

# TAX UPDATE

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## **A Defining Moment—Brokerage Trade or Business Podcast of March 9, 2009**

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## **The Real Estate Salesperson and §469(c)(7)(C)**

In one sense, this week's case has to be approached cautiously, as it came down in a TC Summary case, a case that makes clear on the cover page on the Tax Court's postings of the cases on their website that it may not be "treated as precedent for any other case." But we can consider the legal analysis inherent in the opinion and the fact that the IRS did end up failing to convince the Tax Court of a position which reports on the California Society's TaxTalk discussion group indicate has been asserted quite often in exams in that state (and the state in which this taxpayer lived).

This week's case involves Sudha Agarwal, a real estate agent who worked full time at a Century 21 brokerage in California. Mrs. Agarwal was licensed as a real estate agent by the state of California and not as a real estate broker. In the case of *Agarwal v. Commissioner*, TC Summary 2009-29 argued that she did not meet the definition of performing her services in a real property trade or business (as defined in §469(c)(7)(C)) to make the election under §469(c)(7)(A) to ignore §469(c)(2) and test her rental real estate activities under the standard tests for a passive activity. The effect of this, when coupled with the proper grouping elections, is to often allow such individuals to deduct losses from rental activities, not having the losses blocked as passive.

## I. Passive Activities and Real Estate Professionals

We should all be aware of the general passive activity rules found in §469 that served to limit taxpayer's ability to deduct passive losses. These rules were enacted in 1986 to serve as what turned out to be a very effective block on what was prior to that date the widespread of investment activities created primarily to spin off losses to be deducted against other income of the investor—the most popular tax shelters of the day.

While as a general rule trade or business activities were tested against the amount of direct involvement a taxpayer had with the activity, rental real estate properties were subjected to special rules. Of special note today, and what was initially very upsetting to real estate professionals, was the provision below found at §469(c)(2)

(2) Passive activity includes any rental activity

Except as provided in paragraph (7), the term "passive activity" includes any rental activity.

The version of the provision that was contained in the Tax Reform Act of 1986 did not contain that first clause that referenced §469(c)(7)—rather, all rental real estate was simply defined as a passive activity. In 1993 Congress, in response to continuing complaints from those who had real estate related businesses about the basic unfairness of such a broad brush treatment against their own business, added §469(c)(7).

At §469(c)(7)(A) Congress added an exception for certain taxpayers to the broad brush treatment of real estate as passive found at §469(c)(2). It provided:

(7) Special rules for taxpayers in real property business

(A) In general

If this paragraph applies to any taxpayer for a taxable year--

(i) paragraph (2) shall not apply to any rental real estate activity of such taxpayer for such taxable year, and

(ii) this section shall be applied as if each interest of the taxpayer in rental real estate were a separate activity.

Notwithstanding clause (ii), a taxpayer may elect to treat all interests in rental real estate as one activity. Nothing in the preceding provisions of this subparagraph shall be construed as affecting the determination of whether the taxpayer materially participates with respect to any interest in a limited

partnership as a limited partner.

If the section applies the default is that each rental is treated as as a separate activity. That creates its own problem—unless an otherwise eligible individual with multiple rentals spends an awful lot of time working on each specific rental, it will be difficult to meet the requirements in the regulations for such an activity to escape passive treatment—in which case the taxpayers would quite often be right back where they started.

However, the last paragraph of §469(c)(7)(A) gives us the option to instead elect to instead group all of our rental activities as a single activity—an election that quite often is a practical necessity in order for the taxpayer to benefit from this provision.

To be a qualified taxpayer, the individual looks to the definition of an eligible taxpayer found in §469(c)(7)(B):

(B) Taxpayers to whom paragraph applies

This paragraph shall apply to a taxpayer for a taxable year if

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

(ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

In the case of a joint return, the requirements of the preceding sentence are satisfied if and only if either spouse separately satisfies such requirements. For purposes of the preceding sentence, activities in which a spouse materially participates shall be determined under subsection (h).

A taxpayer must show that more than ½ of the personal services he/she performs during a year are in a real property trade or business in which the taxpayer materially participates (so someone doing real estate work “on the side” need not apply) and that activity must amount to at least 750 hours of such work. As well, §469(c)(7)(D) contains additional restrictions for such work:

(D) Special rules for subparagraph (B)

(i) Closely held C Corporations

In the case of a closely held C corporation, the requirements of

subparagraph (B) shall be treated as met for any taxable year if more than 50 percent of the gross receipts of such corporation for such taxable year are derived from real property trades or businesses in which the corporation materially participates.

