SUPERIOR COURT OF THE DISTRICT OF COLUMBIA
TAX DIVISION

E.K. and N.E. HOBSON	:	
	:	
Petitioners	:	
	:	Tax Docket No. 5956-93
v.	:	Judge Long
	:	
	:	
DISTRICT OF COLUMBIA	:	
	:	
Respondent	:	

MEMORANDUM OPINION AND ORDER

The above-captioned case came before this Court as an appeal from a final determination of a deficiency of tax for tax years 1989 and 1990. The parties herein have filed cross motions for partial summary judgment. The following facts are undisputed except where noted.

Facts

During tax years 1989 and 1990, Petitioners (husband and wife) resided at 8220 Eastern Avenue, N.W., in the District of Columbia and were responsible for paying personal income taxes to the District. During tax years 1989 and 1990, Petitioners owned twelve parcels of real property in the District of Columbia, which they operated as rental properties.

Petitioners reported aggregate losses on these rental properties of $52,930 for tax year 1989 and losses of $56,103 for tax year 1990. Petitioners claimed an adjustment to their income on their joint 1989 individual tax return in the amount of $52,930. Petitioners claimed

an adjustment to income on their joint 1990 District of Columbia individual tax return in the amount of $56,103.

On January 13, 1993, the District of Columbia Department of Finance and Revenue (hereinafter the "Government") issued a deficiency notice for tax years 1989 and 1990 based on the disallowance of the rental real estate losses claimed in excess of $25,000.

On July 20, 1993, Petitioners participated in a hearing with Mrs. Marsha Napper, Tax Auditor, and Mrs. Mary Pettus, Hearing Officer to contest the tax assessment.

On July 21, 1993, the Government issued a letter of "Final Determination" to Petitioners. Citing Internal Revenue Code section 469, the Government indicated that the passive loss rules prohibit claiming losses in excess of $25,000. Further, the Government stated that pursuant to District of Columbia Income and Franchise Tax Act, section 47-1812.10(a)(3), "the tax may be assessed . . . at any time within five years after the return was filed, if the taxpayer omits from gross income an amount properly included in gross income which is in excess of 25 percent of the amount of gross income stated on the return." See Final Determination letter dated July 21, 1993.

The District disallowed the excess loss claimed by Petitioners on their income tax returns, which resulted in

$3,206.25 in additional taxes and penalties owing to the District of Columbia for tax year 1989, and $3,195.00 of additional taxes and penalties owing to the District of Columbia for tax year 1990.

After application of a refund credit for tax year 1991, the alleged tax due for deficiencies for 1989 and 1990 totalled $4,833.21. Petitioners paid the deficiency of $4,833.21 in August 1993 and filed the instant appeal.

Issues Presented

Petitioners' Complaint, filed January 14, 1994, alleges that the Government erred in (1) treating the Petitioners' twelve rental properties as one rental activity and (2) limiting the total deduction for passive activity losses to $25,000.

First, Petitioners contend that each rental property should be treated as a separate activity with respect to the $25,000 deduction for losses from real estate activities.

Second, Petitioners allege that the Government incorrectly applied the statute of limitations provisions of sections 47-1803 and 47-1812.10 of the District of Columbia Code.

Third, Petitioners argue that they failed to receive proper notice of the assessment under the Administrative Procedure Act.

Petitioners seek a refund for income tax paid in tax years 1989 and 1990 in the amount of $8,638.21.

The Government filed an Answer on March 1, 1994, asserting as defenses the statute of limitations and Petitioners' failure to state a claim upon which relief can be granted.

On July 18, 1994, the Government filed a Motion for Summary Judgment.

On September 19, 1994, Petitioners filed a Response to the Government's Motion for Summary Judgment which will be treated as Petitioners' own Motion for Summary Judgment. It is upon these cross-Motions for Summary Judgment that the Court now rules.

Analysis

Petitioners' Position.

Petitioners raise two claims[1] in their Motion for Summary Judgment (captioned "Motion for Denial of Summary Judgment in Favor of Respondent").

