ACTION ON DECISION

Subject: Carol A. and Roy E. Stanley v. United States
W.D. Ark. No:5:14-cv-5236 (2015)

Issues:

1) Was Roy E. Stanley (Taxpayer) a "5-percent owner" (within the meaning of §§ 469(c)(7)(D)(ii) and 416(i)(1)(B) of the Internal Revenue Code) of Lindsey Management Co., Inc.?

2) Did Taxpayers (Taxpayer husband and wife filing jointly) appropriately "group" the aggregated rental real estate activity with other non-rental trade or business activities under § 1.469-4?

Discussion:

In 2009 and 2010, Taxpayer was President Emeritus of Lindsey Management Co., Inc. ("LMC"), a property management company that manages apartment complexes, golf courses, and commercial properties in Arkansas and surrounding states. For 2009 and 2010, Taxpayers reported as non-passive the income and losses from their ownership interests in these entities, as well as from their directly-owned rental real estate. The IRS reclassified the income and losses from these entities as passive. Taxpayers argued that Taxpayer qualified as a real estate professional for purposes of § 469(c)(7) and that they materially participated in their aggregated rental real estate activity. Taxpayers further contended that they should be allowed to treat all of their rental real estate and non-rental trade or business activities such as the golf courses as a single "grouped" activity under § 1.469-4.

5-Percent Owner Rule

We disagree with the court's finding to the extent that it implies that mere possession of a stock certificate, disregarding any other conditions, restrictions or other limitations on the rights of the possessor with respect to the stock, constitutes ownership for purposes of § 469(c)(7), and to the extent it found the Taxpayer to own the stock given the particular conditions, restrictions and other limitations on the rights of the Taxpayer with respect to the stock. For purposes of determining whether Taxpayer qualified as a real estate professional under § 469(c)(7), personal services performed by the Taxpayer as an employee are not treated as performed in a real

property trade or business unless the Taxpayer is a "5-percent owner" (as defined in § 416(i)(1)(B)) of the employer. The court found that the evidence presented by Taxpayers (primarily a stock certificate) was sufficient to show that Taxpayer held ten percent of the stock of LMC for tax years 2009 and 2010. The court noted that Taxpayer's ownership of the stock was acknowledged by employment agreements that memorialized the understanding between the parties that Taxpayer would relinquish his stock upon full retirement. The court noted that it construed the evidence as a legal issue of what may constitute or substantiate ownership, but also noted that in the event it may be construed as an issue of evidentiary sufficiency, the Taxpayer had shown his ownership by a preponderance of the evidence.

However, we believe that considering all the rights held by the Taxpayer, including the conditions on those rights, Taxpayer was not a "5-percent owner" of LMC, because his right to receive the 10-percent "Percentage Salary" (as it was referred to pursuant to the terms of the employment agreements dated 1/17/94 (including addenda)) and 3/24/08 lacked the indicia of an "entrepreneurial stake" that was the impetus of the 5-percent owner requirement for purposes of § 469. Taxpayer provided nothing more than his "time and labor" (that is, his work as an employee at LMC) in exchange for the Percentage Salary; he received no consideration when he relinquished his right to the Percentage Salary when he retired and terminated employment with LMC. Furthermore, the employment agreements put restrictions on the entitlement of Taxpayer and his estate to the Percentage Salary, including a limited time period to continue to receive such Percentage Salary after the occurrence of disability or death, and the requirement to relinquish his 10-percent ownership interest upon full retirement. The employment agreements do not contain any provisions requiring Taxpayer to receive consideration for relinquishing the 10-percent ownership interest, and Taxpayer received no consideration. This evidences that the applicable provisions made the Taxpayer's right to the Percentage Salary more akin to a type of compensation or benefit of his employment relationship than an indication of stock ownership in LMC. Accordingly, we believe that the arrangement that Taxpayer had with LMC may properly be characterized as Taxpayer having been permitted by LMC and LMC's other shareholders to temporarily hold the stock for the period of his employment as a means of measuring and paying additional compensation, rather than as Taxpayer having owned the stock as a means of measuring and paying the Taxpayer a portion of any increase in value of the corporation (and having the Taxpayer experience some type of economic loss upon any decrease in value of the corporation).

Grouping Rental Real Estate Activities of Real Estate Professionals With Non-Rental Activities

The court reasoned that, read in context, § 1.469-9(e)(3)(i) bars "grouping" of rental real estate activities with other types of activities only for purposes of determining material participation and does not categorically bar a real estate professional from "grouping" rental real estate with non-rental trade or business activities for other purposes of § 469, "including for purposes of determining passive activity loss and credit." The court reasoned that this section appears to apply to "grouping" for purposes of determining material participation or, perhaps, to aggregating rental activities pursuant to § 1.469-9(g). Accordingly, the court found that Taxpayers were not categorically prohibited from "grouping" their aggregated rental real estate activity with their other non-rental trade or business activities under § 1.469-4(d)(1).

We believe the court incorrectly interpreted the "for purposes of this section" language in § 1.469-9(e)(3)(i) to determine that this rule only applies for purposes of applying § 469(c)(7) and, more specifically, only for determining whether a taxpayer materially participates in a rental real estate activity. The court never reconciled the language in § 1.469-9(e)(3)(i) with the regulatory language in § 1.469-9(e)(1) or the statutory language in § 469(c)(7)(A)(ii) from which the regulatory language is derived, both of which make clear that those rules apply for all purposes of § 469. With respect to the statutory language in particular, the phrase "this section" necessarily refers to § 469 generally and not to a particular subsection such as § 469(c)(7). We believe the statute and regulations require real estate professionals to demonstrate material participation in their rental real estate activities through work they perform directly in the rental real estate activities, and not simply by virtue of the work performed in their other real property trades or businesses (such as real estate construction or development businesses). Otherwise, § 469(c)(7)(A)(ii) would serve no purpose. The rules in § 1.469-9(e)(1) and (3)(i) simply reiterate this statutory prohibition.

In this case, Taxpayers desired to "group" the aggregated rental real estate activity with interests in adjacent golf courses, in order for Taxpayer's work performed in managing the rental real estate to count towards meeting the material participation requirements for the golf courses. Determining whether a taxpayer materially participates in a trade or business activity is the central inquiry in determining whether a taxpayer's losses and credits from that activity will be subject to limitation under § 469. From this initial determination all other consequences under § 469 will follow. Accordingly, we believe there is no statutory or regulatory foundation for the court's finding that taxpayers that qualify as real estate professionals under § 469(c)(7) generally are permitted to "group" their rental real estate activities with other non-rental

trade or business activities “for other purposes of § 469” beyond determining material participation in the rental real estate activities.

Recommendation: Nonacquiescence.

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