



OFFICE OF  
CHIEF COUNSEL

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

MEMORANDUM FOR DISTRICT COUNSEL

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE)  
CC:DOM:FS

SUBJECT: PASSIVE ACTIVITY RULES

This Field Service Advice responds to your memorandum dated February 15, 2000. 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

Taxpayer	=
Trust	=
Partnership	=
Date 1	=
Date 2	=
Year 1	=
Year 2	=
\$x	=
\$y	=
a%	=
b%	=
c%	=
d%	=
e%	=
f%	=

ISSUE

Is Trust considered a separate entity from Taxpayer in determining material participation in Partnership for purposes of applying the passive activity loss and credit limitations of Internal Revenue Code § 469?

### CONCLUSION

No. Under the grantor trust provisions of sections 671 through 679, Taxpayer is treated as the owner of Trust and its assets. Accordingly, the passive activity loss and credit limitations of section 469 will be applied to the income, deductions, and credits from Trust's interest in Partnership at Taxpayer's individual level, not at the trust level.

### FACTS

Taxpayer is the grantor and co-trustee of Trust. On Date 1, Year 1, Taxpayer formed Partnership with Taxpayer and Trust as the sole partners. Taxpayer owned a a% general interest and a b% limited interest. Trust owned a c% general interest. During Year 2, Taxpayer assigned portions of his limited partnership interest to Trust, so that, on Date 2, Year 2, the Trust owned a d% limited interest in addition to the c% general interest. Based upon your incoming request, we are to presume that Taxpayer materially participated in the activities of the Partnership.

On its Year 2 Form 1065, Partnership reported an ordinary loss of \$x and a rental loss of \$y. Schedules K-1 were attached showing two partners, Trust and Taxpayer. The income and losses were allocated e% (c% + d%) to Trust and f% (100% - e%) to Taxpayer.

Based upon your incoming request, we are to presume that Trust is a grantor trust as defined in sections 671 through 677.

### LAW AND ANALYSIS

Section 469 generally disallows passive activity losses and passive activity credits for taxpayers described in section 469(a)(2). In general, a passive activity is any activity involving the conduct of a trade or business in which the taxpayer does not materially participate, or any activity involving a rental activity, without regard to whether the taxpayer participates in such activity. Section 469(c).

Taxpayers subject to the passive activity loss and credit limitations include, among others, any individual, estate, or trust. Section 469(a)(2). Treas. Reg. § 1.469-1T(b)(2) clarifies that this rule does not apply to trusts or portions of trusts described in section 671. A trust described in section 671 is a trust whereby the grantor (or another) retains certain controls over the trust income, corpus, or both, to such an extent that the grantor (or another) will be treated as the owner of the

trust property and income or a portion thereof, for federal income tax purposes. See sections 671-679.

Section 671 and the regulations interpreting that section provide that when a grantor is treated as wholly owning a trust, the grantor must take into account in computing his income tax liability all of the trust's items of income, deduction, and credit as though the trust had not been in existence during the period the grantor is treated as the owner. Treas. Reg. § 1.671-3(a)(1). When a grantor or other person is treated as the sole owner of a trust for federal income tax purposes under section 671, that person is treated as the owner of all of the trust's assets. See Estate of O'Connor v. Commissioner, 69 T.C. 165, 174 (1977) ("When a grantor or other person has certain powers in respect of trust property that are tantamount to dominion and control over such property, the Code "looks through" the trust form and deems such grantor or other person to be the owner of the trust property and attributes the trust income to such person.").

The rule in Treas. Reg. § 1.469-1T(b)(2) excepting grantor trusts (within the meaning of section 671) from the application of section 469 is consistent with the treatment of the grantor (or other person) under section 671 as the owner of the trust's assets. Under the grantor trust rules, the grantor (or another) is treated as the owner of the trust's assets and takes into account the trust's items of income, deduction, and credit. As an individual, the grantor is subject to section 469. Accordingly, it is appropriate that the passive activity rules of section 469 are applied to the trust's income, deductions, and credits on the individual level of the grantor or other person treated as the owner. See S. Rep. No. 99-313, at 735, n.21 (1986) ("In the case of a grantor trust, however, material participation is determined at the grantor rather than the entity level."). See also, Staff of the Jt. Comm. on Taxation, 99<sup>th</sup> Cong., General Explanation of the Tax Reform Act of 1986, at 242, n. 33 (1987).

Based upon the facts as presented in your incoming request, we are to presume Trust is a grantor trust within the meaning of section 671. Accordingly, Taxpayer is treated as the owner of Trust for federal income tax purposes. As the owner of Trust, Taxpayer is treated as the owner of all of Trust's property, including Trust's partnership interest. See also, Madorin v. Commissioner, 84 T.C. 667 (1985) (finding that the grantor trust provisions result in the grantor's being treated as the owner of the partnership interest held by the trust). Accordingly, the deductions and credits attributable to Trust's interest in Partnership are subject to the limitations of section 469 on Taxpayer's individual level. In your incoming request, you noted we are to presume that Taxpayer materially participated in the partnership. Based on this presumption, to the extent Partnership generated trade or business losses (as opposed to rental), such losses reported by Taxpayer that are attributable to Trust's interest in Partnership would not be subject to the passive loss and credit limitations of section 469.

We note that an additional issue is present. The only partners of Partnership are Taxpayer and Trust. As outlined above, under section 671, when a trust is characterized as a grantor trust, the trust is ignored for income tax purposes and the grantor is treated as the owner of the trust's assets. Accordingly, because the trust at issue is a grantor trust as defined in sections 671 through 679, Taxpayer is treated as the owner of the assets of Trust, including the partnership interest held by the Trust. Because Taxpayer, and not the grantor trust, is treated as owning the partnership interest held as an asset of Trust, Taxpayer is the sole partner of the Partnership. In order to be a valid partnership for federal tax purposes, the partnership must have two or more partners. Based on the facts presented, it appears that a valid partnership does not exist for federal tax purposes.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



This Field Service Advice considers only the first question raised in your request. It is our feeling that our response to the first question resolves the issue, thus making a response to questions two through four not relevant to the potential adjustment.

We additionally note that because the losses and credits attributable to the trust assets are subject to the passive activity loss and credit limitations of section 469 on the individual level of the person treated as the owner, the exemption (contained in Treas. Reg. § 1.469-1T(b)(2)) of grantor trusts from the application of section 469 poses no potential for choice of entity abuse by taxpayers.

Further, because Taxpayer reported both his individual share and the Trust's share of the income and losses of the Partnership on Taxpayer's individual return, the fact that no valid partnership existed most likely will not necessitate a further adjustment.

Please call if you have any further questions.

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