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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR HARRY M. ASCH
DISTRICT COUNSEL CC:WR:SCA:LN
ATTN: LOUIS JACK

FROM: DEBORAH BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE) CC:DOM

SUBJECT: PASSIVE LOSS RULES

This Field Service Advice responds to your memorandum dated July 16, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

T =
Bank =
Company =
Year 1 =
Year 2 =
Year 3 =

ISSUES

1. Whether the Year 1 closing agreement and Year 3 filing procedure address whether the sale of securities pledged as collateral to support a letter of credit to participate in Company generates passive income.

2. Whether under I.R.C. § 469 and the applicable regulations, the sale of securities pledged as collateral to support a letter of credit to participate in Company generates passive income.

CONCLUSIONS

1. The Year 1 closing agreement and Year 3 filing procedure exclude income from collateral supporting a letter of credit from the definition of “Company income,” and the Year 1 closing agreement provides that where the closing agreement does not provide a rule of taxation, T shall be taxable under the general provisions of the Internal Revenue Code. Accordingly, whether the sale generates passive income is determined under section 469 and the applicable regulations.

2. The sale of the pledged securities generates nonpassive portfolio income under section 469(e)(1)(A)(ii) and Temp. Treas. Reg. section 1.469-2T(c)(3)(i)(C).

FACTS

During Years 2 and 3, T was an underwriter for Company. The amount of risk that T was permitted to underwrite was determined by the amount of property that he maintained on deposit. This deposit requirement could be satisfied by providing the sums directly to Company, or by providing Company with a letter of credit. T supplied Company with a letter of credit from Bank. T pledged securities to Bank as collateral for the letter of credit. In addition, T granted Bank various powers with regard to the pledged securities. We do not know the exact nature of those powers, but T has taken the position that he surrendered all dominion and control over the pledged securities.

During Years 2 and 3, the syndicates in which T participated apparently experienced substantial losses and Company drew upon T’s letter of credit. Bank then sold the pledged securities which resulted in a substantial gain for T. On his returns, T treated the gain from the sale of the pledged securities as passive income from his underwriting activities.

In Year 1, the Service and the Underwriters at Company entered into a closing agreement which sets out the manner in which the “Company's income” (or loss) of underwriters shall be treated for U.S. federal income tax and federal excise tax purposes. In Year 3, the parties also entered into a filing procedure under and in pursuant to the closing agreement. The Year 3 filing procedure is effective for Year 2 and subsequent years. See Article VI(1). The Year 3 filing procedure specifically excludes income on collateral supporting a letter of credit from the definition of "Company's income." See Article III(3)(B). Where the Year 1 closing agreement does not provide a rule of taxation, the underwriters shall be taxable under the general provisions of the Internal Revenue Code. See Article III(2).

T argues that the securities sold were investments made within the ordinary course of a trade or business of furnishing insurance within the meaning of Temp. Treas.

Reg. section 1.469-2T(c)(3)(ii)(C). The Service asserts that the gain from the sale of the pledged securities is properly characterized as nonpassive portfolio income under section 469(e)(1)(A)(ii) and Temp. Treas. Reg. section 1.469-2T(c)(3)(i)(C). This case is calendered for trial.

LAW AND ANALYSIS

Issue 1

The income at issue in this case was generated from the sale of securities pledged as collateral to support a letter of credit to participate in Company. The Year 1 closing agreement sets out the manner in which the “Company's income” (or loss) of underwriters shall be treated for U.S. federal income tax and federal excise tax purposes. The Year 3 filing procedure established under and in pursuant to the Year 1 closing agreement between the Service and the Underwriters at Company specifically excludes income on collateral supporting a letter of credit from the definition of "Company's income." See Article III(3)(B). The Year 3 filing procedure is effective for taxable years of all underwriters beginning after December 31, 1991. See Article VI(1). Hence, the Year 3 filing procedure applies to T and the years in issue. Where the Year 1 closing agreement does not provide a rule of taxation, the underwriters shall be taxable under the general provisions of the Internal Revenue Code. See Article III(2). Accordingly, by operation of law and pursuant to the Year 1 closing agreement, the character of this income is to be determined under the Internal Revenue Code and regulations.

Issue 2

The principal issue in this case is whether the income from the sale of the securities pledged as collateral to support a letter of credit to participate in Company generated passive income because they were investments made within the ordinary course of a trade or business of furnishing insurance within the meaning of Temp. Treas. Reg. section 1.469-2T(c)(3)(ii)(C), or whether the subject income is portfolio income which is specifically excluded from passive income under section 469(e)(1)(A). We conclude that the sale of the pledged securities generated nonpassive portfolio income.

Section 469 (a) disallows the passive activity loss and the passive activity credit for the taxable year of individuals, estates, trusts, and certain types of corporations. A “passive activity” includes a trade or business activity in which the taxpayer does not materially participate. Section 469(c)(1). In general, a taxpayer’s “passive activity loss” for a taxable year equals the amount by which the taxpayer’s aggregate losses from all passive activities (passive activity deductions) exceed the taxpayer's aggregate income from all passive activities (passive activity gross income) for the taxable year. Section 469(d)(1); Temp. Treas. Reg. section 1.469-2T(b). The passive loss rules were enacted as part of the Tax Reform Act of 1986 in response to the Congressional belief that action was "needed to curb the expansion of tax sheltering." S. Rep. No. 313, 99th Cong., 2d Sess. 713 (1986), 1986-3 C.B. 713, 714.

