INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Date of Communication: Not Applicable

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Control No.: TAM-118359-98

Taxpayers' names:
Taxpayers' address:

Taxpayers' EINs

Year involved:
Date of conference:

Legend: X =

Y =

taxpayers =

Partnership =

State =

Company =

Issue: Is a recharacterization of the taxpayers' activities from nonpassive to passive for purposes of the passive activity loss and credit limit rules of § 469 of the Internal Revenue Code a change in a "method of accounting" for purposes of §§ 446(e) and 481(a)?

Conclusion: The recharacterization of the taxpayers' activities from nonpassive to passive for purposes of the passive activity loss and credit limit rules of § 469 is not a change in a method of accounting for purposes of §§ 446(e) and 481(a).

Facts: X owns a one percent general partner interest and X and Y (collectively, "the taxpayers") own a 99 percent limited partner interest, through their living trust, in Partnership, a State limited partnership. Partnership developed a nursing home in State and hired a management company, Company, to operate the nursing home in exchange for a fee plus a portion of the profits. The nursing home became fully operational in 1990.

The taxpayers determined that they materially participated in the nursing home from 1990 through 1994, and therefore, they treated the majority of the losses flowing from the partnership as not being subject to the passive loss limitation rules under § 469. Treatment of the losses for the 1990 through 1994 tax years as nonpassive resulted in the losses either being carried back to prior years or offsetting other income in those years. This treatment allowed the taxpayers to offset their ordinary income with the losses from the nursing home on their tax returns from 1990 through 1994.

Taxpayers' 1994 tax year is under examination. An examiner has questioned whether the taxpayers were correct in deciding that their ownership of the nursing home was not a passive activity in 1994. Specifically questioned is whether the taxpayers were correct when they decided that they "materially participated," as defined in § 469(h), in the nursing home activity in 1994.

The examiner's position is that the taxpayers did not materially participate in the activity in 1994 and that the nursing home ownership was a passive activity, which resulted in the taxpayers being subject to the passive activity loss and credit limit rules of § 469 in 1994. The examiner has requested guidance with respect to whether a recharacterization of the taxpayers' activities from nonpassive to passive for purposes of § 469 is a change in a method of accounting for purposes of § 446(e), requiring the computation of an adjustment under § 481(a).

The taxpayers do not agree with the examiner's § 469 position. However, the taxpayers and the examiner have agreed that only the change in a method of accounting issue would be submitted to the national office for consideration. Both the taxpayers and the examiner have agreed that the national office should assume for purposes of answering the change in a method of accounting issue that the examiner is correct in regard to the taxpayers' lack of material participation in the nursing home activity. Thus, for purposes of this technical advice memorandum, the national office will assume that the taxpayers did not materially participate in the nursing home activity

in 1994 and were therefore subject to the passive activity loss and credit limit rules of § 469 in that year.

Law and Analysis: Section 446(a) states the general rule that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes income in keeping its books. See § 1.446-1(a)(1) of the Income Tax Regulations.

Section 1.446-1(a)(1) provides in pertinent part that the term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method and an accrual method.

Section 1.446-1(e) provides the rules governing the adoption or change of a method of accounting. See also Rev. Proc. 97-27, 1997-1 C.B. 680 (which provides the general procedures for obtaining the consent of the Commissioner of Internal Revenue to change a method of accounting for federal income tax purposes). Section 1.446-1(e)(2)(ii)(*a*) states that a change in the method of accounting includes a change in the over-all plan of accounting for gross income or deductions or a change in the treatment of any material item used in such over-all plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment.[1] A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction.

Section 1.446-1(e)(2)(ii)(*b*) provides in pertinent part that a change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability. Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts.

Rev. Proc. 97-27, section 2.01(1), explains that in determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant

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[1] Rev. Rul. 90-38, 1990-1 C.B. 57 explains that the treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns represents consistent treatment of that item for purposes of § 1.446-1(e)(2)(ii)(*a*). However, if a taxpayer treats an item properly in the first return that reflects the item, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns.

question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the tax year in which the income is reported, it involves timing and is therefore a method of accounting.

Rev. Proc. 97-27, section 2.01(3), states that a change in the characterization of an item may also constitute a change in method of accounting if the change has the effect of shifting income from one period to another.

Section 481(a) provides in pertinent part that when computing a taxpayer's taxable income for any tax year if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding tax year was computed, then there shall be taken into account those adjustments that are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted.

Section 469(c) generally defines "passive activity" as any activity which involves the conduct of a trade or business in which the taxpayer does not materially participate and any rental activity.

Section 469 denies certain taxpayers the use of deductions arising from passive activities to offset income from personal services, portfolio income and income from a trade or business which is not a passive activity ("nonpassive income"). Generally, deductions arising from passive activities may only be used to offset the income arising from passive activities. If in any tax year a deduction arising from a passive activity can not be fully used against the income from the passive activity and the net income from other passive activities, the taxpayer is permitted to carryforward the unused portion of the deduction. When the taxpayer disposes of its interest in the passive activity in a fully taxable transaction with an unrelated party, if any unused deduction from the disposed of activity remains after first being used to offset income from the disposition of the activity and net income from other passive activities, the taxpayer may apply the excess deduction to offset other income.

Thus, § 469 divides certain taxpayers' activities into two categories--passive or not passive. Then, § 469 places special restrictions on the use of losses arising from activities characterized as passive.

