. which for tax purposes elected to be treated as an S Corporation. Barbara Snyder owned all the stock of Snyder & Snyder.

2. On December 22, 2004, Mrs. Bahas and Ms. Snyder entered into an employment agreement. At the time Mrs. Bahas did not have a real estate license. Pursuant to that agreement, Mrs. Bahas was hired to be the office manager and Ms. Snyder’s assistant. She received an hourly wage ($7.50 per hour) for her duties as the office manager. As the assistant to Ms. Snyder, Mrs. Bahas received the same $7.50 hourly wage “during normal business hours” but no hourly wage “outside of normal business hours.” However, she was entitled to receive “10% of the gross sales of Barbara Snyder on a bi-weekly basis.”
3. Starting January 1, 2006, by which date it was assumed Mrs. Bahas would be a licensed real estate agent, Mrs. Bahas would receive (as a licensed real estate agent assistant to Ms. Snyder) “6 percent of the net profits of Snyder & Snyder to be paid once a year upon completion of the company’s tax return.” According to pay stubs she received from Snyder & Snyder, Mrs. Bahas worked there during 2006 for 1,759.5 hours and during 2007 for 1,869.5 hours.

4. During 2006 and 2007 Mr. & Mrs. Bahas jointly owned and managed three rental properties in Akron, Ohio. Their ownership of these properties was not related to Mrs. Bahas’s employment at Snyder & Snyder. Taxpayers spent less than 750 hours managing these properties during each of 2006 and 2007.

5. Taxpayers filed tax returns for 2006 and 2007 and reported a loss of $39,154 for 2006 and a loss of $12,195 for 2007 in connection with their rental properties.

6. IRS determined that:
   a. the losses claimed from their rental properties were passive activity losses;
   b. had no passive activity income against which these rental losses could be offset;
   c. did not meet the requirements of §469(c)(7); and
   d. $2,537 of the rental loss claimed for 2006 (and none for 2007) was allowable.

Burden Of Proof

1. In general, the Commissioner’s determinations set forth in a notice of deficiency are presumed correct, and the taxpayer bears the burden of proving that the determinations are incorrect.
2. §7491(a) provides that under certain circumstances, the burden of proof with respect to factual matters shifts to the Commissioner. Taxpayers neither alleged nor proved that this section is herein applicable. Therefore, the taxpayers bear the burden of proof.

Rental Losses

1. §469(a) provides a general rule that the deduction of passive activity losses is suspended.

2. §469(c)(1) defines a passive activity as any activity:
   a. which involves the conduct of any trade or business, and
   b. in which the taxpayer does not materially participate.

3. §469(d)(1) provides that a passive activity loss is defined as the amount by which:
   a. the aggregate losses from all passive activities for the taxable year exceed
   b. the aggregate income from all passive activities for such year.

4. §469(c)(2)-(4) provides that a rental real estate activity is generally treated as a passive activity without regard to whether the taxpayer materially participates in the activity.

5. §469(i) provides an exception to the general rule where the taxpayer is an individual and actively participates in rental real estate activities. The individual may deduct up to $25,000 of losses subject to a phase out if the individual’s adjusted gross income exceeds $100,000.

6. §469(c)(7)(B) provides another exception where the taxpayer is a real estate professional who materially participates in a real property trade or business. A taxpayer qualifies if:
   a. 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
b. 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.

7. In the case of a joint return, the exception applies if either spouse separately satisfies both requirements.

8. §469(h)(1) provides that a taxpayer is treated as materially participating in a real property activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous and substantial.

9. Mrs. Bahas maintains that she was engaged in a real property business in 2006 and 2007 because she worked more than 750 hours per year as a licensed real estate agent assistant for Ms. Snyder. She asserts that she actively showed and sold houses to home buyers as an agent for Snyder & Snyder and therefore should be able to use the hours from Snyder and Snyder to make the 750 hours.

