

Part I

Section 702(b).—Character of Items Constituting Distributive Share

26 CFR 1.702-1(b): Character of items constituting distributive share
(Also: §§ 162, 212, 703)

Rev. Rul. 2008-39

ISSUE

Under the facts described below, how are the management fees incurred by each of the lower tier partnerships (LTPs) and the management fee incurred by the upper tier partnership (UTP) taken into account in computing the tax liability of an individual who is a limited partner (LP) of UTP?

FACTS

LP, an individual, owns a limited partnership interest in UTP. UTP owns limited partnership interests in several LTPs. Each LTP is engaged in the business of trading in securities and such business constitutes a trade or business within the meaning of § 162 of the Internal Revenue Code (Code). UTP's activities consist solely of acquiring, holding, and disposing of interests in LTPs, and such activities, without regard to the activities of LTPs, do not constitute a trade or business within the meaning of § 162.

Instead, UTP's activities (without regard to the activities of LTPs) consist of holding limited partnership interests in LTPs for the production of income within the meaning of § 212. UTP and each LTP pay an annual management fee to their respective managers in consideration for management services performed for their benefit. Each management fee is computed as a specified percentage of the value of the net assets owned by UTP and each LTP, as the case may be.

The management fee paid or incurred by each LTP is an ordinary and necessary business expense within the meaning of § 162 in carrying on its trade or business. The management fee paid or incurred by UTP, without regard to the activities of LTP, is an ordinary and necessary expense in carrying on its investment activities. UTP's management fee is not paid or incurred by UTP on behalf of any LTP in connection with an LTP's trade or business. None of the management fees are properly capitalized under § 263.

Under the terms of the partnership agreement of each LTP, UTP receives a distributive share of the items of income, gain, loss, deduction and credit of each LTP. Under the terms of UTP's partnership agreement, LP receives a distributive share of UTP's items of income, gain, loss, deduction and credit.

LAW AND ANALYSIS

Section 162(a) provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 212 provides that in the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year (1) for the production or collection of income, (2) for the management, conservation, or maintenance of property held for the production of income, or (3) in connection with the determination, collection, or refund of any tax.

Section 1.212-1(d) of the Income Tax Regulations provides that expenses, to be deductible under § 212, must be “ordinary and necessary.” Thus, such expenses must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

Section 1.212-1(g) provides that fees for services of investment counsel and similar expenses paid or incurred by a taxpayer in connection with investments held by the taxpayer are deductible under § 212 if they are paid or incurred for the production of income and they are ordinary and necessary under the circumstances.

Section 702(a)(8) provides that, in determining the partner’s income tax, each partner shall take into account the partner’s distributive share of the partnership’s taxable income or loss, exclusive of the items requiring separate computation under § 702(a)(1) through (7). Section 702(a)(1) through (6) lists specific items of income, gain, loss, deduction or credit that must be separately stated by a partnership. Section 702(a)(7) provides that other items of income, gain, loss, deduction or credit also must be separately stated if required by regulations prescribed by the Secretary.

Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of § 702(a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Section 703(a) provides that the taxable income of a partnership shall be computed in the same manner as in the case of an individual, except that the items listed in § 702(a) shall be separately stated and the deductions listed in paragraph (2) of § 703(a) shall not be allowed.

Section 703(a)(2)(E) provides that the additional itemized deductions for individuals in part VII of subchapter B of the Code, including expenses described in § 212, are not allowed to the partnership.

Section 1.702-1(a)(1) through (a)(8)(i) lists specific items of income, gain, loss, deduction or credit that must be separately stated by a partnership. Specifically, § 1.702-1(a)(8)(i) provides, in part, that each partner shall take into account separately the partner's distributive share of the partnership's nonbusiness expenses that are described in § 212.

In Butler v. Commissioner, 36 T.C. 1097 (1961), acq., 1962-2 C.B. 4, the Tax Court held that, because loans made by a limited partner to a partnership were a vital factor in the existence and furtherance of the partnership's business and were proximately related to the business activities of the partnership, the limited partner was entitled to a business bad debt deduction. The Tax Court noted its agreement with

other cases that “[b]y reason of being a partner in a business petitioner was individually engaged in business.” 36 T.C. at 1106. Other courts have permitted a general partner to deduct as a trade or business expense amounts paid on behalf of the business of the partnership. In Ward v. Commissioner, 20 T.C. 332 (1953), acq., 1956-2 C.B. 4, aff’d, 224 F.2d 547 (9th Cir. 1955), following the termination of a general partnership, a general partner paid medical expenses of a partnership employee. The court held that the partner was individually engaged in business by reason of being a partner. Because of the termination of the partnership, the fact that the partner was no longer in business at the time of the expense did not mean the deduction was denied. A similar result was reached in Flood v. United States, 133 F. 2d 173 (1st Cir. 1943).

