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Self-Charged Management Fees Under the Passive Loss Rules

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Where an individual or other person subject to the passive loss rules owns an interest in a passive activity and also lends money or provides services to the activity, the question arises as to whether the non-passive interest or fee income received may be offset by the person's share of expenses and losses of the passive activity. Proposed regulations generally permit a netting of the interest expense of the passive activity (often referred to as self-charged interest) against interest income, but do not specifically address other types of self-charged income or expense.

The Tax Court recently held that an individual's share of management fee expenses incurred by pass-through entities engaged in passive activities, consisting of fees paid to an S corporation of which the individual was the principal shareholder, may be offset against the fee income allocated to the individual as a shareholder of the S corporation. *Hillman v. Commissioner*, 114 T.C. No. 6 (February 29, 2000). Thus, the fee income could be offset by management fee expenses under the passive loss rules. The decision is noteworthy not only for its conclusion on the substantive issue presented, but also for its analysis regarding (i) the effect of statutory language directing that regulations be issued to implement provisions of the statute and (ii) the impact of an alleged failure by Treasury to comply fully with such directives.

Background

The passive loss rules under section 469 of the Internal Revenue Code (the "Code") generally limit the deductibility of losses from passive activities, as incurred by an individual, closely held corporation, or certain other persons, to such person's income from passive activities for the taxable period. The term "passive activity" generally includes any "rental activity", that is, an activity "where payments are principally for the use of tangible property" (including real property), regardless of whether the taxpayer materially participates in that activity.

In real estate as well as other contexts, an individual or other person subject to the passive loss rules frequently has more than one economic interest in a rental activity. For example, a member of a partnership conducting a rental activity may also derive interest or fee income from a loan to the partnership or from management or other services provided to the partnership.

Generally, interest income attributable to a loan or fees attributable to the provision of services to an entity conducting a passive activity will not be treated as income from that activity, and therefore will not be taken into account in determining passive income or loss from that activity. Thus, for example (absent the application of the special rule discussed below), if the sole shareholder of an S corporation receives $10 of interest annually under a debt obligation of the corporation held by him, the corporation conducts a rental

activity, and the rental activity operates on a break-even basis excluding the interest expense (such that the corporation has a net loss of $10 after the interest expense), the individual's $10 of interest income from the loan cannot be offset by the $10 of passive loss passed through to the individual as a shareholder of the S corporation -- notwithstanding that, on an aggregate basis, the individual has no net income from his combined holdings as a creditor and stockholder of the corporation.

When the passive loss rules were enacted in 1986, subsection (k) of section 469 (now subsection (l)) provided, in relevant part, that "The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of [section 469], including regulations . . . (2) which provide that certain items of gross income will not be taken into account in determining income or loss from any activity (and the treatment of expenses allocable to such income)."

Although the statute does not refer specifically to self-charged interest or other items, the Conference Report for the Tax Reform Act of 1986 identified the treatment of self-charged interest as an issue, and stated that a taxpayer receiving interest income with respect to a loan to a pass-through entity in which he has an ownership interest should be allowed to offset the interest expense passed through to the taxpayer against the interest income. The Report also stated that the regulations expected to address self-charged interest "may also, to the extent appropriate, identify other situations in which netting of the kind described above [for self-charged interest] is appropriate with respect to a payment to a taxpayer by an entity in which he has an ownership interest" (H.R. 99-841, at II-147 (1986)).

In 1991, the IRS proposed a regulation setting forth rules applicable to lending transactions between a taxpayer and a pass-through entity in which the taxpayer holds a direct or qualifying indirect interest. Where the taxpayer holding an ownership interest in a pass-through entity has lent money to the entity, the proposed regulation recharacterizes the interest income attributable to the loan as passive activity income, thus permitting a netting against that income of the taxpayer's share of passive interest expense of the entity.

The regulation (Prop. Reg. Search7RH 1.469-7) was proposed to be effective for taxable years after 1986, but has not yet been finalized. No similar "netting" rules were proposed with respect to other self-charged items, such as management fees for services provided to a pass-through entity by the holder of an ownership interest in the entity.

The "Hillman" Case

David Hillman ("Hillman") owned, throughout 1993 and 1994 (the years at issue), more than 90% of the stock of Southern Management Corporation ("SMC"), an S corporation. SMC provided real estate management services to approximately 90 partnerships, joint ventures, and other pass-through entities (collectively the "partnerships") that were involved in real estate rental activities.

Hillman also owned, directly or through an upper-tier entity, interests in each of the partnerships.

The opinion states that Hillman did not participate in the activities of the partnerships during the years at issue, but that Hillman did materially participate in the real estate management activity of SMC.

Hillman and his wife (the petitioners) received compensation from SMC which was deducted by SMC as an expense. SMC in turn separately reported management fee income (after deduction of expenses) on the Schedule K-1s issued by the corporation to Hillman.

The management fee expenses of the partnerships were "passive" since the fees were incurred in real estate rental activities. The portion of the management fee paid by each partnership to SMC that was allocable to Hillman's ownership interest in the partnership, however, was treated by the petitioners as an expense incurred in non-passive activities.

The IRS issued a notice of deficiency disallowing the petitioners' treatment of the management fee expenses passed through to Hillman as non-passive. The notice of deficiency referred to the proposed regulation providing that certain interest from lending transactions may be treated as self-charged (and therefore netted). The disallowance was apparently based on the fact that no regulation had been issued concerning special treatment of self-charged items other than interest.

Consistent with the notice of determination, the Commissioner argued before the Tax Court that the netting result sought by the petitioners was available only as to lending transactions with respect to which the proposed regulation permitted self-charged interest income to offset interest expense. Since no regulation had been issued permitting netting of other self-charged items, Hillman was not entitled, under the passive loss rules, to offset his share of management fee expenses against associated management fee income.

The court observed that the Commissioner did not dispute that the circumstances before the court comported with the circumstances described in the proposed regulation referred to above that permit netting, but for the fact that the proposed regulation dealt with interest and not management fee expenses.

The petitioners argued that the proposed regulation was arbitrary, capricious, and in violation of the Congressional mandate to issue appropriate regulations under section 469, insofar as the proposed regulation omitted provisions to address self-charged items other than interest. They also argued that in the absence of specific regulations dealing with items other than interest, the court should interpret the statute, in light of the legislative history, as authorizing special treatment (that is, netting) for other self-charged items.

The court ultimately accepted the petitioners' argument that the provision of section 469 requiring Treasury to prescribe appropriate regulations was "self-executing" with respect to this issue, and therefore that (at least absent any specific regulation to the contrary) netting should be permitted with respect to self-charged items in addition to interest.

The opinion states that in light of the legislative history calling for netting of at least some self-charged items, and the statutory directive to issue such regulations as are appropriate to implement section 469, the Commissioner's position that specific regulations were necessary to permit netting with respect to non-lending transactions, and that such netting could not occur absent an applicable regulation, was difficult to accept.

Having decided that the absence of regulations on self-charged items for non-lending transactions did not justify the Commissioner's conclusion that no such netting was permissible, the court quickly concluded that netting should be permitted under the circumstances presented in this case.

The court observed that, to the extent of Hillman's allocable share of the partnerships' management fees, there was no "net accretion of wealth" to Hillman by reason of the management service fees; in effect, Hillman was simply paying the fees to himself. The court then reasoned that requiring Hillman to include those fees in his income, while suspending the offsetting deduction under the passive loss rules, would result in a mismatch (of income and expense) and not advance any established tax policy.

Observations

On a technical level, the Commissioner's argument that the statute, and perhaps the committee reports (to the extent relevant), gave the IRS the discretion to decide whether or not to permit any netting of self-charged expenses other than interest, and that by not issuing such regulations netting was effectively disallowed by the statute itself, had some merit, especially since the provision authorizing regulations did not specifically refer to self-charged interest or other items.

The court was clearly troubled, however, by the failure of the government to present any argument as to why netting, apparently permissible for lending transactions, should not be permitted for self-charged amounts arising from other transactions. Also, the circumstance that the government was prepared to give operative effect to a proposed regulation to permit the desired netting treatment with respect to self-charged interest may have effectively precluded the Commissioner from arguing, notwithstanding the committee report discussion referred to above, that no special rule was appropriate for self-charged items as a class.

If regulations had been issued dealing with self-charged expenses in non-lending transactions, it appears highly likely to the authors that, taking into account the legislative history and the underlying policy considerations, such regulations would have permitted netting in the circumstances before the court. If the court was of the same view, it may well have considered it unfair for the IRS to attempt to deny the taxpayers the same treatment merely because no such regulations had been issued.

Perhaps the most surprising aspect of the case is the Commissioner's decision to pursue this tax deficiency in the courts without being prepared to justify the failure to issue a regulation addressing the treatment of self-charged items other than interest (or to finalize Prop. Reg. Search7RH 1.469-7), or to otherwise address as a substantive matter whether netting should be permitted for such items.