(ii) Personal services as an employee

For purposes of subparagraph (B), personal services performed as an employee shall not be treated as performed in real property trades or businesses. The preceding sentence shall not apply if such employee is a 5-percent owner (as defined in section 416(i)(1)(B) in the employer.

Neither of these provisions are relevant to today's case, though the special treatment of employees vs. owner-employees is an important “quirk” in this provision, as it represents one of the few times that the tax law grants a benefit to an individual who meets the definition of a 5-percent owner (normally that classification works against the individual whenever the IRC mentions it).

The key issue for today is determining just what is a “real property trade or business” which would qualify for this treatment. That leads us to today's provision that gets put under the microscope--§469(c)(7)(C)

(C) Real property trade or business

For purposes of this paragraph, the term "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

The last item in this list is the one that today's case deals with—that of participating in a brokerage trade or business. The IRS has been reported to have been asserting regularly on examination that since state license real estate brokers, to be performing services in a brokerage trade or business, one must be a licensed broker as opposed to being a licensed real estate agent. As we'll discover, at least in this case the Tax Court did not accept that assertion.

## II. The Case

As noted initially, this is a Tax Court Summary opinion and, as such, does not directly have precedential value. But it certainly is a case of interest, especially in a market that now has become “more challenging” in real estate and for which we now have a five year net operating loss carryback provision for 2008. So the matter may carry some very real interest for many clients who are real estate agents that would like to take advantage of this provision to be able to use what may be significant rental losses they now have.

**A. The Facts**

We'll let the Tax Court's opinion outline the nature of Ms. Agarwal's business activities:

During 2001 and 2002 Sudha Agarwal (Mrs. Agarwal) worked full time as a real estate agent at "Century 21 Albert Foulad Realty" (brokerage firm).<sup>2</sup> During 2001 and 2002 Mrs. Agarwal was licensed as a real estate agent under California law; she was not a licensed as a broker.<sup>3</sup> She worked for a brokerage firm pursuant to an "Independent Contractor Agreement (Between Broker and Associate Licensee)". 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.

Given that Ms. Agarwal would be expected to have expertise in real estate and be around such properties regularly, it's not surprising to find that she and her husband owned two rental properties during the years involved—nor should it be surprising that these rentals produced tax losses for the years:

For 2001 petitioners reported total rents of \$36,367 on Schedule E. They also reported total expenses of \$76,471.78 for a \$40,104.78 loss (which they rounded down to \$40,104). For 2002 they reported total rents of \$45,521 on Schedule E and total expenses of \$65,177 for a \$19,656 loss.

The IRS on examination did not allow those losses. As noted:

In the notice of deficiency issued to petitioners, respondent disallowed their Schedule E losses for each year because: (1) Passive losses are allowed only to the extent that they qualify for the special allowance for rental real estate and the transitional phase-in rule; and (2) petitioners' losses were in excess of their passive income, the special allowance, and the phase-in rule.

**B. What is a Brokerage?**

The only real issue in dispute was whether Ms. Agarwal's activities were performed in a real property trade or business. The taxpayers said yes, but the IRS argued no.

Petitioners argue 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".

In reply, respondent argues that Mrs. Agarwal was a licensed real estate agent, not a licensed real estate broker. Thus, under California law, according to respondent, 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 section 469(c)(7)(C).

The Tax Court had to decide whether, in fact, the term we find in the IRC refers to someone possessing a state brokerage license, or whether the term has a broader level of coverage.

The Tax Court points out that words in a statute are ordinarily presumed to have the meaning commonly attributed to them. Given that, the Court goes on to observe:

A term's common or approved usage may be established by a dictionary. *Rousey v. Jacoway*, 544 U.S. 320 (2005); *Smith v. United States*, 508 U.S. 223, 228-229 (1993). Webster's Third New International Dictionary 282 (2002) defines the term "brokerage" as "the business of a broker" or "the fee or commission for transacting business as a broker." [Emphasis added.]

The opinion then goes on to outline a five activities it considers indicative of the business of a real estate broker:

The Court further concludes that for purposes of section 469, the "business" of a real estate broker includes, but is not limited to: (1) Selling, exchanging, purchasing, renting, or leasing real property; (2) offering to do those activities; (3) negotiating the terms of a real estate contract; (4) listing of real property for sale, lease, or exchange; or (5) procuring prospective sellers, purchasers, lessors, or lessees.

