OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE
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MEMORANDUM FOR

Attn:

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated August 18, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer	=
Year 1	=
Year 2	=
Year 3	=
V	=
W	=
$X	= $
$Y	= $
A	=

ISSUES:

1. Whether Taxpayer properly elected to treat his rental real estate activities in Year 1 and Year 2 as one activity under Internal Revenue Code section 469(c)(7)(A) and Treas. Reg. § 1.469-9(g).

2. If Taxpayer did not make a proper election under section 469(c)(7)(A), whether he substantially complied with the provisions of Treas. Reg. § 1.469-9(g) in Year 1 and Year 2, entitling him to treat his rental real estate activities as one activity under section 469(c)(7)(A).

3. If Taxpayer did not make a proper election under section 469(c)(7)(A) and has not substantially complied with Treas. Reg. §1.469-9(g), whether he can obtain a judicial extension of time to file the election for Year 1 and Year 2 without pursuing administrative relief under Treas. Reg. § 301.9100-3.

CONCLUSIONS:

1. Taxpayer failed to properly elect to treat his rental real estate activities in Year 1 and Year 2 as one activity under section 469(c)(7)(A) and Treas. Reg. § 1.469-9(g).

2. Taxpayer did not substantially comply with the provisions of Treas. Reg. § 1.469-9(g) in Year 1 or Year 2.

3. Having failed to pursue administrative relief under Treas. Reg. § 301.9100-3, Taxpayer is not entitled to a judicial extension of time to file the election for Year 1 and Year 2 under section 469(c)(7)(A).

FACTS:

During Year 1 and Year 2, Taxpayer owned several rental properties. Neither Taxpayer nor his family used the properties for personal purposes during Year 1 or Year 2.

In Year 1, Taxpayer performed V hours of personal services with respect to the rental properties. During the same year, Taxpayer performed W hours of personal services as a commercial airline pilot.

In Year 2, Taxpayer has not established the hours of personal services performed with respect to the rental properties or as a commercial airline pilot. You estimate that Taxpayer performed in excess of 750 hours of personal services with respect to the rental properties. You estimate further that more than one-half of the personal services performed by Taxpayer in trades or businesses were performed with respect to the rental activities.

On his Year 1 and Year 2 Forms 1040, Individual Income Tax Return, Taxpayer separately stated the income and expenses from each rental real estate interest on Schedule E. All properties showed a net loss. The net losses were aggregated and the total loss, $X for Year 1 and $Y for Year 2, was reported on line 17 of the Forms 1040.

In Year 2, prior to filing the Year 1 return, Taxpayer's income tax return preparer contacted A to determine the proper manner of making the election under section 469(c)(7)(A). It is not clear what information A imparted to Taxpayer's tax return preparer.

Taxpayer did not attach to his Year 1 or Year 2 income tax return a statement as required under Treas. Reg. § 1.469-9(g)(3) indicating that he elected under section 469(c)(7)(A) to treat his rental real estate activities as a single activity. Taxpayer has not requested an extension of time to make an election under the administrative relief provisions set forth in Treas. Reg. § 301.9100-3, and he has declined District Counsel's suggestion to seek such administrative relief.

Taxpayer made a valid election under section 469(c)(7)(A) in Year 3.

LAW AND ANALYSIS

ISSUE 1

In general, a taxpayer is allowed to deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 162(a). An individual is allowed to deduct all ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income; for the management, conservation or maintenance of property held for the production of income; or in connection with the determination, collection, or refund of any tax. Section 212.

An individual generally is not allowed a passive activity loss or credit. Section 469(a)(1) and (a)(2)(A). A passive activity is any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate. Section 469(c)(1). Except as provided in section 469(c)(7), a passive activity includes any rental activity regardless of whether the taxpayer materially participates in the activity. Section 469(c)(2) and (4).

If a taxpayer comes within section 469(c)(7), a rental real estate activity is not, by definition, a passive activity. Section 469(c)(7)(A)(i). Pursuant to section 469(c)(7)(A)-

> 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.

Section 469(c)(7)(B) provides, in part, that section 469(c)(7) 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.

Section 469(c)(7)(C) provides that the term "real property trade or business" means-

> any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

A taxpayer is treated as materially participating in an activity if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial. Section 469(h)(1).