10. The hours Mrs. Bahas worked at Snyder & Snyder do not qualify as hours worked in a real property trade or business for purposes of §469(c)(7)(B)(ii).

§469(c)(7)(B)(ii) provides that for purposes of subparagraph (B), personal services performed as an employee shall not be treated as performed in real property trades or businesses unless the employee owns more than 5% of the value of the company.

11. Relying on IRS Publication 925, Mrs. Bahas argued that because she was entitled to receive 6 percent of Snyder & Snyder’s net profits as compensation for her efforts as a licensed real estate assistant, she owned more than a 5-percent profits interest in Snyder & Snyder. Mrs. Bahas claims her position is supported by a passage on page 5 of IRS Publication 925 which stated:

Do not count personal services you performed as an employee in real property trades or businesses unless you were a 5% owner of your employer. You were a 5% owner if you owned (or are considered to have owned) more than 5% of your employer’s outstanding stock, outstanding voting stock or capital or profits interest.
12. Mrs. Bahas’s position is flawed. Snyder & Snyder is an Ohio corporation, owned entirely by Ms. Snyder. A 5-percent owner for purposes of §469(c)(7)(D)(ii) is defined in §416(i)(1)(B)(i), which provides:

a. if the employer is a corporation, then any person who owns (or is considered as owning within the meaning of §318) more than 5 percent of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation, or

b. if the employer is not a corporation, then any person who owns more than 5 percent of the capital or profits interest in the employer.

13. Mrs. Bahas’s employment agreement does not provide for the transfer of any stock to her. Her right to 6 percent of the net profits of Snyder & Snyder would terminate should her employment with Snyder & Snyder cease. Therefore, Mrs. Bahas’s employment agreement with Snyder & Snyder only defined how Mrs. Bahas would be compensated for services rendered; i.e., her compensation would be based, in part, on the profits of the company. Therefore, the court concluded that Mrs. Bahas did not meet the 5-percent ownership requirement of §469(c)(7)(D)(ii).


Affirming the tax court, the Ninth Circuit Court of Appeals has upheld the validity of §469 regulations recharacterizing self-rental income as nonpassive for purposes of the passive activity loss (PAL) rules. As a result, the taxpayers could not use losses from their rental properties to offset rental income earned from their wholly-owned businesses.

Tax Professional Reminder: The Ninth Circuit joins the Seventh (Krukowski, CA7, 89 AFTR 2d 2002-827), First (Sidell, CA1, 86 AFTR 2d 2000-6229, and Fifth Circuits (Fransen, CA5, 84 AFTR 2d 99-6360) in upholding the validity of the self-rental recharacterization rule.
Background:

1. Under §469, losses from a passive activity can be used only to offset passive activity income, not income from other sources such as salary and dividends. §469(l) gives IRS authority to prescribe “such regulations as may be necessary or appropriate to carry out provisions of this section.

2. The recharacterization or self-rental rule of Reg. §1.469-2(f)(6), provides that income from rental realty is not passive income if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the tax year.

   **Tax Professional Education Point:** The self-rental rule blocks a taxpayer with passive activity losses from one activity from artificially creating passive activity income from another activity in order to absorb the losses.

3. The regulations treat a taxpayer as participating in a C corporation subject to the PAL rules (i.e., a C corporation that is closely held), so the self-rental recharacterization rule applies if the taxpayer rents property he owns to a closely held C corporation in which he materially participates. (Reg. §1.469-11(c)(1)(ii))

Facts:

1. Gary Beecher wholly-owned and worked full-time for a C corporation in the business of repairing auto interiors, and his wife, Dolores, wholly-owned and worked full-time for another C corporation in the business of removing dents from autos.

2. Both corporations’ offices were located in the Beechers’ home. The corporations paid the Beechers rent for the use of this office space.