It then looks at the California licensing definitions which the IRS believes are controlling:

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. Code sec. 10131 (West 2008). 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. Code sec. 10132 (West 2008).

To give the IRS its due, the argument would be that clearly the state of California sees a difference between a real estate broker and a real estate salesman, a distinction many (perhaps all) states make. And since Ms. Agarwal was an independent contractor, her business was a real estate salesperson not that of a real estate broker.

But the Court did not accept that attempt to push the state law definition into this equation. Rather it stated:

But whether Mrs. Agarwal is characterized as a broker or a salesperson for State law purposes is irrelevant for Federal income tax purposes -- the test is whether she was engaged in "brokerage" within the meaning of section 469, as defined supra. 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 section 469(c)(7)(C).

The result followed from this finding, as the Court immediately went on to point out:

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. See sec. 469(c)(7); sec. 1.469-9(b)(6), (c)(1), Income Tax Regs. Because Mrs. Agarwal is a qualifying taxpayer and she materially participated with respect to each property,<sup>4</sup> petitioners are entitled to deduct their 2001 and 2002 Schedule E losses.

### C. When the Shoe is On the Other Foot

It is interesting to note that in a 2007 case involving another area of the law, the IRS had prevailed when a taxpayer tried to hide behind a state law definition used for licensing to avoid a tax consequence the taxpayer did not like. In the case of *Rainbow Tax Service, Inc. v. Commissioner*, 128 TC No. 5, the IRS argued that a taxpayer could not look to state law to determine what was "accounting" for purposes of a taxpayer being subject to the flat 35% tax applicable to personal service corporations.

In that the taxpayer was pointing to state law:

Petitioner argues that under Nevada law, accounting services can be performed only by C.P.A.s, and that because petitioner is not a C.P.A. firm,

does not employ C.P.A.s, and does not perform services which are restricted under Nevada law to C.P.A.s, petitioner should not be treated as performing accounting services.

In essence, petitioner would treat only those services which require a C.P.A. license as accounting services and would treat other tax return preparation and bookkeeping services as nonaccounting services.

That position is interestingly close to the one that the IRS was pushing in this week's case, though obviously with very different results.

Technically the *Rainbow Tax Service* court pointed out the difference between "public accounting" and "accounting," deeming what a CPA does as public accounting. But like today's case, the Court again looks to dictionary definitions for the activities, first for tax services and whether they fit the definition of accounting:

Accounting has been defined as:

the process of recording transactions in the financial records of a business and periodically extracting, sorting, and summarizing the recorded transactions to produce a set of financial records. \* \* \* [Blacks's Law Dictionary 21 (8th ed. 2004).]

Tax return preparation, which requires extracting information relating to financial transactions, analyzing that information, and then summarizing and reporting that information on a tax return, fits within the above general definition of accounting.

And then next looking at bookkeeping, the other service that Rainbow Tax Service claimed to perform that, not being restricted to CPAs under Nevada law, was not accounting:

Bookkeeping, which section 448 and the regulations thereunder do not address, has been defined elsewhere as:

a branch of accounting that deals with the systematic classification, recording, and summarizing of business and financial transactions in books of account. \* \* \* [Webster's Third New International Dictionary (1981).]

Not only does bookkeeping constitute a "branch" of accounting, but our system of double entry bookkeeping undergirds modern financial accounting.

In a footnote entry, the Court goes on to give us a history lesson in accounting history and its link to bookkeeping, noting that Luca Pacioli is deemed the “Father of Accounting” for first documenting the double entry process of bookkeeping.

### **III. Conclusions**

While the case underlying this discussion is a TC Summary case that is not to be cited as precedent, the Court gives a rather concise and, at least to this person, compelling argument that §469(c)(7)(C) should not be read so narrowly as to defer to state law licensing definitions, rather applying a “common usage” standard to determine if a real estate salesperson performs their services in a brokerage business—and answered in the affirmative.

The *Rainbow Tax Services* case is precedential (a published Tax Court opinion) that, at the IRS's behest, had previously used a very similar approach to define a term referenced in the Code which also had state law licensing issues—coming to the same conclusion that we looked to common meaning, and the taxpayers met that definition. Certainly the logic of *Rainbow Tax Services* would seem to suggest the result that a real estate salesperson might, despite not being themselves a state licensed real estate broker, nevertheless be performing such services as far as federal law is concerned. Viewed that way, the *Agarwal* opinion serves as an example of the application of the *Rainbow Tax Services* rationale to the definition found at §469(c)(7)(C).