First, Petitioners claim that the Government's deficiency notice for tax year 1989 was issued beyond the applicable statute of limitations. Petitioners argue that section 1812.10(a)(1) of Title 47 of the Code requires the

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[1] Petitioners concede that this Court does not have jurisdiction to entertain their third claim, i.e. that the hearing to contest the deficiency assessment did not conform to the requirements provided for in the Administrative Procedures Act (D.C. Code § 1-1501 et seq.).

Government to make a final assessment of taxes due within three years of the filing of the return. Petitioners contend that the Government did not make its final determination until after the three year statute of limitations had run.

Further, Petitioners argue that the Government incorrectly relied on section 1812.10(a)(3) of the Code. Section 1812.10(a)(1) provides five years for assessment after filing of tax returns where the omitted income is in excess of 25 percent of stated gross income. Petitioners contend that they did not omit any income from gross income, but rather assert that they made simply made adjustments to gross income in the form of deductions for passive activity losses.

Second, Petitioners claim that the Government incorrectly assessed deficiencies against Petitioners' *1989 and 1990 tax returns* due to the denial of passive loss deductions. Petitioners contend that section 469(i)(2) of the Internal Revenue Code[2] limits the passive loss deduction to $25,000 for **each** passive activity, but does not limit the **total** deduction for passive losses to $25,000. Therefore, Petitioners argue that the statute allows them to deduct a maximum of $25,000 in passive

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[2] Section 469(i) of the Internal Revenue Code was adopted by the District of Columbia as provided in section 1803.2(b) of Title 47 of the District of Columbia Code.

activity losses for **each** of their twelve rental properties.

Respondent's Position.

First, the Government argues that it made its assessment prior to the expiration of the statute of limitations as set forth in section 1810.10(a)(1). 47 D.C. § 1812.10(a)(1). Pursuant to section 1812.10(a)(1), the Government contends that it has three years within which to assess deficiencies against taxpayers and that the three year period begins running from the deadline for filing tax returns.

Since tax returns for tax year 1989 were due by April 15, 1990, the Government asserts that it had until April 15, 1993 to assess a deficiency against Petitioners for tax year 1989. The Government indicates that the deficiency notice was sent and received by Petitioners in January 1993, approximately <u>three months</u> before the expiration of the statute of limitations.

Second, the Government acknowledges that the Code allows a taxpayer to offset $25,000 of nonpassive income with passive activity losses. The Government asserts, however, that this exception is limited to a **maximum, aggregate** amount of $25,000. 26 U.S.C.A. § 469(i)(2) (Supp. 1994).

The Government also refers to language in section 469(i)(1) of the Internal Revenue Code which provides a

"natural person" a passive activity loss for losses "attributable to **all** rental real estate activities with respect to which such individual actively participated . . . ". I.R.C. § 469(i)(1) (emphasis added).

Finally, the Government states that Petitioners' reliance on tax regulation section 469-4T(k) is misplaced. Section 469-4T(k) is designed to aid taxpayers in applying the aggregation rules. It does not increase the total deduction a taxpayer is permitted to take for passive losses.

Resolution of the Cross Motions. The pending motions are adjudicated as follows. Petitioners' Motion for Summary Judgment must be denied. Respondent's Motion for Summary Judgment must be granted.

Statute of Limitations Claim

Section 1812.10(a)(1) of the Code states that "[t]he amount of income or franchise tax, or both, imposed by this chapter **shall be assessed within 3 years after the return is filed**, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period;". 47 D.C. Code § 1812.10(a)(1) [emphasis added].

Petitioners argue that section 1812.10(a)(1) is a "final determination" statute, rather than a "notice" statute. For the following reasons, Petitioners' construction of section 1812.10(a)(1) is incorrect.

By its plain language, section 1812.10(a)(1) requires the Government to make an **assessment** of a taxpayer's income tax return within three years of the date of filing the return. In simple terms, rendering an assessment means the same thing as presenting a bill for payment.

Section 1812.10(a)(1) does not contain any language to support Petitioners' claim that the Government is required to make a **"final determination"** within three years of filing. In other words, the Government simply needs to **begin** the process of assessment within three years; it need not **complete** it within that period.

