Passive Losses

Agarwal, TC Summary Opinion 2009-29 (March 2, 2009)

Victory For A California Real Estate Salesperson

Key Facts

- She is a full time California licensed real estate salesperson (not a broker).
- She and her husband (an engineer) spent 170 hours managing each of the two rental properties.
- "They were the only persons who managed their rental properties."

Sec. 469(c)(7)

A rental activity is not per se passive if:

1) more than one-half of the personal services performed …are performed in real property trades or businesses in which the taxpayer materially participates, and
2) 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.

…the term "real property trade or business" means any real property …brokerage trade or business. (Sec. 469(c)(7)(C))

IRS Argument

- IRS argued that because Mrs. Agarwal was a licensed real estate agent and not a licensed real estate broker, under California law, she 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 section 469(c)(7)(C).

Holding: She Is In The Real Estate Business

- Whether Mrs. Agarwal is characterized as a broker or a salesperson for California (State law) purposes is irrelevant for federal income tax purposes.
- "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."

Holding – The Rental Loss is Nonpassive

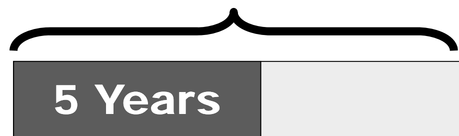
- "Because Mrs. Agarwal is a qualifying taxpayer and she materially participated with respect to each property, petitioners are entitled to deduct their 2001 and 2002 Schedule E losses."
- Although not discussed by the Tax Court, the Agarwals apparently met the Sec 1.469-5T(a)(3) test: "the individual participates more than 100 hours..and such individual's participation…is not less than …any other individual.

TAM 200911009 (Nov. 24, 2008)

Material Participation By Retired Surviving Spouse of Retired Farmer

Sec. 469(h)(3)

Look-Back Rule: 5 out of 10



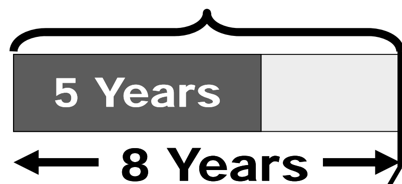
H Materially Participates

469(h)(3)

Section 469(h)(3) provides that a taxpayer shall be treated as materially participating in any farming activity for a taxable year if …section 2032A(b) would cause the requirements of § 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity if such taxpayer had died during the taxable year.

