Chief Counsel Advice Memoranda 201428008

Interactions of sections 469(g) and 121 of the Internal Revenue Code.

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ISSUE

What is the treatment of suspended passive activity losses from a passive rental activity, formerly used as a taxpayer's principal residence, under *§ 469 of the Internal Revenue Code* (Code), if gain from the sale of the property to an unrelated party is excluded from the taxpayer's gross income under *§ 121 of the Code*?

CONCLUSION

Gain excluded from gross income under *§ 121 of the Code* is not an item of passive activity gross income for purposes of *§ 469*. Therefore, the excluded gain does not offset suspended passive activity losses. To the extent that the losses from the rental activity, including the suspended passive activity losses, exceed any net income or gain for the taxable year of [*2] the disposition from all other passive activities, the losses will be treated as not from a passive activity.

FACTS

Individual A buys a principal residence for $700,000 and owns and uses the residence as his principal residence for 2 years before converting the residence into a rental property. Individual A then converts the property to a rental activity that is A's only passive activity for purposes of *§ 469*. During each year that the property is rented, it produces $10,000 net losses that are disallowed as passive losses under *§ 469(a)*. Within three years of renting the property, A sells the entire property to an unrelated third party for $800,000, realizing a net gain on the sale of $100,000 (not taking into account the $30,000 suspended passive losses). A's $100,000 of gain from the sale of the property is excluded from A's gross income as provided under *§ 121(a)*.

LAW

Section 469(a) of the Code provides, in part, that the passive activity loss of an individual shall not be allowed. *Section 469(b)* provides, in part, that a loss from an activity disallowed under *§ 469(a)* is treated as a deduction allocable to such activity in the next taxable year. Such disallowed losses are commonly [*3] referred to as "suspended passive activity losses."

Section 469(g)(1)(A) of the Code provides that if a taxpayer sells his entire interest in a passive activity to an unrelated party, and all gain or loss realized is recognized, then the excess of any loss from such activity for such taxable year over any net income or gain for such taxable year from all other passive activities shall be treated as a loss which is not from a passive activity.

Section 1.469-2T(c)(1) of the Income Tax Regulations (regulations) provides except as otherwise provided in the regulations under *§ 469*, passive activity gross income for a taxable year includes an item of gross income if and only if such income is from a passive activity.

Section 1.469-2T(c)(2)(i)(A) of the regulations provides that except as otherwise provided in the regulations under *§ 469*, any gain recognized upon the sale, exchange, or other disposition (a "disposition") of an interest in property used in an activity at the time of the disposition:

(1) The gain is treated as gross income from such activity for the taxable year or years in which it is recognized;

(2) If the activity is a passive activity of the taxpayer for the taxable year of the [*4] disposition, the gain is treated as passive activity gross income for the taxable year or years in which it is recognized; and

(3) If the activity is not a passive activity of the taxpayer for the taxable year of the disposition, the gain is treated as not from a passive activity.

Section 61(a)(3) of the Code provides, that except as otherwise provided, gross income means all income from whatever source derived, including gains derived from dealings in property.

Section 1001(a) of the Code provides the gain from the sale of other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in *§ 1011* for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

Section 1001(c) of the Code provides that except as otherwise provided, the entire amount of the gain or loss determined under this section on the sale or exchange of property shall be recognized.

Section 1.1002-1(b) of the regulations provides, in part, that the exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general [*5] and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception.

Section 1.1002-1(c) provides, in part, that exceptions to the general rule are made, for example, by *§§ 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035* and *1036*. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial.

Section 1.1002-1(d) of the regulations provides that ordinarily, to constitute an exchange, there must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

Section 121(a) provides that gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property

has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

Section 121(b) provides, in part, that the amount of gain excluded from gross income under *subsection (a)* with [*6] respect to any sale or exchange shall not exceed $250,000 (or $500,000 in the case of a husband and wife filing a joint return).

ANALYSIS

Section 121 is an exclusion provision for gain realized under *§1001(a)* and recognized under *§ 1001(c)*. Specifically, *§121(a)* provides "gross income shall not include gain from the sale or exchange."

Section 121 is not a nonrecognition provision for property exchanges. Nonrecognition Code sections generally provide "no gain or loss shall be recognized." The sale of a principal residence is not an exchange of reciprocal property in which particular differences exist between the property parted with, and the property acquired, but such differences are more formal than substantial. Rather a sale of a principal residence is a transfer of property for money consideration and, as such, gain realized on the sale is recognized in the year of the sale. *Section 121* is simply an exclusion provision for gain that is realized and recognized in the year of sale.

In these facts, because $100,000 of gain realized is recognized upon the sale of Individual A's entire interest in a passive activity to an unrelated party, *§ 469(g)(1)(A)* applies. Therefore, to the extent [*7] that that the suspended passive activity losses exceed any net income or gain for the taxable year of the disposition from all other passive activities, the $30,000 losses will be treated as not from a passive activity under *§ 469(g)(1)(A)*. Because the $100,000 gain on the sale of the residence is excluded from Individual A's gross income under *§ 121*, it is not an item of passive activity gross income for purposes of *§ 469*. Therefore, the excluded gain from the sale will not offset the $30,000 suspended passive activity losses from the property.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call (202) 317-6850 if you have any further questions.

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