While section 1812.10(a)(2) provides a general definition of "finally determined", this term of art is included in and applicable only to section 1812.10(e), which governs a situation in which a taxpayer's amount of taxable income is changed or corrected. In that factual scenario, "a taxpayer shall, within 90 days after such change or correction is **finally determined**, report in writing such changed or corrected taxable income to the District of Columbia". 47 D.C. Code § 1812.10(e) [emphasis added].

Clearly, the instant matter does not involve a change or correction to Petitioners' taxable income. Rather, the Government judged Petitioners' income tax return to be deficient and, consequently, issued a deficiency notice with an appropriate tax assessment.

The deadline for filing 1989 income tax returns was April 15, 1990. Pursuant to section 1812.10(a)(1) therefore, the Government had until April 15, 1993 to make an assessment against the Petitioners' 1989 tax return. The Government's assessment, therefore, was made prior to April 15, 1993, the date the statute of limitations provided in section 1812.10(a)(1) expired.

For purposes of clarity, it should be noted that the Government's reliance on section 1812.10(a)(3) in the Letter of Final Determination is inappropriate.

The Petitioners did not underreport **gross income** on their 1989 or 1990 tax returns as set forth in section 47-1812.10(a)(3). Instead, the Petitioners subtracted excessive deductions for passive activity losses from **gross income**, which caused a reduction in Petitioners' reported **net income**.

The applicable statute of limitations in this case, therefore, is the three year period in which to assess taxes as provided in section 1812.10(a)(1) of the Code. The five year statute of limitations set forth in section 1812.10(a)(3) of the Code is appropriate only in a situation where a taxpayer underreports gross income.

Passive Loss Claim

Section 469(a)(2) of Title 26 of the Internal Revenue Code provides that, "the term 'passive activity' includes any rental activity". 26 U.S.C.A. § 469(a)(2). The

general rules with regard to passive activity losses are that (1) passive activity losses can always be used to offset passive activity income and (2) passive activity losses cannot generally be used to offset nonpassive, ordinary income.

An exception to the general rule exists in section 469(i)(1) which states that, "[i]n the case of any natural person, subsection (a) shall not apply to that portion of the passive activity loss or the deduction equivalent . . . . of the passive activity credit for any taxable year which is attributable to **all rental real estate activities** with respect to which such individual actively participated in such taxable year . . . ". 26 U.S.C.A. § 469(i)(1) (emphasis added).

Section 469(i)(2) provides a dollar limitation on this exception providing, "[t]he **aggregate amount** to which paragraph (1) applies for any taxable year **shall not exceed $25,000**. 26 U.S.C.A. § 469(i)(2).

In their 1989 District of Columbia income tax return, Petitioners reported passive income of $2,748.00 and passive losses of $52,930.00. According to the language of § 469(i)(2), however, Petitioners were only entitled to claim passive losses of $27,748.00 (i.e. deduction for $2,748.00 of passive income plus $25,000.00 aggregate amount for passive losses). The remainder of the passive loss, $27,930.00 ($52,930.00 minus $25,000.00 aggregate

deduction), should have been carried over to be applied against income realized in subsequent tax years, rather than claimed entirely in tax year 1990.

In their 1990 District of Columbia income tax return, Petitioners reported passive income of $588.00 and passive losses of $56,103.00. Therefore, Petitioners were only entitled to claim a deduction of $25,588.00 (i.e. deduction of $588.00 of passive income plus $25,000.00 aggregate amount for passive losses). The remainder of the loss, $31,103.00 ($56,103.00 minus $25,000.00 aggregate deduction), should have been carried over to subsequent tax years.

Pursuant to Super.Ct.Civ.R. 56(c), this Court has reviewed the entire record, including the pleadings which the parties submitted in support of their respective motions. There are no material facts in dispute. Rather, this case is grounded upon the Court's application of the law to the facts of record.

WHEREFORE, it is by the Court this 28th day of November, 1994

ORDERED that Petitioners' Motion for Summary Judgment is hereby denied; and it is

FURTHER ORDERED that Respondent's Motion for Summary Judgment is hereby granted.

Cheryl M. Long
Judge

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