3. In addition to renting this portion of their home, the Beechers also owned five rental properties. On their 1997, 1998 and 1999 returns, the Beechers reported net income from leasing office space to their C corporations of $39,307, $23,387 and $22,160, respectively. During these years, the combined losses from the five other rental properties exceeded the income derived from their office leases.
4. On their 1997 through 1999 returns, the Beechers offset the losses from the rental properties against the income from the office leases and, as a result, paid no tax on the rental income paid to them by their corporations.

5. IRS said the offset was not allowed under the recharacterization rule in Reg. §1.469-11(c)(1)(ii), and the Tax Court agreed. The Beechers appealed to the Ninth Circuit but lost again.

Ninth Circuit upholds Self-Rental Rule. Affirming the tax court, the Ninth Circuit held that IRS’s interpretation of §469 in Reg. §1.469-11(c)(1)(ii) was valid and was supported by the legislative history of §469. The Ninth Circuit rejected the Beechers’ claim that Congress’ delegation of authority to issue the self-rental rule was unconstitutional. It also rejected the Beechers’ claim that §469(1) was enacted to combat abusive transactions and therefore should not apply to their situation.

Chapter III Interactive Self-Study Questions

1. Which of the following statements is correct with regards to the exception to the annual $25,000 special allowance limitation for passive activity losses?

   a. Any employee of a real estate firm may deduct unlimited passive losses, as long as this employee works at least 750 hours selling real estate during the year.

   b. If the taxpayer does not meet the 750 hour requirement, the spouse’s hours worked can be used to meet the requirement to deduct unlimited losses.

   c. A real estate professional who materially participates and performs more than 750 hours in real estate trades may deduct unlimited passive losses from rental activities.

   d. All of the above.
Answer:

a. is incorrect: Any services that are performed as an employee in a real estate trade or business do not count toward the tests unless the taxpayer is an employee who owns 5% or greater of the business.

b. is incorrect: If the taxpayer files a joint return then the spouse's personal services are not included in determining meeting these qualifications.

c. is correct: §469(c)(7)(B) defines a "real estate professional" as one who meets both of the following tests:

- more than 50% of the personal services performed in trades or business by the taxpayer during the tax year are performed in real property trades or businesses in which the taxpayer materially participates,

and

- such taxpayer performs more than 750 hours of services during the tax year in real estate trades or businesses in which the taxpayer materially participates.

2. A taxpayer with sells rental property for $150,000. The property has an adjusted basis of $120,000. The property also has a suspended Passive Activity Loss of $50,000. What is the net effect on AGI on Form 1040?

a. $30,000 increase  
b. $30,000 decrease  
c. $20,000 increase  
d. $20,000 decrease
**Answer:**

d. is the **correct** answer:

Sales price $150,000

**Less:** Adjusted Basis $120,000

*Recognized* capital gain $30,000 **Schedule D**

**Less:** Allowable suspended PAL $(50,000) **Schedule E**

Net *recognized* effect on sale $(20,000) **Net Effect on AGI**

Because the *suspended* PAL retains its character, the $50,000 allowable suspended PAL is now offset against other ordinary income and portfolio income.

3. A taxpayer sold rental property with an adjusted basis of $100,000 for $180,000. The taxpayer’s return from the prior year showed $60,000 of suspended passive activity losses carrying over to the current tax year. What is the net taxable effect on the current year’s tax return?

a. $20,000 increase

b. $60,000 decrease

c. $80,000 increase

d. None of the above

**Answer:**

Choice “a” is **correct**:

Net sales price $180,000

**Less:** Adjusted basis $(100,000)

*Recognized* capital gain on sale $80,000 **Schedule D**

**Less:** Allowable suspended PAL $(60,000) **Schedule E**

Net recognized effect $20,000 **Net Effect on AGI**

b. is incorrect. The $60,000 PAL is allowed to offset ordinary income and reported on Schedule E.

c. is incorrect. $80,000 is the realized gain from the sale, but is offset by the $60,000 PAL.