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Passive Loss Rules

New Regulations Governing Self-Charged Interest

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On August 21, 2002, the U.S Treasury Department issued final regulations governing the treatment of "self-charged (the "Regulations") under the passive activity loss limitations of Internal Revenue Code section 469 (the passive loss rules).

Under the passive loss rules, if aggregate losses from passive activities exceed aggregate income from passive activities for the taxable year, the excess losses may not be used to offset income from nonpassive activities for the taxable year. Under section 469(e)(1), certain income is not taken into account in determining the income or loss from passive activities, and instead is considered "portfolio" income. Generally, portfolio income includes income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business.

Under these rules, lending transactions between passthrough entities and their owners may result in portfolio interest income for the owners that cannot be offset against interest expense arising from the same transaction. For example, if a partner lends money to a partnership through which the partner conducts a passive activity, the partner's income from the interest charged to the partnership would be portfolio income and the partner's distributive share of the partnership's interest expense would be a passive activity deduction, which could not be used to offset the interest income produced by the loan.

Section 469(1)

To address this inappropriate result, section 469(l) provides:

> The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of this section [469], including regulations . . . 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 legislative history of this provision indicates that:

> [T]o 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.

The final regulations, which were issued pursuant to this congressional mandate, address two types of lending transactions: loans to a passthrough entity (defined as an S corporation or a partnership) by its owners, and loans by a passthrough entity to its owners.

The Regulations provide rules for determining the extent to which interest income received by an owner of an interest in a passthrough entity from lending transactions between the passthrough entity and its owners may be offset by interest deductions from the transactions.

Offsetting of income and deductions is permitted only for these two types of transactions and only if the items of interest income and expense are recognized in the same year. Generally, the Regulations enable offsetting by recharacterizing an appropriate amount of interest income as passive income. The regulations provide for an election out of self-charged treatment, which is effective for all subsequent years unless revoked with the consent of the Internal Revenue Service.

Items Not Addressed

The Regulations were finalized largely in their proposed form with few surprises. One of their of the Regulations lies in what they fail to address: self-charged items other than interest. Most significantly, self-charged management fees are outside the scope of the regulation and, therefore, an economically meaningless management fee by a passthrough entity to its members results in active income and a disallowed passive deduction.

The preamble to the regulations addresses this omission as follows:

> Noting that Congress authorized the Secretary to identify other situations in which self-charged treatment is appropriate, several commentators suggested that self-charged treatment be extended to other transactions involving rental real estate activities, such as the payment of management fees and salaries. After publication of the proposed regulations, Congress considered the impact of section 469 on rental real estate transactions and enacted specific relief in section

> 469(c)(7) for certain real estate professionals for taxable years beginning after 1993. There was no indication in the legislative history of section 469(c)(7) that Congress considered additional relief for real estate transactions necessary or desirable. Moreover, there is less justification for the complexity of a self-charged rule in this area after the enactment of section 469(c)(7) because that change substantially reduced the number of real estate transactions that would benefit from a self-charged rule. Accordingly, the regulations do not extend the self-charged treatment to other transactions involving rental real estate.

The preamble thus defends the omission of self-charged management fees from the regulations based on the enactment of the "real estate professional" provision contained in section 469(c)(7). Generally, the term passive activity means a trade or business in which the taxpayer does not "materially participate." However, section 469(c)(2) makes any rental activity automatically passive. Section 469(c)(7) provides that, if certain requirements are met, the *per se* rule that rental real estate is passive does not apply and, therefore, if a taxpayer materially participates in a rental real estate activity (most often by spending more than 500 hours during such year on the activity) the rental activity will be considered nonpassive.

For this special rule to apply to a taxpayer, the personal services which such taxpayer performs in real property trades or businesses in which he materially participates must (i) constitute more than half of the personal services performed by the taxpayer in trades or businesses during the taxable year and (ii) amount to more than 750 hours.

Section 469(c)(7)

With this background we can appreciate the preamble's reference to section 469(c)(7). This section allows certain real estate professionals to qualify all of their real estate activities as nonpassive and often, those receiving management fee income in the real estate industry will be able to avail themselves of these provisions. The preamble argues that (i) the absence of any mention of self-charged management fees in the legislative history of the real estate professional rules indicates that Congress is no longer interested in ameliorating the self-charged management fees problem and (ii) the real estate professional rules "substantially reduce the number of real estate transactions that would benefit from a self-charged rule."

The first of these arguments assumes a remarkable view of legislative history: that an omission in the legislative history of an amendment to an Internal Revenue Code section (i.e., the amendment adding the real estate professional rules) can amount to a repeal of a previously enacted provision contained in such section (i.e., section 469(l)).

The requirement that the secretary "identify other situations in which self-charged treatment is appropriate" is contained in section 469(l) cited above. The following excerpts from the House Conference Report for the Tax Reform Act of 1986, which enacted this provision, indicate that the regulations contemplated by section 469(l) were intended to encompass interest and other similar items:

> [T]o 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.
>
> 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.

The self-charged management scenario seems to be as compelling a situation for remediation as self-charged interest and, therefore, section 469(l) seems to obligate Treasury to address this case in its regulations. If Congress wanted to modify section 469(l), they could have amended it as part of the 1993 Act which added the real estate professional provisions. If laws were to cease to have legislative effect when Congress loses interest, then (apart from election years) we would have no laws at all.

In its second argument, Treasury concedes that although the real estate professional rules reduce the frequency of the self-charged management fee problem, they do not eliminate it. For example, many owners of real estate management companies receive self-charged management fees, but are fortunate enough to lead lifestyles which do not enable them to work the necessary hours for real estate professional qualification. Thus, Treasury seems to be saying that they need not bother curing this injustice since it will now occur less frequently.

This argument is unlikely to provide much comfort to those unfairly disadvantaged. Moreover, as we have seen from government's litigation position in *Hillman v. Commissioner*, No. 00-1915 (4th Cir. 2001), having failed to issue congressionally mandated regulations addressing management fees, the government will then invoke the lack of regulations against taxpayers who try to offset self-charged management fee income against the deductions attributable to it.

Conclusion

In today's ultra-complex tax environment, Treasury has its hands full with its mission to generate timely guidance. Yet, the decision to move ahead with one project and bury another should, in good conscience, be based on equitable rather than fiscal considerations.