



There's English and There's the IRC—Passive, Active Conduct and Carrying On

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The Many Faces of Passive Activities

The Internal Revenue Code contains a number of provisions that either use the term “passive” or use concepts that tax professionals tend to reference back to the idea of a passive standard. Many tax professionals seem to mix up the application of these terms, which is problematical because Congress had no such idea of a unified view of this concept when they passed different provisions at different times. In essence, although we got a unified definition of a child we don't have a unified definition of a passive or active activity.

Section 469

The major provision most practitioners look towards in dealing with a passive activity is §469, the provision added back in the 1986 Tax Act to attack the tax shelters that were being heavily marketed at that time. The Code provides a limited definition

(c) Passive activity defined

For purposes of this section--

(1) In general

The term "passive activity" means any activity--

- (A) which involves the conduct of any trade or business, and
- (B) in which the taxpayer does not materially participate.

This general rule required that there be a trade or business, and then that the taxpayer did not materially participate. Material participation is defined at §469(h) and provides:

(h) Material participation defined

For purposes of this section--

(1) In general

A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is--

- (A) regular,
- (B) continuous, and
- (C) substantial.

(2) Interests in limited partnerships

Except as provided in regulations, no interest in a limited partnership as a limited partner shall be treated as an interest with respect to which a taxpayer materially participates.

(3) Treatment of certain retired individuals and surviving spouses

A taxpayer shall be treated as materially participating in any farming activity for a taxable year if paragraph (4) or (5) of section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity if such taxpayer had died during the taxable year.

(4) Certain closely held C corporations and personal service corporations

A closely held C corporation or personal service corporation shall be treated as materially participating in an activity only if--

(A) 1 or more shareholders holding stock representing more than 50 percent (by value) of the outstanding stock of such corporation materially participate in such activity, or

(B) in the case of a closely held C corporation (other than a personal service corporation), the requirements of section 465(c)(7)(C) (without regard to clause (iv)) are met with respect to such activity.

(5) Participation by spouse

In determining whether a taxpayer materially participates, the participation of the spouse of the taxpayer shall be taken into account.

Congress added a number of special rules for what is passive under these rules. Specifically rental activities are generally defined as passive activities¹ with a special rule for “active rental real estate” that gave a special loss allowance² and an exception added later for those involved in certain real estate activities.³ As well, working interests in oil and gas activities get a special break.⁴

Congress also added statutory provisions to bring certain activities that would not normally be a trade or business into a trade or business for application of those rules, since that is one of the requirements to fall under §469. These special rules yank in research and experimentation activity under §174⁵ and allow the IRS to bring in certain activities that are related to a trade or business or are simply for the production of income under which deductions are allowed under §212.⁶

Conceptually Congress was looking at “passive” as a reference to those investments that were being marketed to individuals based on tax benefits, but from which the investor has no real direct dealings or interest. Congress also gave the IRS broad regulatory discretion in this area via §469(l) which provides:

(l) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out provisions of this section, including regulations--

(1) which specify what constitutes an activity, material participation, or active participation for purposes of this section,

¹ IRC §469(c)(2)

² IRC §469(i)

³ IRC §469(c)(7)

⁴ IRC §469(c)(3)

⁵ IRC §469(c)(5)

⁶ IRC §469(c)(6)

- (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),
- (3) requiring net income or gain from a limited partnership or other passive activity to be treated as not from a passive activity,
- (4) which provide for the determination of the allocation of interest expense for purposes of this section, and
- (5) which deal with changes in marital status and changes between joint returns and separate returns.

The IRS has made significant use of this provision to issue detailed regulations defining what constitutes a passive activity, the level of activity necessary to achieve material participation status, and various other issues. You'll find these regulations at §§1.469-1 through 11, some of which are final and some of which continue to exist only in temporary form.⁷ As the goal of §469 was to shut down what Congress perceived at the time to be abusive tax shelters, these regulations are geared towards addressing specific issues (such as the initial rush after the 1986 Act to create "PIGS"—that is, passive income generators).

Section 179 Active Trade or Business

A reference we also find to a taxpayer's conduct is a reference found in §179, specifically at §179(b)(3)(A) which provides:

- (3) Limitation based on income from trade or business
 - (A) In general

The amount allowed as a deduction under subsection (a) for any taxable year (determined after the application of paragraphs (1) and (2)) shall not exceed the aggregate amount of taxable income of the taxpayer for such taxable year which is derived from the active conduct by the taxpayer of any trade or business during such taxable year.

The reference is also duplicated at §179(d) for use in the definition of §179 property.

Regulation §1.179-2(c)(6)(ii) defines what is meant by "active conduct"

- (ii) Active conduct.

⁷ These regulations predate the requirement that temporary regulations under the IRC can only stay in effect for ten years, so they may be around for a while.