A qualifying taxpayer is a taxpayer that owns at least one interest in rental real estate and meets the requirements of section 469(c)(7)(B). Treas. Reg. § 1.469-9(b)(6) and (c)(1). To make the election to treat all interests in rental real estate as a single rental real estate activity, the qualifying taxpayer must file a statement with his original income tax return for the taxable year. Treas. Reg. § 1.469-9(g)(3). The statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to section 469(c)(7)(A). Treas. Reg. § 1.469-9(g)(3).

Treas. Reg. § 1.469-9(g) was added by T.D. 8645, 1996-1 C.B. 73, and is effective for taxable years beginning on or after January 1, 1995, and to elections made under section 469(c)(7)(A) and Treas. Reg. § 1.469-9(g) with returns filed on or after January 1, 1995.[1] Accordingly, Treas. Reg. § 1.469-9(g) is applicable for Taxpayer's Year 1 and Year 2 tax years.

The Tax Court has held that a taxpayer may not retroactively make the election under section 469(c)(7)(A). If no election under section 469(c)(7) is made, the passive loss rules are applied as if each interest of the taxpayer in rental real estate were a separate activity. See Notice of Service of Transcript in Boyce v. Commissioner, No. 16091-97 (T.C. filed March 17, 1998.)

If Taxpayer met the requirements of 469(c)(7)(B),[2] his rental real estate activities were not, by definition, passive activities; however, he would have to show that he materially participated in each rental real estate activity, or, if he elected to treat all of his rental real estate interests as one activity, that he materially participated in the one activity. Taxpayer failed to make the election by filing a statement with his original income tax return for Year 1 and Year 2, as required under Treas. Reg. § 1.469-9(g)(3). Accordingly, Taxpayer is not entitled to treat his interests in rental real estate as one activity.

ISSUE 2

Substantial compliance with a regulation is sufficient when the regulation requires a procedural detail that does not go to the essence of the statute. If the requirement goes to the essence of the statute, it is mandatory and must be met. Young v. Commissioner, 783 F.2d 1201, 1205 (5th Cir. 1986), aff'g 83 T.C. 831 (1984); American Air Filter Co. v. Commissioner, 81 T.C. 709, 719 (1983); Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837, 846 (1978); Sperapani v. Commissioner, 42 T.C. 308, 331-32 (1964). To determine whether a regulatory provision setting forth how an election is to be made goes to the essence of the statute, and therefore must be literally complied with, the following factors are considered:

- Whether the taxpayer's failure to comply fully defeats the purpose of the statute;

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[1] Proposed regulations providing guidance for making an election under section 469(c)(7) were published on January 10, 1995. Prop. Treas. Reg. § 1.469-9, 60 Fed. Reg. 2557 (1995). The subparagraph in the proposed regulations addressing the election is identical to the subparagraph in the final regulation.

[2] We express no opinion as to whether Taxpayer satisfies the requirements of section 469(c)(7)(B).

- The relationship of the regulatory requirement to other provisions;
- The terms of the underlying statute;
- Whether the sanction imposed on the taxpayer for the failure is excessive and out of proportion to the default;
- Whether the taxpayer attempts to benefit from hindsight by adopting a position inconsistent with his original action or omission;
- Whether the Commissioner is prejudiced by the untimely election; and
- Whether the regulation provided with detailed specificity the manner in which an election was to be made.

American Air Filter Co., 81 T.C. at 719-20; Valdes v. Commissioner, 60 T.C. 910, 913 (1973).

Whether a taxpayer materially participates in his rental real estate activities is determined as if each interest of the taxpayer in rental real estate is a separate activity, unless the taxpayer elects under section 469(c)(7)(A) to treat all interests in rental real estate as one activity. If the taxpayer does not attach the required election statement to the return, the Service cannot otherwise discern from the return that the election was made and cannot determine whether the taxpayer needed to meet the substantive requirement of section 469(c)(7). Accordingly, the requirement to file an election under section 469(c)(7)(A) goes to the essence of the statute and must be met.