For a number of years, including 1994, the taxpayers have been required to determine whether the nursing home activity was a passive activity subject to the passive activity loss limit rules of § 469. Basically, this has required that the taxpayers determine whether, based on the facts for that year, they materially participated in their nursing home activity. If they materially participated, the nursing home activity was not

a passive activity that year and any loss for that year would not be limited by § 469. In contrast, if they did not materially participate, the nursing home activity was a passive activity that year and any loss for that year could not be freely used to offset income. Because the determination of whether the nursing home activity is a passive activity is based on each year's facts, the taxpayers' nursing home activity could be considered passive in one year but not in the next year.

Assuming that the examiner is correct that, in 1994, the taxpayers did not materially participate in their nursing home activity and, therefore, the taxpayers' nursing home activity should be recharacterized from nonpassive to passive for purposes of § 469, the issue to be decided by the national office is whether this recharacterization is a change in a method of accounting under § 446(e). This issue involves only the characterization of an activity as either nonpassive or passive.

Each year the taxpayers review their facts and decide whether during that year they materially participated in their nursing home activity. If the taxpayers did not materially participate, their nursing home activity must be classified as passive under the § 469 rules. Based on the facts present in one year, the activity may be nonpassive in that year, while in another year, under the facts present in that year, the activity may be passive. Under the argument advocated by the examiner, each year that the activity changed from nonpassive to passive, or vice versa, the taxpayers would be required to file a Form 3115, Application for Change in Accounting Method. In each year of change, the taxpayers would be required to compute an adjustment under § 481(a). If, for example, a taxpayer materially participated in an activity in 1997, but did not in 1998, the examiner would have the taxpayer file a Form 3115 for 1998. Any amounts that were properly deducted in 1997 because the activity was nonpassive, that would have been deferred had the activity been passive would be included in the computation under § 481(a). Similarly, in the instant case, the examiner believes that if the taxpayers did not materially participate in 1994, the examiner may bring into income in 1994 any amounts that were deducted in prior years, that would not have been deductible in those years if the taxpayers had not materially participated in those years. The examiner believes that this may be done, by virtue of § 481(a), without regard to whether the taxpayers materially participated in the nursing home activity in the prior years. The examiner notes that this is because, if a change from determining that a taxpayer materially participated in an activity to determining that it did not materially participate in the activity is a change in method of accounting, § 481(a) authorizes necessary adjustments to prevent amounts from being duplicated or omitted.

We do not believe that a determination of whether a taxpayer materially participates in an activity is a method of accounting. In this case, the taxpayers' determination of whether they materially participate in their nursing home activity does not determine into which period an item of income or deduction will be placed. The

taxpayers' determination does not involve the treatment of a "material item." Simply, determining whether the taxpayers materially participated in their activity for purposes of classifying the activity as passive or not is not an "item"--it is not a recurring incidence of income or expense. Instead, the taxpayers' determination establishes the character of their activity for that year--it is either passive or it is not passive. Once the character of the activity is determined, then if the activity is passive, the taxpayers must apply the statutorily mandated rules of § 469 to any existing loss.

The issue involved in this technical advice request is distinguishable from that addressed in Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781 (11th Cir. 1984), a case cited by the examiner in support for the conclusion that a method of accounting will be changed when the treatment of the taxpayers' activities is changed from nonpassive to passive under § 469. As discussed in the examiner's submission, the taxpayer in Knight-Ridder used a reserve accounting method for its advertising revenue. Advertising customers that met certain criteria were entitled to a rebate of a portion of their advertising payment. Knight-Ridder accrued advertising revenue as income and deducted an estimate of the amount that would be refunded under its rebate program. Knight-Ridder was not obligated to pay, and was therefore not entitled to deduct, the advertising rebates until the advertiser met the rebate criteria. The Government proposed to change Knight-Ridder's method of accounting to the correct method. Knight-Ridder agreed that its reporting was improper, but argued that it was not a method of accounting subject to the provisions of §§ 446 and 481(a). Knight-Ridder argued that since it was deducting amounts that might never be deductible, the proper time for the taking of deductions was not at issue. The court concluded that Knight-Ridder's reserve method of accounting would have reported excess deductions as income when Knight-Ridder terminated its affairs, thus the proper time for the taking of deductions was at issue.

In Knight-Ridder, unlike the instant case, the treatment of an item of expense (the advertising rebates) was at issue. The instant case involves no item of income or expense, but, rather the factual determination of whether the taxpayers materially participated in an activity during a given year. Recently, the United States Tax Court was presented with the argument that § 469 was an accounting method provision. St. Charles Investment Co. v. Commissioner, 110 T.C. 46 (1998). Although the case was decided on other grounds, the Court gave some indication that it did not believe that § 469 was an accounting method provision. For example, the Court stated-

> we note that, although Congress placed section 469 in a part of the Code entitled "Methods of Accounting", the legislative history indicates that such treatment is not as significant as petitioner would have us believe. The statute

> itself and the legislative history treat section 469 separately from the provisions dealing with accounting matters. Compare title V, entitled "Tax Shelter Limitations; Interest Limitations", which includes the provisions of section 469, with title VIII "Accounting Provisions" of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2233-2249, 2345-2375; H. Conf. Rept. 99-841 (Vol. II), supra, 1986-3 C.B. (Vol. 4) at 134, 285.

Id. at 53-54. Similarly, the Court rejected the taxpayer's attempt to reinforce its method of accounting argument with language in the § 469 regulations. *Id*. at 54.

Assuming that the taxpayers did not materially participate in the nursing home activity in 1994, the taxpayers mischaracterized their nursing home activity in 1994 when they failed to treat the nursing home activity as a passive activity under § 469 rules. The taxpayers made an error in 1994 and the correction of this error is not a change in a method of accounting.

Caveat: A copy of this technical advice memorandum is to be given to the taxpayers. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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