Passive activity gross income does not include "portfolio income," as defined in section 469(e)(1) and Temp. Treas. Reg. section 1.469-2T(c)(3)(i). The legislative history of section 469 indicates that portfolio income should not be included in passive activity gross income because "[p]ortfolio investments ordinarily give rise to positive income, and are not likely to generate losses which could be applied to shelter other income." S. Rep. No. 313, 99th Cong., 2d Sess. 713 (1986), 1986-3 C.B. 713, 728.

Portfolio income generally includes all gross income, other than income derived in the ordinary course of a trade or business, that is attributable to interest, dividends, annuities, or royalties and income derived from the sale of assets producing such income or assets held for investment. Section 469(e)(1)(A)(ii) and Temp. Treas. Reg. section 1.469-2T(c)(3)(i)(C). Therefore, the gain at issue in this case is presumptively nonpassive portfolio income unless the regulatory exception for "gross income derived in the ordinary course of a trade or business" applies.

Temp. Treas. Reg. section 1.469-2T(c)(3)(ii) defines the phrase "gross income derived in the ordinary course of a trade or business" solely for purposes of section 469. Temp. Treas. Reg. section 1.469-2T(c)(3)(ii)(C) specifically provides that the "income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies" is gross income derived in the ordinary course of a trade or business. This regulatory exception was provided in recognition of the fact that insurance companies invest to offset underwriting losses and the exception refers to this investment aspect inherent in the insurance business.

An examination of what is defined as "gross income derived in the ordinary course of a trade or business" under Temp. Treas. Reg. section 1.469-2T(c)(3)(i) reveals that the exceptions carved out of portfolio income are items directly attributable to the nature of each business listed. The legislative history explains the phrase "gross income derived in the ordinary course of a trade or business."

> The rule treating portfolio income as not from a passive activity does not apply to the extent that income, of a type generally regarded as portfolio income, is derived in the ordinary course of a trade or business. For example, the business income of a bank typically is largely interest. Similarly, a securities broker/dealer may earn a

> substantial portion of the income from the business in the form of dividends and gains on sales of dividend-bearing instruments. Interest income may also arise in the ordinary course of a trade or business with respect to installment sales and interest charges on accounts receivable.
>
> In these cases, the rationale for treating portfolio-type income as not from the passive activity does not apply, since deriving such income is what the business activity actually, in whole or in part, involves. Accordingly, interest, dividend, or royalty income which is derived in the ordinary course of a trade or business is not treated, for purposes of the passive loss provision, as portfolio income. If a taxpayer directly, or through a passthrough entity, owns an interest in an activity deriving such income, such income is treated as part of the activity, which, as a whole, may or may not be treated as passive, depending on whether the taxpayer materially participates in the activity.

S. Rep. No. 313, 99th Cong., 2d Sess. 713 (1986), 1986-3 C.B. 713, 729 - 730.

The pledged securities in this case were not an integral part of the economic activity of underwriting. T did not purchase these pledged securities in the ordinary course of his insurance activity. Rather, T pledged pre-owned securities to Bank. Presumably T would have been entitled to substitute alternative collateral to support the letter of credit, and presumably the insurance activity would not be entitled to all gains on the securities. The regulation requires that the investment be “made in the ordinary course of a trade or business of furnishing insurance,” a requirement which would exclude investments, such as T’s, which are initially made apart from the trade or business of furnishing insurance. Therefore, by its terms, the regulatory exception that T relies upon does not apply.

Further, if the income from the pledged securities is to be treated as passive income under Temp. Treas. Reg. section 1.469-2T(c)(3)(ii)(C), taxpayers would have an unfettered ability to transform portfolio income into passive income simply by transferring appreciated investment assets to underwriting activities. For instance, in this case, a considerable amount of gain may be attributable to appreciation prior to T’s pledge of the securities. Characterizing the income as passive would permit abuse and would be in direct violation of the deliberate wording of the regulation.

In addition, as a general proposition, the sale of investment or personal property may be motivated by trade or business losses, but that motivation is not sufficient to transform the sale into a trade or business transaction. This situation is analogous to a taxpayer who sells his personal residence in order to meet a business expense. The business expense may be deductible, but the loss on the sale of the personal residence is nondeductible. See Meersman v. Commissioner, T.C. Memo 1993-47; Meersman v. Commissioner, T.C. Memo 1993-242. Likewise, in this case, T's underwriting losses may have forced the sale of the securities, but that economic connection will not prevent the gain on the securities from being properly treated as portfolio income.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We believe that the technical position asserted herein concerning the application of section 469 is supported by the Code, regulations, and legislative history. We have not been apprised of all of the circumstances surrounding the sale of the pledged securities and do not know the exact nature of the powers given to Bank. There are a few critical facts which need to be developed to support the legal position taken in this memorandum. [redacted] We recommend that you elicit these facts during the trial which is scheduled for

We strongly recommend that you send in the brief as early as possible so that we may assist you in further developing the Service's position in this case. Please call if you have any further questions.

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