In addition, if an election is made, the election is binding for the taxable year in which it is made and for all future years in which the taxpayer is a qualifying taxpayer, even if there are intervening years in which the taxpayer is not a qualifying taxpayer. Treas. Reg. § 1.469-9(g)(1). The taxpayer may revoke the election only in the taxable year in which a material change in the taxpayer's facts and circumstances occurs or in a subsequent year in which the facts and circumstances remain materially changed from those in the taxable year for which the election was made. Treas. Reg. § 1.469-9(g)(3). To revoke the election, the taxpayer must file a statement with the taxpayer's original income tax return for the year of revocation. The statement must contain a declaration that the taxpayer is revoking the election and an explanation of the nature of the material change. Treas. Reg. § 1.469-9(g)(3).

Based on the above, the filing of an election with the taxpayer's income tax return notifies the Service of the taxpayer's intention to treat his interests in rental real estate as one activity. Whether the election is made potentially impacts the character of losses generated from the rental real estate interests and treatment of

suspended losses upon disposition of an interest for the year of election and all subsequent years until the election is revoked. See section 469(g).

Accordingly, the requirement to file an election under section 469(c)(7)(A) goes to the essence of the statute, is mandatory, and must be met. To hold otherwise

> would permit a taxpayer to make no election until he is audited and forced to make the election. In effect, taxpayers' position would reward a taxpayer who plays the "audit lottery." Thus, taxpayers have shown no justification for disregarding the Commissioner's regulation.

Notice of Service of Transcript, Boyce v. Commissioner, No. 16091-97, slip op. at 9. Because Taxpayer failed to comply with Treas. Reg. § 1.469-9(g)(3) in Year 1 and Year 2, he is not entitled to treat his rental real estate interests as one activity in those years.

Even if the court determines that substantial compliance with Treas. Reg. § 1.469-9(g)(3) is sufficient because the regulation requires a procedural detail that does not go to the essence of the statute, Taxpayer failed to substantially comply with the regulation. The courts have found substantial compliance where the filing of an election merely confirms an election that has been made in substance. While no court has addressed the election requirements set forth in Treas. Reg. § 1.469-9(g), cases addressing other elections illustrate what constitutes substantial compliance. For example, in Sperapani v. Commissioner, 42 T.C. 308 (1964), the court held that the taxpayer substantially complied with an election to have his proprietorship taxed as a corporation under section 1361 when he filed the election but failed to include some of the required information establishing that the qualifications of section 1361(b) were met and failed to include an agreement required by the regulations. In Columbia Iron & Metal Co. v. Commissioner, 61 T.C. 5 (1973), the court held that the taxpayer substantially complied with an election to treat a charitable contribution made within 2 ½ months after the close of the previous taxable year as deductible in the previous taxable year. In that case, the taxpayer claimed the deduction on its return but failed to attach a copy of the corporate minutes authorizing the contribution and the verified, written declaration of an officer of the corporation, as required by the regulations. In American Air Filter Co., 81 T.C. at 719-23, the court held that the taxpayer substantially complied with an election under section 963 where the taxpayer fulfilled the essential purpose of section 963 and its failure to file the election was a clerical omission. In Tipps v. Commissioner, 74 T.C. 458 (1980), the court held that, when a partnership included all the information required for an election under Treas. Reg. § 1.167(k)-4(b), except the per-unit information, the partnership had substantially complied with the regulations.

On his Year 1 and Year 2 income tax returns, Taxpayer separately stated the income and expenses from each rental real estate interest on three Schedules E.

All properties showed a net loss. The net losses were aggregated and the total loss, $X for Year 1 and $Y for Year 2, was reported on line 17 of each Form 1040. As filed, the Year 1 and Year 2 income tax returns are devoid of any indication that Taxpayer intended to make an election under section 469(c)(7)(A). To the contrary, the returns were filed in the same manner they would have been filed if Taxpayer had not intended to make the election. Accordingly, Taxpayer has failed to substantially comply with Treas. Reg. § 1.469-9(g)(3) and is therefore not entitled to an election under section 469(c)(7)(A). See, e.g., Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837, 846-48 (1978) (underlying requirement that an application for certification had been made to the proper State certifying authority before the return is filed relates to the essential qualification for election for rapid amortization under section 169 and is not a mere procedural detail); Dunanvant v. Commissioner, 63 T.C. 316 (1974) (failure to file election required by section 333 precluded taxpayers' use of section 333 because the election had a substantive effect on the classification of the particular individual shareholder as a "qualified electing shareholder" and on the status of every other electing individual because of an 80 percent rule in section 333(c)(1)); and Valdes, 60 T.C. at 915 (taxpayers failed to make an unequivocal election to use the extended expropriation loss carryover provisions).

