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Tax Watch

IRS Ruling on Passive Activity May Offer Tax Break Possibilities

by Steven M. Friedman and Samuel H. Hoppe

Taxpayers often consider depreciable real estate a viable investment vehicle because of its potential for capital appreciation and cash flow and its inherent qualities as a tax shelter. From a purely tax perspective, depreciable real estate historically provides a positive cash flow while creating noncash or "paper" losses primarily through depreciation deductions in the early years of ownership that can shelter income from non-real estate activities.

The ability to generate losses was such an advantage that a whole cottage industry sprang up around the creation and exploitation of real estate partnerships during the early 1980s. Effectively, taxpayers could buy an interest in real estate and shelter their ordinary income with losses passed through to them. However, as with many too-good-to-be-true tax schemes, Congress found this practice to be abusive.

As part of the Tax Reform Act of 1986, Congress enacted the infamous passive-activity rules that effectively disallow taxpayers from sheltering nonpassive, or active, income with losses generated from passive activities.

Passive-Activity Loss Rules

In general, Internal Revenue Code Section 469 applies to individuals (including partners and S corporation shareholders), trusts, estates, and personal-service corporations. It defines a passive activity as the conduct of any business in which the taxpayer does not materially participate, which means participating regularly, continuously, and substantially.

Rental activities are considered passive for the purposes of IRC Section 469, regardless of participation, unless the taxpayer meets the “real-property business exception.” This exception requires that:

• more than half of a taxpayer’s total personal service performed in a business must be in a real-property business (including development, construction, acquisition, conversion, rental, operation, management, leasing, or brokerage); and

• the taxpayer performs more than 750 hours of services during the taxable year in real-property businesses in which the taxpayer materially participates.

Any losses disallowed pursuant to the passive-activity loss rules of IRC Section 469 are suspended until they can be used to offset passive income in future tax years.

These rules notwithstanding, the U.S. Tax Court ruled earlier this year that under certain conditions, deductions incurred as part of a passive activity could be used to offset income from nonpassive activities.

Hillman v. Commissioner

During 1993, David and Suzanne Hillman owned 100 percent of Southern Management Corp.’s stock. During 1994, they owned 94.3 percent of SMC’s stock. SMC was classified as an S corporation for federal income tax purposes and it provided real estate management services to about 90 pass-through entities, including joint ventures, limited partnerships, and S corporations that were involved in real estate rental activities (the partnerships). The Hillmans owned either direct or indirect interests in each partnership. The general partner of each either was the Hillmans or an upper-tier partnership or S corporation in which they owned an interest.

During the 1993 and 1994 tax years, the Hillmans did not participate in partnership activities. They did, however, participate in SMC’s activities by performing management services that SMC had contracted for the partnerships. SMC engaged in a real estate management activity that the Hillmans treated as a separate activity not aggregated with SMC’s other activities. The Hillmans materially participated in SMC’s real estate management activity in excess of 500 hours. The Hillmans did not materially participate in any other operations SMC conducted, such as recreational services, medical insurance plan underwriting, credit and collection services, and a maintenance-training academy.

They reported as income — and SMC deducted as an expense — compensation paid to them for real estate management services for 1993 and 1994. SMC separately reported management fee income (after deducting expenses) on the Hillmans' 1993 and 1994 schedules K-1 (Beneficiary's Share of Income, Deductions, Credits, etc.). The portion of the management fee that the partnerships paid to SMC (allocable to the Hillmans' ownership percentage in each partnership) was deducted and resulted in ordinary losses from trade or business on the Hillmans' schedules K-1 for 1993 and 1994 or on the schedules K-1 of upper-tier partnerships and S corporations for those periods.

Computing their taxable income for those years, the Hillmans treated the total amounts of the self-charged management fee deduction (the deduction arising from the transaction between the partnerships and SMC that provided the passive management fees expense and nonpassive income) as a reduction from the Hillmans' gross income from activities characterized as nonpassive under IRC Section 469.

Issues Under Consideration

The main point at issue in *Hillman v. Commissioner* is that the Hillmans used passive self-charged management fee expenses that were incurred by the partnership and paid to SMC to offset their nonpassive income from SMC. In response to this treatment, the Internal Revenue Service issued a notice of deficiency disallowing the characterization of the management fee expense as nonpassive. The IRS contended that the proposed regulations issued pursuant to IRC Section 469(l) provide that only lending transactions may be treated as self-charged.

Under the proposed regulations, a taxpayer that was both the payer and recipient of interest was allowed, to some extent, to offset passive interest deductions against nonpassive interest income. The IRS contended, however, that it has not issued regulations dealing with self-charged items other than interest.

Conversely, the Hillmans argued that their facts were identical to those the proposed regulations outlined, except that the self-charged items were management fees rather than interest deductions and income. They further contended that Congress intended to provide self-charged treatment for interest and other appropriate items. Moreover, they argued that the IRS did not make a distinction between interest and management fees within the self-charged regime.

The Court's Ruling

Ultimately, the court ruled for the Hillmans. It allowed them to treat management fees that generated nonpassive income and passive deductions — and were paid and received by pass-through entities in which they had an interest — as offsetting self-charged items under the passive-activity loss rules of IRC Section 469.

Citing *Estate of Maddox v. Commissioner*, the court stated that, "The failure to issue regulations covering nonlending transactions should not be a reason to preclude taxpayers from congressionally intended and appropriate relief." The court further opined that the IRS did not "articulate 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.

The court's decision presents taxpayers who invest in real estate through closely held pass-through entities with the authority to support sheltering active income from those activities with passive deductions.

Specifically, taxpayers with self-charged items between closely held entities in which the taxpayer either has direct or indirect interests may be able to offset pass-through items of income from active entities with self-charged items of deductions from passive entities within the meaning of IRC Section 469. Consult with your tax adviser before planning any tax strategy.

Steven M. Friedman is a tax partner and Samuel H. Hoppe is a tax professional in the McLean, Va., office of Ernst & Young. Contact them at (703) 747-1000 or steve.friedman@ey.com and samuel.hoppe@ey.com.

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