OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
September 13, 2000

Number: **200111001**
Release Date: 3/16/2001
UILC: 163.00-00
212.00-00
469.00-00

TL-N-1550-00
CC:PSI:BR9

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ILLINOIS DISTRICT COUNSEL

FROM: Associate Chief Counsel (Passthroughs & Special Industries)
CC:PSI

SUBJECT: Trader Partnership

This Field Service Advice responds to your memorandum dated June 8, 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.

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LEGEND:

T =
Year 1 =

Year 2 =
a = $
b = $
c = $
d = $

ISSUES:

1. Whether a partner in a "trader" partnership may claim as a trade or business expense the operating expenses of the partnership.

2. Whether a partner in a "trader" partnership should treat his ordinary income or losses from the partnership as arising from a passive activity for purposes of section 469.

3. Whether section 163(d) limits the deduction of any interest expense flowing through to a noncorporate partner from a "trader" partnership.

CONCLUSION:

1. A partner in a "trader" partnership may claim as a trade or business expense the section 162 expenses of the partnership.

2. A partner must treat his ordinary income or losses from a "trader" partnership as not arising from a passive activity.

3. For noncorporate partners, section 163(d) will limit the deduction of interest expense that is not attributable to the partnership's trading activity. In addition, for those noncorporate partners who do not materially participate in the trading activity, section 163(d) also will limit the deduction of interest expense that is attributable to the partnership's trading activity.

FACTS:

T is a partnership. For purposes of this Field Service Advice, we are assuming that T is a trader in securities. T is a partner in other partnerships that are traders in securities. Some such partnerships are in turn partners in additional partnerships that are investors in securities.

For Year 1, T claimed $a of trade or business expenses and $b of portfolio expenses. For Year 2, T claimed $c of trade or business expenses and $d of portfolio expenses. In both years, the portfolio expenses resulted from T's investments in partnerships in which it held an indirect interest.

LAW AND ANALYSIS

With regard to a partnership involved in securities transactions, there is a distinction between a securities "dealer" and all other partnerships. A securities "dealer" is a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business. Based on the assumption made for purposes of this advice, T is not a securities "dealer" partnership.

To the extent a partnership is not a securities "dealer" partnership, it may be a "trader" or "investor" partnership. In general, a "trader" buys and sells securities with reasonable frequency in an endeavor to catch the swings in the daily market movement and profit thereby on a short-term basis. A "trader" can be engaged in a trade or business if the activity is conducted with continuity and regularity and with a primary purpose of producing income or profit; expenses incurred in the trading activity would constitute trade or business expenses. Commissioner v. Groetzinger, 480 U.S. 23 (1987). An "investor" purchases securities for capital appreciation and income, usually without regard to short-term developments that would influence the price of the securities on the daily market. See Moller v. United States, 721 F.2d 810, 813 (Fed. Cir. 1983), rev'g 553 F. Supp. 1071 (Cl. Ct. 1982); Liang v. Commissioner, 23 T.C. 1040, 1043 (1955); Hart v. Commissioner, T.C. Memo. 1997-11, aff'd without opinion, 135 F.3d 764 (3d Cir. 1997). Investing is not a trade or business, regardless of the amount and regularity of the activity; expenses incidental to investing are not deductible as having been paid or incurred in a trade or business. Groetzinger, 480 U.S. at 30; Higgins v. Commissioner, 312 U.S. 212 (1941). Based on the assumption made for purposes of this advice, T is a "trader" partnership.

For noncorporate taxpayers (and few specially defined corporations), interest expense attributable to a trade or business activity is deductible subject to the limitation of section 469. The deduction for interest expense attributable to an investment activity, however, is not subject to the limitation of section 469, but is instead subject to the limitation of section 163(d)(1) for noncorporate taxpayers. Under section 163(d)(5)(A)(ii), certain interest expense attributable to trade or business activity will be characterized as investment interest expense if the taxpayer does not materially participate in the activity but is required to treat the activity as nonpassive. Thus, it is not sufficient for a taxpayer to simply allocate interest expense between a trade or business activity and an investment activity, the further determination must be made as to whether the trade or business interest expense will be subject to the limitation of section 469 or will instead be characterized as investment interest expense under the special provisions of section 163(d)(5)(A)(ii).

Trade or Business Expenses

The taxable income of a partnership is computed in the same manner as an individual, except that certain items described in section 702 must be separately stated and certain itemized deductions for individuals are not allowed to the partnership. I.R.C. § 703(a). In determining his income tax, each partner is required to take into account separately his distributive share of the partnership items of income, gain, loss, deductions, and credits. I.R.C. § 702(a). Section 212 expenses are separately passed through to, and accounted for by, the partners under section 702(a)(7). I.R.C. § 703(a)(2)(E); Baylin v. United States, 30 Fed. Cl. 248 (1993), aff'd, 43 F.3d 1451 (Fed. Cir. 1995); Treas. Reg. § 1.702-1(a)(8)(i). In general, nonseparately-stated business expenses are netted against gross income to determine net income. Treas. Reg. § 1.702-1(a)(9).