Retired Farmers

Look-Back Rule: 5 out of 8

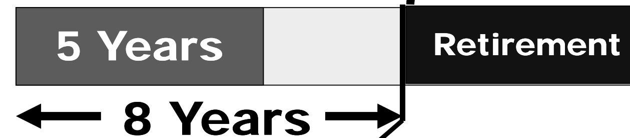


H Retires

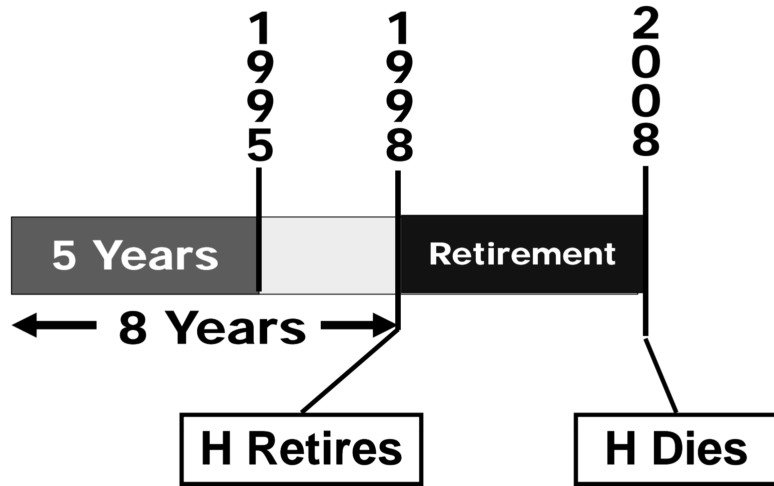
Begins collecting Social Security

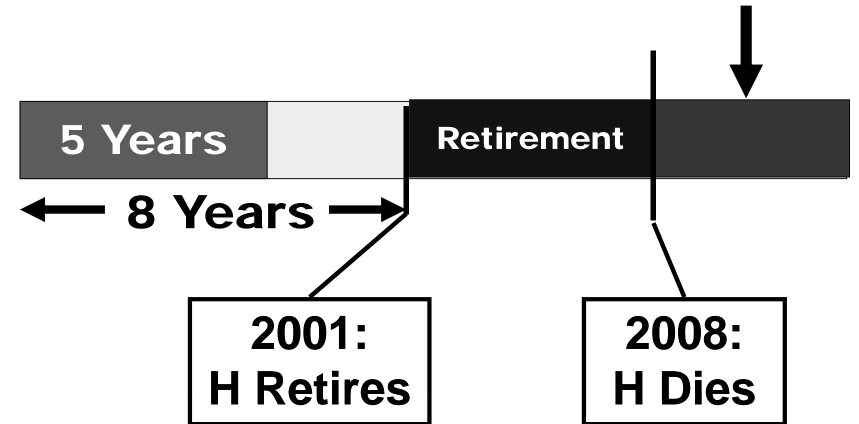
Actual Material Particip'n

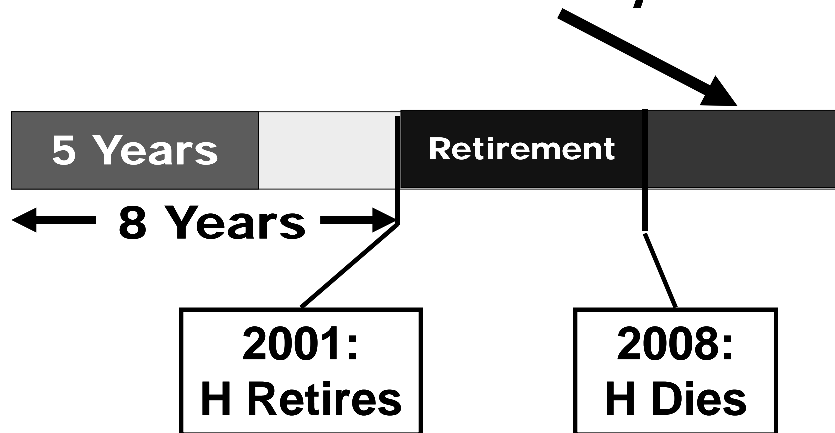
Material Participation Look-Back Continues



H Retires







Garnett v. Comm'r **(2009), 132 TC No. 19 (June 30, 2009)**
Thompson v. U.S., 104 AFTR 2d ¶2009-5124 **(Ct Fed Cl 7/20/2009)**

LLC and LLP Interest NOT A Limited Partnership Interest For PAL Purposes

Hegarty v. Comm'r, TC Summary Opinion 2009-153 (Oct. 6, 2009)

Taxpayers Meet The More Than 100 Hour PAL Test Applied To LLC Interest

Key Facts

- In 2003, Mr. and Mrs. Hegarty formed Blue Marlin, LLC, a Maryland limited liability company, with each owning a 50% interest (treated as a partnership).
- Blue Marlin was organized to conduct a charter fishing business using a 46-foot luxury cruiser.
- The couple's participation in the business exceeded 100 hours during 2003.
- They were the only individuals who participated in the business.

Holding

- The Tax Court again rejected the IRS view that an LLC member is to be treated like a limited partner for purposes of determining material participation under Sec. 469.
- The Tax Court was satisfied that the Hegartys participated in the business for more than 100 hours during 2003, and that their participation was not less than the participation of any other individual during that year.