For purposes of this section, the determination of whether a trade or business is actively conducted by the taxpayer is to be made from all the facts and circumstances and is to be applied in light of the purpose of the active conduct requirement of section 179(b)(3)(A). In the context of section 179, the purpose of the active conduct requirement is to prevent a passive investor in a trade or business from deducting section 179 expenses against taxable income derived from that trade or business. Consistent with this purpose, a taxpayer generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business. Generally, a partner is considered to actively conduct a trade or business of the partnership if the partner meaningfully participates in the management or operations of the trade or business. A mere passive investor in a trade or business does not actively conduct the trade or business.

At Reg. §1.179-2(c)(6)(iii) the IRS gives an example to explain this requirement.

(iii) Example.

The following example illustrates the provisions of paragraph (c)(6)(ii) of this section.

Example. A owns a salon as a sole proprietorship and employs B to operate it. A periodically meets with B to review developments relating to the business. A also approves the salon's annual budget that is prepared by B. B performs all the necessary operating functions, including hiring beauticians, acquiring the necessary beauty supplies, and writing the checks to pay all bills and the beauticians' salaries. In 1991, B purchased, as provided for in the salon's annual budget, equipment costing \$9,500 for use in the active conduct of the salon. There were no other purchases of section 179 property during 1991. A's net income from the salon, before any section 179 deduction, totaled \$8,000. A also is a partner in PRS, a calendar-year partnership, which owns a grocery store. C, a partner in PRS, runs the grocery store for the partnership, making all the management and operating decisions. PRS did not purchase any section 179 property during 1991. A's allocable share of partnership net income was \$6,000. Based on the facts and circumstances, A meaningfully participates in the management of the salon. However, A does not meaningfully participate in the management or operations of the trade or business of PRS. Under section 179(b)(3)(A) and this paragraph (c), A's aggregate taxable income derived from the active conduct by A of any trade or business is \$8,000, the net income from the salon.

It is interesting to note that these regulations make no reference to the regulations under §469 or §469 itself, although the regulations came after that. That is not just an oversight, as some might think—the actual term used in the IRC for §179 (“active

conduct of a trade or business”) is not used in §469. While it certainly would appear that some of the same factors would impact whether a taxpayer was actively conducting a trade or business and whether the taxpayer was subject to the passive activity rules on that same trade or business, the regulation we do have applies a general “facts and circumstances” test as opposed to what are often mechanical tests or statutory overriding definitions found in §469.

So this means that just because a taxpayer is determined to be “materially participating” for §469 purposes (or deemed to be so by an overriding provision in §469) you cannot assume the taxpayer is actively participating for purposes of §179—and vice-versa. An obvious example would be an investor who passively holds a working interest in an oil and gas well. That investor is deemed not subject to the passive activity limits of §469⁸, but would have no similar statutory relief under §179.

So here a tax professional has to apply a “smell” test using the broad outlines given in the regulation noted above.

Passive Investment Income of an S Corporation

While Congress did not use the term “passive” in §179, they did use that exact word in §§1362(d)(3) and 1375 when discussing the excess passive income issue for an S corporation. §1375 imposes a tax on an S corporation that has both excess passive income for a year and has accumulated earnings and profits, while §1362(d)(3) causes an S corporation with excess passive income and accumulated earnings and profits for three consecutive years to have its S status terminated.

The definition of passive income in §1362(d)(3)(C) is as follows:

(C) Passive investment income defined

For purposes of this paragraph--

(i) In general

Except as otherwise provided in this subparagraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom).

(ii) Exception for interest on notes from sales of inventory

The term "passive investment income" shall not include interest on any obligation acquired in the ordinary course of the corporation's trade or business from its sale of property described in section 1221(a)(1).

⁸ IRC §469(c)(3)

(iii) Treatment of certain lending or finance companies

If the S corporation meets the requirements of section 542(c)(6) for the taxable year, the term "passive investment income" shall not include gross receipts for the taxable year which are derived directly from the active and regular conduct of a lending or finance business (as defined in section 542(d)(1)).

(iv) Treatment of certain liquidations

Gross receipts derived from sales or exchanges of stock or securities shall not include amounts received by an S corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the S corporation owned more than 50 percent of each class of stock of the liquidating corporation.

§1375 references the same definition for passive investment income.⁹

Note that this definition includes items that are considered "portfolio income" under §469 and specifically excluded from the definition of passive income for that section.¹⁰ So it's clear that §469 is not likely to provide binding guidance in this area. As well, a key issue in this area has revolved around rental activities, since the issue may arise if an S corporation owned real estate used in its trade or business, sells off its operating assets and now is "stuck" with a piece of real estate.

In many cases, that real estate is substantially appreciated, so that simply terminating the S corporation and distributing the real estate is made distasteful by the fact that gain would have to be recognized by the corporation due to the application of §311(b)(1), which requires a corporation to recognize gain if it distributes appreciated assets to a shareholder—a provision that applies to all corporations, regardless of whether they are C or S corporations. So the shareholder wants to just have the S corporation rent the building to the new owners of the business so that the income or loss will just pass through, and will only worry about liquidating the S corporation when the building is finally sold.

This scenario seems to run directly afoul of the restrictions against passive income found in §1362(d)(3), as "rents" is one of the prohibited types of income. However, there is relief granted in the regulations. In Reg. §1.1362-2(c)(5)(ii)(B) we find the following exceptions for rents:

(B) Rents

(1) In general.