In Goodwin v. Commissioner, 75 T.C. 424 (1980), aff’d, 691 F.2d 490 (3d Cir. 1982), the Tax Court concluded that, for the purpose of characterizing partnership expenses for purposes of § 162, a partnership must be viewed as a substantive economic entity clearly distinct from its partners. In Goodwin, the taxpayer was individually engaged in real estate activities and attempted to claim deductions under § 162(a) for his distributive share as a limited partner of certain startup costs incurred by two limited partnerships formed to construct housing projects. The taxpayer argued that his activities as a partner constituted an expansion or continuation of his existing trade or business. The Tax Court, citing Madison Gas and Electric Co. v. Commissioner, 72 T.C. 521 (1979), aff’d, 633 F.2d 512 (7th Cir. 1980), held that in the context of § 162, the character of deductions incurred by the partnership, i.e., whether the deductions are incurred in the course of a trade or business, must be resolved at the partnership level.

The partnership was not yet carrying on a trade or business at the time the startup costs were paid or incurred. Accordingly, the Tax Court determined that the taxpayer's share of the startup costs were not deductible under § 162 regardless of the taxpayer's individual activities.

The Tax Court in Goodwin distinguished the question of whether a partnership expense was an ordinary and necessary expense incurred in carrying on the trade or business of a partnership from the question of whether a partner may deduct unreimbursed amounts paid by the partner on behalf of the partnership. It was the latter question that the Tax Court concluded was the issue in Butler, Ward, and Flood. In Goodwin, the Tax Court interpreted Butler, Ward, and Flood to stand for the proposition that, under certain facts, a partner may be entitled to individually deduct under § 162 as an ordinary and necessary expense an amount paid by the partner on behalf of the partnership for which the partner is not reimbursed. See also Cropland Chemical v. Commissioner, 75 T.C. 288 (1980); Klein v. Commissioner, 25 T.C. 1045 (1956), acq., 1956-2 C.B. 4; and Rev. Rul. 70-253, 1970-1 C.B. 31.

UTP's management fee is not an ordinary and necessary expense paid or incurred by UTP on behalf of the LTPs in carrying on the trading business of the LTPs. Thus, the reasoning and conclusions in Butler, Ward, and Flood are inapposite to the facts presented in this ruling.

Further, the reasoning and conclusions in Rev. Rul. 98-15, 1998-1 C.B. 718, do not apply to the question presented in this ruling. Rev. Rul. 98-15 addresses whether, under the facts described in that ruling, an organization that operates an acute care

hospital continues to qualify for exemption from federal income tax as an organization described in § 501(c)(3) when it forms a limited liability company (LLC) with a for-profit corporation and then contributes its hospital and all of its other operating assets to the LLC, which then operates the hospital. The question addressed in Rev. Rul. 98-15 is distinguishable from the question presented in this ruling.

Accordingly, under Goodwin, the question of whether the management fee paid or incurred by UTP may be deducted under § 162 or § 212 must be resolved solely by reference to the activities of UTP. Because UTP itself is not engaged in a trade or business within the meaning of § 162 and because the management fee is not paid or incurred on behalf of any LTP in connection with an LTP's trade or business, the management fee is not deductible under § 162. Instead, UTP's annual management fees are ordinary and necessary expenses described in § 212 paid or incurred in connection with UTP's investment activities. Accordingly, LP's share of the UTP's management fee is deductible under § 212. Pursuant to § 703(a)(2)(E), UTP does not take into account UTP's management fees in computing UTP's taxable income. Instead, § 1.702-1(8)(a)(i) requires that UTP separately state UTP's management fees and that LP take into account separately LP's distributive share of UTP's management fees.

Because the management fee of each LTP is an ordinary and necessary expense paid or incurred in carrying on the trade or business of the LTP, the management fee is deductible under § 162. As a result, each LTP takes its management fee into account in computing its taxable income or loss described in

§ 702(a)(8), and UTP takes into account its distributive share of the taxable income or loss of each LTP in computing UTP's own taxable income or loss described in § 702(a)(8). LP takes into account its distributive share of UTP's taxable income or loss in computing LP's tax liability.

HOLDING

UTP's management fee is not an ordinary and necessary expense paid or incurred by UTP on behalf of the LTPs in carrying on their trading business. The management fee paid or incurred by UTP constitutes an expense described in § 212. This expense is not taken into account in computing UTP's taxable income or loss described in § 702(a)(8). Instead, the management fee must be separately stated by UTP and separately taken into account by LP in computing LP's tax liability.

The management fee paid or incurred by an LTP constitutes an expense described in § 162 and is taken into account in computing the LTP's taxable income or loss described in § 702(a)(8). UTP's distributive share of taxable income or loss of an LTP is taken into account in computing UTP's taxable income or loss described in § 702(a)(8). In computing LP's tax liability, LP takes into account LP's distributive share of UTP's taxable income or loss.

DRAFTING INFORMATION

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