Builthouse v. U.S., Seventh Circuit January 15, 2009

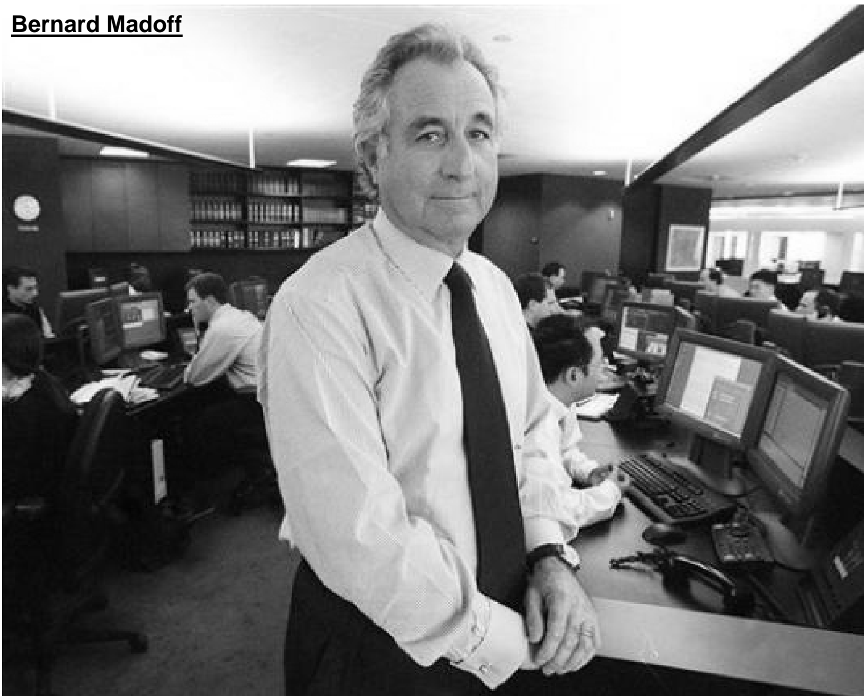
Stock Worthless in 1995, Not 1997

Holding

- The Seventh Circuit rejected the taxpayers' argument that their stock (an S Corporation) in a construction company was worthless in 1997.
- The court agreed with the IRS that the stock was worthless in 1995, despite some continuing efforts by the company.

Charles Ponzi

Bernard Madoff



5-12

Relief For Ponzi Scheme Victims

Revenue Ruling 2009-9
Revenue Procedure 2009-20

Rev. Rul. 2009-9 Holdings 1 - 5

Scope – Holding 1

1) Is a loss from criminal fraud or embezzlement in a transaction entered into for profit a theft loss or a capital loss?

   The theft loss is an ordinary loss (unlike open market stock purchases involving cooked books--Rev. Rul. 77-17).

Rev. Rul. 2009-9 – Holding 2

2) Sec. 165(c)(2) Controls. Deductible as a "loss incurred in a transaction entered into for profit"--Sec. 165(c)(2), not (c)(3).

Rev Rul 2009-9

Because a Sec. 165(c)(2) theft loss:

- No \$100 (\$500 in 2009) cut nor 10% of AGI cut.
- The related legal fees and accounting fees relating to recovery of the stolen property are also deductible under Sec. 165(c)(2) as part of the theft. See *Ginesky*, TC Memo 1994-551.

Rev. Rul. 2009-9 – Holding 3

3) Year of Discovery and Recovery Potential. It may be difficult to establish:

- Year of discovery, and
- The absence of a "reasonable prospect of recovery"

Rev. Rul. 2009-9 – Holding 4

Amount of Theft Loss for a "fraudulent investment arrangement":

Initial investment

\+ Additional investments

\+ Income reported in years before discovery (even if closed by the statute of limitations)

\- Withdrawals

\- Reimbursements or claims with a reasonable prospect of recovery

= Theft Loss

Rev. Rul. 2009-9: Good News/Bad News

- Good news, the theft loss is allowed even for bogus income reported in years closed by the statute of limitations.
- Bad news, the IRS disagrees with the filing of amended returns (removing the bogus income) for pre-discovery years.

Rev. Rul. 2009-9

5) NOL Treatment: The theft loss can create or increase an NOL.

The NOL arising from casualty or theft may be carried back 3 years (instead of 2) and forward 20 years. (§172(b)(1)(F))

Rev. Proc. 2009-20

Losses for which the discovery year is a taxable year beginning after December 31, 2007.

"Specified Fraudulent Arrangement"

A specified fraudulent arrangement is an arrangement in which a party (the lead figure) receives cash or property from investors; purports to earn income for the investors; reports income amounts to the investors that are partially or wholly fictitious; makes payments…

Rev. Proc. 2009-20 -- Concessions

"The Service will not challenge the following treatment by the qualified investor of a qualified loss":

1) The loss is a theft loss.

2) A qualified investor's discovery year is the taxable year of the investor in which the indictment, information, or complaint described in section 4.02 of [Rev Proc 2009-20] is filed.

Rev. Proc. 2009-20 -- Concessions

3) Amount Deductible:

- 95% if no pursuit of 3rd parties.
- 75% if pursuit of 3rd parties.

