Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Index Number: 0469.10-00

Number: **199924023**
Release Date: 6/18/1999

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:03-PLR-115857-98
Date:
March 18, 1999

Legend

Company =

B =

C =

D =

E =

F =

G =

H =

I =

Dear

This letter is in response to your letter dated August 3, 1998, and subsequent correspondences, requesting a ruling under § 469 of the Internal Revenue Code. Specifically, a ruling was requested that certain interest income generated by Company be treated as derived in the ordinary course of a trade or business under § 1.469-2T(c)(3)(ii) of the Income Tax Regulations for purposes of calculating passive activity gross income.

FACTS

Company is an entity classified as a partnership for federal tax purposes. Company's members currently consist of B, C, D, and E. C is also a passthrough entity with interests held by F, G, H, and I. Company is a freight payment, auditing, and information management service provider for large manufacturers. The relevant portion of Company's business functions as follows: 1) Company pre-audits a client's freight bills, 2) Company notifies the client which bills should be paid and in what amounts, 3) the client forwards the necessary funds to Company, and 4) Company pays the shippers within a period set by contract with the client (float period). Company generates revenue from these functions through a mixture of service fees charged to its clients and interest earned on the clients' funds during the float period (float revenue). Company's ruling request addresses only float revenue. Company has not asked for a ruling concerning interest earned on its own capital.

The amount of service fees charged to a client and the float revenue generated are inversely related. The exact amount of fees and the length of the float period are determined during the negotiation of the service contract. Clients may negotiate lower fees by permitting a longer float period. The exact interrelationship between fee and float is irrelevant to Company as long as the combined amounts generate the desired profit margin. Over the past two years, more than thirty percent of Company's total revenue has been float revenue.

It has been represented that G, H, and I do not currently materially participate in the trade or business of Company. In addition, D and E anticipate transferring portions of their interests in Company to subsequent members who will likely not materially participate in the activity.

LAW AND ANALYSIS

Section 469 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). Taxpayers can own passive activities directly or through passthrough entities.

In general, a taxpayer's "passive activity loss" for a taxable year equals the amount by which the taxpayer's deductions from passive activities (passive activity deductions) exceed the taxpayer's gross income from passive activities (passive activity gross income) for the taxable year. Section 469(d)(1) and § 1.469-2T(b).

Passive activity gross income and net active income do not include "portfolio income," as defined in § 469(e)(1) of the Code and § 1.469-2T(c)(3)(i) of the regulations. Portfolio income generally includes gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business.

Accordingly, § 1.469-2T(c)(3)(ii) lists the only situations in which the items of gross income described in § 1.469-2T(c)(3)(i) are considered derived in the ordinary course of a trade or business, and thus are not portfolio income for the purposes of § 469. Interest income not described in one of the specific provisions of § 1.469-2T(c)(3)(ii) may be excluded from portfolio income only if the Commissioner identifies it as income derived in the ordinary course of a trade or business. Company is not involved in the trade or business of lending money, nor is the float revenue generated through accounts receivables. Therefore, the float revenue cannot be excluded from portfolio income under § 1.469-2T(c)(3)(ii)(A) or (B). The float revenue will be considered portfolio income unless the Commissioner identifies it as income derived in the ordinary course of a trade or business pursuant to § 1.469-2T(c)(3)(ii)(G).

Company contracts with its clients to generate revenue. The exact composition of this revenue will be derived from a mixture of service fees and float revenue depending on the particular contract negotiated with client. The amount of service fees charged to a client and the length of the float period negotiated with a client are inversely proportional. Thus, Company does not generate float revenue in addition to service fees, rather, float revenue is properly viewed as a substitute for service fees. The legislative history of § 469 indicates that portfolio income should not be included in passive activity gross income because portfolio items generally are positive income sources that do not bear, at least to the same extent as other items, deductible expenses. See Senate Report No. 99-313, 99th Cong., 2d Sess (1986) 1986-3 C.B. Vol. 3 at 719. In this case, float revenue (as a substitute for service fees) will bear deductible expenses to the same extent as service fee revenue. Therefore, under these circumstances, the float revenue does not present the qualities associated with portfolio income.

CONCLUSION

Under the facts represented, it is appropriate to treat the float revenue as derived in the ordinary course of a trade or business under § 1.469-2T(c)(3)(ii)(G). The float revenue will not be considered portfolio income, and will instead be included in the calculation of passive activity gross income under § 469(e) and § 1.469-2T(c) for taxpayers who do not materially participate in Company's activity.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether any member's interest in Company is properly treated as a passive or nonpassive activity under § 469.

This letter is issued only to the taxpayer who requested it. Under § 6110(k)(3), it may not be used or cited as precedent.

Company should attach a copy of this letter to its next federal income tax return. We enclose a copy for that purpose.

Pursuant to a power of attorney on file with this office, a copy of this ruling is being sent to your representative.

Sincerely yours,

William P. O'Shea
Chief,
Branch 3
Office of the Assistant
Chief Counsel
(Passthroughs and Special
Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes