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Reprising Self-Charged Management Fees

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After one reads enough tax cases, they sometimes start to look alike, but the opinion in *Hillman v. Commissioner*, No. 00-1915 (4th Cir. 2001), issued on July 30, 2001, seemed too familiar. The exact same case was decided on April 17, 2001, by the same court and (save for one additional sentence) with the same opinion! It is hard enough reading these cases once—why the unsolicited encore?

From the additional sentence added to the opinion and from the new dissenting opinion on a procedural matter, we can infer that after the reversal of the Tax Court decision in April, the Court of Appeals for the Fourth Circuit was asked to clarify whether or not the case was remanded to the Tax Court. The Circuit Court, therefore, reissued its opinion to clarify that the case was indeed remanded to the Tax Court for consideration of a second argument raised by the taxpayer, which the Tax Court had specifically declined to address, since it had agreed with the taxpayer's first argument. Curiously, as a result of this odd situation, Senior Circuit Judge Hamilton, who wrote the Court's opinion on the substantive tax issue, also is the author of the dissenting opinion opposing the remand.

Passive Loss Rules

The issue litigated in *Hillman* related to the so-called passive loss rules, which generally provide that individuals, estates, trusts and certain closely held corporations and personal service corporations can deduct losses from passive activities (generally, activities in which the taxpayer does not materially participate) only to the extent of the taxpayer's income from passive activities.

During 1993, David H. Hillman owned all of the stock of Southern Management Corporation ("SMC"), and during 1994, he owned 94.34 percent of SMC's stock. SMC was classified as an S corporation during 1993 and 1994. SMC provided real estate management services to approximately 90 passthrough entities (partnerships and S corporations) that were involved in real estate rental activities. Hillman owned either direct or indirect interests in each of the passthrough entities.

During 1993 and 1994, Hillman did not participate in the activities of the passthrough entities. He did, however, materially participate in the management activities of SMC by performing management services that SMC had contracted to perform for the passthrough entities.

In computing his taxable income for 1993 and 1994, Hillman reported as income his share of the compensation paid to SMC by the passthrough entities and deducted from that income his share of the management fee expenses of the passthrough entities.

The IRS disallowed the deduction of the management fee expense. The Tax Court held that Hillman properly offset the management fee deductions against the active management fee income and the Fourth Circuit reversed.

Internal Revenue Code section 469(l) provides that:

> The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of this section [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) . . . .

The following excerpts from the House Conference Report for the Tax Reform Act of 1986, which enacted this provision, indicate that these regulations were intended to encompass interest and other similar items:

> Self-charged interest.—A further issue with respect to portfolio income arises where an individual receives interest income on debt of a passthrough entity in which he owns an interest. Under certain circumstances, the interest may essentially be "self-charged," and thus lack economic significance. For example, assume that a taxpayer charges $100 of interest on a loan to an S corporation in which he is the sole shareholder. In form, the transaction could be viewed as giving rise to offsetting payments of interest income and passthrough interest expense, although in economic substance the taxpayer has paid the interest to himself.
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> Under these circumstances, it is not appropriate to treat the transaction as giving rise both to portfolio interest income and to passive interest expense. Rather, to the extent that a taxpayer receives interest income with respect to a loan to a passthrough entity in which he has an ownership interest, such income should be allowed to offset the interest expense passed through to the taxpayer from the activity for the same taxable year.
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> . . . .
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> The conferees anticipate that Treasury regulations will be issued to provide for the above result. Such regulations may also, to the extent appropriate, identify other situations in which netting of the kind described above is appropriate with respect to a payment to a taxpayer by an entity in which he has an ownership interest.

To date, Treasury has issued one proposed regulation and no final regulations under section 469(l)(2). The proposed regulation deals only with self-charged interest and does not address self-charged management fees.

The court concluded that, notwithstanding this legislative history, the passive loss rules (embodied in section 469) prohibited the deduction of the management fee expenses and "nothing in the plain language of IRC Search7RH 469 suggests that an exception to . . . [the] general prohibition against a taxpayer's deducting passive activity losses from nonpassive activity gains exists where, as in the present case, the taxpayer essentially paid a management fee to himself." The court then invoked the "plain meaning" doctrine of statutory interpretation to deny relief to Hillman.

The crux of the issue and the basic distinction between the reasoning of the Tax Court and that of the Fourth Circuit is whether section 469(l)(2) has any effect in the absence of regulations—*i.e.*, is it self-effectuating? Does section 469(l)(2) add a new rule or does it merely empower the Secretary to do so?

Since the Tax Court found the provision to be self-effectuating, the plain meaning doctrine never came into play. However, since, in the Fourth Circuit's view, section 469(l)(2) has no effect in the absence of regulations, the court felt constrained to apply the plain meaning of the statute. Despite holding against the taxpayer, the court agreed with the taxpayer's position as a policy matter:

> We do note, however, that we see no reason why the factual situation before us is not deserving of exemption from operation of IRC Search7RH 469(a) as proposed by the Secretary with regard to an interest payment in a self-charged transaction. . . . But, this is an inequity in the United States Tax Code that only Congress or the Secretary (as the holder of delegated authority from Congress) has the authority to ameliorate.

Is a Regulation Necessary?

One cannot help wondering whether the Government really believes that section 469(l)(2) has no impact without a regulation. In that case, even self-charged interest, which is covered by a proposed regulation under section 469(l)(2), should not qualify for relief. A proposed regulation is just that, a *proposed* regulation. Yet, from the Tax Court opinion it seems that the Government's position was based on the absence of self-charged management fees in the proposed regulation. Thus, it appears that the Government itself is inconsistent in its assertion that section 469(l)(2) is not self-effectuating; if section 469(l)(2) were truly ineffective without a regulation, a proposed regulation could not change the status quo.

The court's decision is understandable, if frustrating. The Government's stance in this case, however, is outright offensive. Not only does the Government fail to issue the congressionally mandated regulations ("The Secretary shall prescribe . . . ."), but it has the audacity to then invoke the lack of regulations to litigate a position that is clearly at odds with congressional intent to benefit taxpayers. As the Tax Court said in its opinion:

> Respondent's position that congressionally intended benefits can be withheld simply by the refusal of the Secretary to issue regulations is peculiarly Draconian.
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> . . . .
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> Respondent's position denying the offset to petitioners is not only contrary to the legislative history and intent of Congress, but it does not appear to be based on any established tax policy or any reason other than the failure to promulgate a regulation. Again, we note that respondent has not articulated any reason why petitioners should be prohibited from recharacterizing the management fees deduction as nonpassive in order to accurately reflect the economic significance of the transaction. Indeed, respondent does not dispute that disallowing self-charged treatment for the management fees would result in the very mismatching that Congress sought to alleviate by directing the Secretary to issue regulations for self-charged transactions.

If the Government had channeled its efforts toward writing congressionally mandated regulations rather than litigating wrong-headed positions, the Fourth Circuit would not have had to decide this case, even once.