The character of any item of loss or deduction is determined as if the item were incurred in the same manner as incurred by the partnership. I.R.C. § 702(b); Treas. Reg. §1.702-1(b). Thus, in general, the character of each item of partnership income or expense is determined at the partnership level, in the absence of a specific statutory provision to the contrary. I.R.C. § 702(b); United States v. Basye, 410 U.S. 441 (1973); Brannen v. Commissioner, 78 T.C. 471, 505 (1982), aff'd, 722 F.2d 695 (11th Cir. 1984). However, if a partnership is a "trader" partnership, the partnership is engaged in a trade or business and the partners are entitled to treat their distributive share of partnership expenses as trade or business expenses. I.R.C. §§ 702(a)(8), 702(b); Basye, supra; Hart, supra; Paoli v. Commissioner, T.C. Memo. 1988-23. Generally, a trade or business expense is deductible.For noncorporate taxpayers (and few specially defined corporations), interest expense attributable to a trade or business activity is deductible subject to the limitation of section 469. The deduction for interest expense attributable to an investment activity, however, is not subject to the limitation of section 469, but is instead subject to the limitation of section 163(d)(1) for noncorporate taxpayers. Under section 163(d)(5)(A)(ii), certain interest expense attributable to trade or business activity will be characterized as investment interest expense if the taxpayer does not materially participate in the activity but is required to treat the activity as nonpassive. Thus, it is not sufficient for a taxpayer to simply allocate interest expense between a trade or business activity and an investment activity, the further determination must be made as to whether the trade or business interest expense will be subject to the limitation of section 469 or will instead be characterized as investment interest expense under the special provisions of section 163(d)(5)(A)(ii).

Passive Activity Loss

An individual generally is not allowed a passive activity loss or credit. I.R.C. §§ 469(a)(1) and (a)(2)(A). A passive activity is any activity which involves the conduct of any trade or business in which the taxpayer does not materially

participate. I.R.C. § 469(c)(1). The term "passive activity loss" means the amount by which the aggregate losses from all passive activities for the taxable year exceed the aggregate income from all passive activities for such year. I.R.C. § 469(d)(1).

In the context of a partnership, section 469 will not affect the partners' ability to characterize their distributive share of partnership trade or business expenses as section 162 deductions. However, if partners do not materially participate in the trade or business activity, then their ability to deduct their share of the expenses will be subject to the limitations of section 469.

In the present case, T is assumed to be a trader. While the ability to deduct losses attributable to the conduct of a trade or business is normally subject to section 469, a special exception exists for the activity of trading personal property for the account of owners of interests in the activity. Under Treas. Reg. § 1.469-1T(e)(6), such an activity is not a passive activity, without regard to whether the activity is a trade or business activity. Treas. Reg. § 1.469-1T(e)(6)(i). Personal property is any personal property of a type which is actively traded. I.R.C. § 1092(d)(1); Treas. Reg. § 1.469-1T(e)(6)(ii). Thus, the activity of T is not a passive activity and the income or losses derived from the activity cannot be passive income or losses. Treas. Reg. § 1.469-1T(e)(6)(iii).

Interest Expense

In general, a deduction is allowed for all interest paid or accrued in a taxable year on indebtedness. I.R.C. § 163(a). For taxpayers (other than corporations) a deduction for personal interest paid or accrued during the taxable year is not allowed. I.R.C. § 163(h)(1). Interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee) is not personal interest; there is no limitation on a deduction for such interest. I.R.C. § 163(h)(2)(A). Investment interest is not personal interest. I.R.C. § 163(h)(2)(B). However, a deduction for investment interest for taxpayers (other than corporations) is limited to the amount of net investment income for the taxable year. I.R.C. § 163(d)(1). The determination of whether interest is investment interest is made at the level of the partnership which incurs the interest.

"Investment interest" is any interest allowable as a deduction that is paid or accrued on indebtedness properly allocable to property held for investment.[1] I.R.C.

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[1] Investment interest expense does not include any interest taken into account under section 469 in computing income or loss from a passive activity of the taxpayer. I.R.C.

§ 163(d)(3)(A). "Property held for investment" includes any property that produces income of a type described in section 469(e)(1). I.R.C. § 163(d)(5)(A)(i).[2] Section 469(e)(1) income includes gross income from interest, dividends, annuities, or royalties (not derived in the ordinary course of a trade or business), as well as gain or loss from the disposition (not in the ordinary course of business) of property that produce income of that type. A trader generates income of this type in the ordinary course of business. Treas. Reg. § 1.469-2T(c)(3)(ii)(D).[3] See also, More v. Commissioner, 115 T.C. No. 9 (2000); Rev. Rul. 93-68, 1993-2 C.B. 72.

