Federal Taxes Weekly Alert,

**Passive activity losses from home converted to rental don't offset excluded homesale gain**

**Chief Counsel Advice 201428008**

In Chief Counsel Advice (CCA), IRS has determined that suspended passive activity losses under Code Sec. 469 from the passive rental of a home which was formerly used as the taxpayer's principal residence, did not offset gain excluded under Code Sec. 121 on the property's sale.

**RIA observation:** This is a taxpayer-friendly result because it leaves suspended losses available to offset taxable income in the future. If IRS had reached a contrary result, the suspended losses would be wasted offsetting gain that wasn't taxable because it had already been excluded under the Code Sec. 121 homesale exclusion.

**Background on PAL rules.** Under the passive activity loss (PAL) rules, except as otherwise provided below, losses from passive activities may only be used to offset passive activity income. (Code Sec. 469(a)) Thus, such losses can't be used to offset income from, for example, compensation, interest or dividends. (Code Sec. 469(e)) Any losses that are unused in a tax year because of this rule are carried forward to the following year(s) until used (Code Sec. 469(b)), or until the taxpayer disposes of the interest in the activity (or substantially all of the activity) in a taxable transaction. (Code Sec. 469(g))

Specifically, under Code Sec. 469(g)(1)(A), if during the tax year a taxpayer disposes of his entire interest in any passive activity, and all gain or loss realized on such disposition is recognized, the excess of (a) any loss from such activity for such tax year (determined after the application of Code Sec. 469(b)), over (b) any net income or gain for such tax year from all
other passive activities (determined after the application of Code Sec. 469(b)), is treated as a loss which is not from a passive activity. The caption to Code Sec. 469(g)(1) refers to such a disposition as a “fully taxable transaction.”

Background on homesale exclusion. Under the Code Sec. 121 homesale exclusion, a taxpayer is allowed to exclude gain resulting from the sale or exchange of property if the property has been owned and used as his principal residence for periods aggregating two or more years over the 5-year period before sale. Unmarried taxpayers may exclude up to $250,000 in gain from the sale of a qualifying residence (Code Sec. 121(b)(2)(A), while married taxpayers meeting certain requirements and filing a joint return can exclude up to $500,000. (Code Sec. 121(b)(2)(A))

Facts. Albert bought a home for $700,000 and owned and used the residence as his principal residence for two years. He then converted the property to a rental activity that was his only passive activity for Code Sec. 469 purposes. During each year that the property was rented, it produced $10,000 net losses that were disallowed as passive losses under Code Sec. 469(a). Within three years of renting the property, Albert sold 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 in suspended passive losses). His $100,000 of gain from the sale of the property was excluded from his gross income as provided under Code Sec. 121(a).

CCA’s conclusion. In the CCA, IRS concluded that the gain excluded from the sale under Code Sec. 121 would not offset the $30,000 suspended passive activity losses from the property.

IRS reasoned that Code Sec. 121 is an exclusion provision for gain realized under Code Sec. 1001(a) and recognized under Code Sec. 1001(c). Specifically, Code Sec. 121(a) provides “gross income shall not include gain from the sale or exchange.” Code Sec. 121 is not a nonrecognition provision for property exchanges.

The sale of a principal residence was a transfer of property for money consideration and, as such, gain realized on the sale was recognized in the year of the sale. However, under Code Sec. 121, the gain that is realized and recognized in the year of sale is excluded from the taxpayer’s income.

IRS determined that under the facts of this case, because the $100,000 of gain realized was recognized upon the sale of Albert's entire interest in a passive activity to an unrelated party, Code Sec. 469(g)(1)(A) applied. Accordingly, to the extent that the suspended passive activity losses exceed any net income or gain for the tax year of the disposition from all other passive activities, the $30,000 losses would be treated as not from a passive activity under Code Sec. 469(g)(1)(A). But because the $100,000 gain on the sale of the residence was excluded from Albert's gross income under Code Sec. 121, it wasn't an item of passive activity gross income.
for purposes of Code Sec. 469. As a result, the excluded gain from the sale didn't offset the $30,000 suspended passive activity losses from the property.

References: For passive activity losses, see FTC 2d/FIN ¶ M-4600 et seq.; United States Tax Reporter ¶ 4694 et seq.; TaxDesk ¶ 315,500 et seq.; TG ¶ 17425 et seq.