The fact that Taxpayer's representative inquired as to how to make the election and that Taxpayer may have intended to make such an election is insufficient. An election under section 469(c)(7)(A) reflects the taxpayer's unequivocal agreement to take the benefits and burdens of treating all interests in rental real estate as one activity. Taxpayer failed to indicate on his Year 1 and Year 2 income tax returns that he intended to accept such benefits and burdens. See Young v. Commissioner, 783 F.2d 1201, 1206 (5th Cir. 1986), aff'g 83 T.C. 831 (1984) ("[N]ineteen bishops swearing as to taxpayers' subjective intent would not carry this argument, because it contends for an irrelevant fact. The Commissioner did not have access to the taxpayers' workpapers and was not otherwise informed of their state of mind.").

Taxpayer contends that he substantively complied with Treas. Reg. § 1.469-9(g) by combining all income and losses from his rental real estate interests on line 17 of the Year 1 and Year 2 income tax returns. Regardless of whether a taxpayer makes an election under section 469(c)(7)(A), all income and losses from rental real estate interests are reported on Schedule E, with the net income or loss aggregated and reported on line 17. Accordingly, the method used by Taxpayer to report his rental real estate interests is not indicative of whether he intended to make an election under section 469(c)(7)(A).

Taxpayer also contends that he substantively complied with Treas. Reg. § 1.469-9(g) because he treated the income and losses from the rental real estate activities as nonpassive, rather than passive. Taxpayer points out that, in the year prior to Year 1, the activities were considered passive and that he did not combine

these prior year passive losses with Year 1 and Year 2 losses. This argument does not distinguish between the *exception* under section 469(c)(7), allowing a qualified taxpayer to treat losses from rental real estate interests in which he materially participated as nonpassive, and the *election* under section 469(c)(7)(A), allowing a taxpayer to elect to treat all rental real estate interests as one activity. A taxpayer could qualify for the exception provided in section 469(c)(7) without making the election provided for in section 469(c)(7)(A).

ISSUE 3

The Commissioner, in his discretion, may grant an extension of time to file an election under section 469(c)(7). Treas. Reg. § 301.9100-3(a). To qualify for an extension, a taxpayer must establish to the satisfaction of the Commissioner that he acted reasonably and in good faith and that granting the extension will not prejudice the interests of the government. Treas. Reg. § 301.9100-3(a). A taxpayer will be deemed to have acted reasonably and in good faith if the taxpayer:

- Requests relief under Treas. Reg. § 301.9100-3 before the failure to make the regulatory election is discovered by the Service;
- Failed to make the election because of intervening events beyond the taxpayer's control;
- Failed to make the election because, after exercising reasonable diligence, the taxpayer was unaware of the necessity for the election;
- Reasonably relied on the written advice of the Service; or
- Reasonably relied on a qualified tax professional and the tax professional failed to make, or advise the taxpayer to make, the election.

Treas. Reg. § 301.9100-3(b)(1). If a taxpayer can establish that he acted reasonably and in good faith, and the extension will not prejudice the interests of the government, he must comply with the procedural requirements set forth in Treas. Reg. § 301.9100-3(e) and request a private letter ruling as provided for under Treas. Reg. § 301.9100-3(e)(5). See also Rev. Proc. 98-1, 1998-1 I.R.B. 7, Section 5.

There is insufficient information to determine if Taxpayer would be entitled to relief under Treas. Reg. § 301.9100-3. If Taxpayer chooses to pursue such relief and submit a request for a private letter ruling, he could request a continuance of his docketed case. Taxpayer has declined to seek an extension of time to file the election under section 469(c)(7) pursuant to the administrative relief provisions of

Treas. Reg. § 301.9100-3. Having failed to obtain administrative relief, Taxpayer is not entitled to a judicial extension of time to file an election.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

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