Minus: actual recovery plus potential insurance or SIPC (Securities Investor Protection Corporation) recovery.

Rev. Proc. 2009-20 -- Conditions

The Taxpayer agrees in a statement attached to the return:

1) No deduction in the discovery year in excess of the loss allowed by the Rev Proc 2009-20.
2) Not to file amended returns to exclude or recharacterize income reported with respect to the investment arrangement in taxable years preceding the discovery year.
3) Not to apply the Sec 1341 claim of right doctrine.
4) Not to apply the doctrine of equitable recoupment or the mitigation provisions in §§ 1311-1314.

Rev. Rul. 2009-9 Holdings 6 & 7

Rev. Rul. 2009-9– Holding 6

6) No Sec 1341 Relief. When a Ponzi scheme victim incurs a loss in a transaction entered into for profit, any theft loss deduction to which the victim may be entitled does not arise from an obligation on the victim's part to restore income. Therefore, the victim is not entitled to the tax benefits of §1341 with regard to victim's theft loss deduction.

Rev. Rul. 2009-9– Holding 7

7) Sections 1311 – 1314. The IRS position in the closed year (income) is not inconsistent with open years because the IRS allows basis for the bogus income to increase the theft loss in the year of discovery.

Alternative Strategy

- **For claw-back payments (return of fradulent conveyances), argue Sec. 1341 relief applies.**

  In CCA 200808019 IRS allowed Sec 1341 relief to a taxpayer who paid back profits earned (and reported on Form 1040) in violation of SEC rule 16(b).

- **Claiming Sec 1341 sacrifices Rev Proc 2009-20 relief.**

Greenberg T.C. Memo 1996-281

- **IRS argued that "that because the trustee in bankruptcy labeled the [Ponzi scheme] payments …as interest on Forms 1099-INT, such payments constitute income."**
- **The taxpayer argued that the money "received from [the fraudster] in 1990 does not represent interest income, but rather payments made to conceal a fraud."**
- **The Tax Court agreed with the taxpayer and concluded that the payments were a tax free return of capital, not income.**

Alternative Strategy

- **For actual withdrawals, argue "open transaction" doctrine return of capital.**
  - **See CCA 200451030**

  "Retroactive recharacterization of [Ponzi scheme] payments as a return of capital under an "open transaction" theory, once the fraud was discovered, **is not warranted**; the appropriate form of cost recovery in such a situation is generally a bad debt or theft loss deduction."

Compare Greenberg

IRS Information Letter 2009-0154 Relief For Indirect Investors

- **The letter observes that most hedge funds are organized as partnerships.**
- **Theft losses of a partnership are determined at the entity level, and partners deduct their ratable share of such losses as reflected on Schedule K-1.**

IRS Information Letter 2009-0154 Relief For Indirect Investors

- The letter also addressed investors whose stolen investments were in IRAs or similar tax-deferred investment vehicles.

  They can take a miscellaneous itemized deduction to the extent they have unrecovered basis after their entire interest in the plan or IRA is distributed.

IRS Fact Sheet 2009-8

Law Changes Related To National Disaster Relief

LMSB-4-0309-010 (June 2009)

LMSB Directive on Business Casualty Losses

Greif (Feb. 2009)

Contractor Negligence Not a Casualty

IRS Response to Letter From Members of Congress (July 2009)

Chief Counsel Supports Casualty Loss For Faulty "Chinese Drywall"

***Rohrs v. Comm'r*, T.C. Summ. 2009-190 (12/10/09)**

Casualty Loss Deduction Allowed to Drunk Driver

Rohr Facts

While driving with a blood-alcohol level of .09 percent (.08 is the California legal limit), Mr. Rohr failed to negotiate a turn and rolled his truck over. The truck was severely damaged. He was cited and arrested for driving under the influence of alcohol (DUI).

Reg. 1.165-7(a)(3)

"…a casualty loss occurs when… The damage results from the faulty driving of the taxpayer or other person operating the automobile but is not due to the willful act or willful negligence of the taxpayer or of one acting in his behalf, …"

Tax Court: Not Gross Negligence

"We agree with petitioner that his actions did not amount to willful or gross negligence. While petitioner's decision to drive after drinking was negligent, that alone does not automatically rise to the level of gross negligence."