Interest (and other expenses) must be allocated as appropriate between investing and trading if T engaged in both activities. Higgins v. Commissioner, 312 U.S. 212 (1941). Rules for allocating interest expense for purposes of applying section 163(d), section 163(h) and section 469 are found in Treas. Reg. § 1.163-8T. In general, interest expense on a debt is allocated in the same manner as the debt to which the interest expense relates is allocated. Treas. Reg. § 1.163-8T(a)(3). The debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. These expenditures may be classified as "trade or business," "passive activity," "investment," "personal," or "portfolio." Treas. Reg. § 1.163-8T(a)(4). The facts do not indicate how the debts incurred by T and the other partnerships should be traced. For purposes of this memorandum, it is assumed that a portion of T's interest expense is allocable to its investment activity and a portion is allocable to its trading (trade or business) activity.

Because it is generated in the ordinary course of business, the interest expense attributable to T's trading activity will not be considered investment interest expense under the general rule of section 163(d)(5)(A)(i). For certain partners, however, such interest expense may be treated as an investment interest expense under the additional rule of section163(d)(5)(A)(ii). Section 163(d)(5)(A)(ii) indicates that "property held for investment" also includes any interest held by a

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§ 163(d)(3)(B)(ii). The activity of a partnership trading securities for its own account is not a passive activity, regardless of whether that activity is a trade or business. Treas. Reg. § 1.469-1T(e)(6). Thus, under the assumed facts, none of the partnerships is engaged in a passive activity, and none of the interest falls within this exclusion.

[2] "Property held for investment" also includes any interest held by a taxpayer in an activity involving the conduct of a trade or business that is not a passive activity and with respect to which the taxpayer does not materially participate. I.R.C. § 163(d)(5)(A)(ii).

[3] An exception is provided to Treas. Reg. § 1.469-2T(c)(3)(ii)(D), for property that has been held for investment by a dealer. See Treas. Reg. § 1.469-2T(c)(3)(iii).

taxpayer in an activity involving the conduct of a trade or business that is not a passive activity and with respect to which the taxpayer does not materially participate. As has been indicated, due to the special rule of Treas. Reg. § 1.469-1T(e)(6), T's trading activity is treated as a nonpassive activity without regard to the degree of participation by T's partners. Thus, partners who do not materially participate in the trading activity will treat their interests in T's trading activity as property held for investment. Such partners will be subject to the limitation of section 163(d) on their distributive share of T's interest expense attributable to its trading activity.

In addition, to the extent T has interest expense that is not attributable to its trading activity, such interest expense would be treated as investment interest expense under the normal operation of section 163(d)(5)(A)(i). Because the trade or business determination is made at the partnership level, T's distributive share of interest expense from partnerships that do not qualify as traders would not be treated as a trade or business expense to T. Rather, such interest expense would be characterized as investment interest expense to T. Thus, when such interest passes through to T's partners, their ability to deduct the expense would be subject to the limitations of section 163(d)(1).

All noncorporate partners of T will be subject to the limitations of section 163(d) on their distributive share of T's investment interest expense. Whether noncorporate partners of T are also subject to the limitations of section 163(d) on their share of T's trading interest expense will depend on each partner's participation. Therefore, depending on a partner's degree of participation, section 163(d) could limit the deductibility of the interest expense associated with the partnership's trading activity for some partners and not others. Treas. Reg. § 1.702-1(a)(8)(ii) requires that each partner take into account separately his distributive share of any partnership items that, if separately taken into account, would result in an income tax liability for that partner different from that which would otherwise result. Thus, T's interest expense associated with its trading activity must be separately passed through to, and accounted for by, the partners of T.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Based on the information provided, T is a "trader" partnership. The line of demarcation between traders and investors depends on the facts in each case. See generally Higgins v. Commissioner, 312 U.S. 212, 217 (1941). In general, a trader is distinguished from an investor by the taxpayer's investment intent; the nature of the income to be derived from the activity; and the frequency, extent and regularity of the taxpayer's trades. See Moller, 721 F.2d at 813; Purvis v. Commissioner, 530 F.2d 1332 (9th Cir. 1976), aff'g T.C. Memo. 1974-164; King v. Commissioner, 89 T.C. 445, 457-59 (1987); Liang v. Commissioner, 23 T.C. 1040,

1043 (1955); Hart v. Commissioner, T.C. Memo. 1997-11; Mayer v. Commissioner, T.C. Memo. 1994-209.

The determination of whether a partnership is a “trader” partnership as opposed to an “investor” partnership is imperative as a partner in a “trader” partnership is treated more advantageously than a partner in an “investor” partnership. For example, if the partnership were an “investor” partnership, the expenses would be passed through to the partner as investment expenses. I.R.C. § 212; Treas. Reg. § 1.702-1(a)(8); Rev. Rul. 75-523, 1975-2 C.B. 257 (holding that expenses incurred by a partnership whose sole activity is to invest in securities are section 212 expenses). Accordingly, individual taxpayers who itemize their deductions would be subject to the 2-percent floor. I.R.C. § 67(a), (b). Thus, we recommend that you carefully analyze the activities of T to verify that T is a “trader” partnership and not an “investor” partnership.

Please call if you have any further questions.

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