⁹ IRC §1375(b)(3)

¹⁰ IRC §469(e)(1)

RENTS means amounts received for the use of, or right to use, property (whether real or personal) of the corporation.

(2) Rents derived in the active trade or business of renting property.

RENTS does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

(3) Produced film rents.

RENTS does not include produced film rents as defined under section 543(a)(5).

(4) Income from leasing self-produced tangible property.

RENTS does not include compensation, however designated, for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the taxpayer, if during the taxable year the taxpayer is engaged in substantial development, manufacturing, or production of real or tangible personal property of the same type.

The exception found at (2) is the key one, and has been the subject of a number of private letter rulings outlining qualification with the provision of specific services as part of the rental. Again, the issue does not depend on §469, nor does qualification as “nonpassive” under this provision mean that the S corporation shareholder now does not have a passive activity for §469 purposes—in fact, in most cases the individual will still have a §469 passive activity.

Self-Employment Tax Issues

Another area that often has tax practitioners attempting to use passive status under §469 is the applicability of self-employment taxes to an individual. This is another section that not only doesn't reference §469, but in fact never uses the word “passive” anywhere in the provision.

IRC §1402 defines what is self-employment income, and right off at the beginning of §1402(a) it provides the following test:

(a) Net earnings from self-employment

The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member;

The first key issue to note is there is a different test for an entity owned directly by an individual and that of a partner in a partnership. For an individual, net earnings from self-employment refers to income from a trade or business carried on by the individual. "Carried on" does imply some sort of active involvement and that the activity is carried on regularly by the individual.

While there is no direct link to §469, some of the same factors might apply in determining if an individual was carrying on the business or was merely a passive investor or someone not involved on a regular enough basis to be considered "carrying on" a trade or business—but the cut-off point clearly could be a very different point. That is, it is possible to be "materially participating" in an activity for §469 purposes, but not be "carrying on" a trade or business for §1402 purposes. One example many practitioners are aware of is the case of a person who receives fiduciary fees for handling the estate of one person, but who is not otherwise in the business of being a professional fiduciary. That income will not be subject to self-employment tax, but it does not then follow that it creates passive income under §469 that could be offset by passive losses.

However, the view is very different for a partner. Note that §1402(a) provides a general rule that income from the trade or business of a partnership is subject to self-employment tax at the partner level. There is no mention made of the level of involvement of the partner. Rather the test for a trade or business takes place at the partnership level and each partner is then "tainted" by that to subject the partner to self-employment tax.

There is one important exception that may confuse many practitioners because it's also generally a case that automatically creates statutory passive activity classification under §469(h)(2) along with statutorily removing the income from self-employment income under §1402(a)(13). That is the case of a limited partner.

The key factor is that the exclusion in both cases is statutory—simply, by definition, a limited partner obtains the classification of passive and not subject to self-employment tax in most cases (there are limited exceptions in each case we won't consider here). But the partner is not exempted from self-employment tax simply because he has a passive activity under §469.

That fact was emphasized in the 2000 Tax Court case of *Norwood v. Commissioner*¹¹ where the court held:

Petitioners argue that petitioner's interest in Gallant is passive, and, therefore, any distributions from the partnership should not be subject to self-employment tax. Respondent contends that the distribution from Gallant is subject to self-employment tax regardless of whether petitioner's involvement is passive or active, because petitioner is a general partner.

We agree with respondent. It is undisputed that petitioner's interest in Gallant was a general partnership interest. Accordingly, his distributive share of the partnership's trade or business income is, subject to the limitations of section 1402(b), subject to the taxes imposed by section 1401 on self-employment income. *Cokes v. Commissioner*, 91 T.C. 222, 229-230 (1988); *Anderson v. Commissioner*, T.C. Memo. 1992-130. That petitioner spent a minimal amount of time engaged in the operations of Gallant is irrelevant to this determination. *Cokes v. Commissioner*, supra at 233; *Anderson v. Commissioner*, supra. The passive activity rules under section 469 have no application in this case. (*emphasis added*) Petitioner's lack of participation in or control over the operations of Gallant does not turn his general partnership interest into a limited partnership interest. A limited partnership must be created in the form prescribed by State law. *Perry v. Commissioner*, T.C. Memo. 1994-215; *Johnson v. Commissioner*, T.C. Memo. 1990-461.

The fact is that there simply is not a link between §469 and §1402 in the IRC, despite many practitioners' belief that the two are linked.

Conclusions

It's important to note that the situations noted make clear why it's important to consult the actual text of the law rather than always "shooting from the hip" especially in this area. Congress has an unfortunate tendency to use similar concepts but have the statutes apply different rules in the area—the passing of a "uniform definition of a child" is only a very limited fix to what are often inconsistent rules in the IRC. Practitioners who attempt to apply rules learned in one context to a different one without understanding the statutory underpinnings do so at their own (and their clients') peril.

¹¹ TC Memo 2000-84