

Payments After Sale of a Business: Is It Passive or Portfolio Income?

by Robert W. Wood • San Francisco

A recent Tax Court case, *Jay W. Edelberg, et ux. v. Commissioner*, T.C. Memo 1995-386 (1995), highlights the often complex and even

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 Byzantine determinations of active, passive and portfolio baskets for purposes of Section 469. As all tax professionals (and many businesspeople) know, the determination of which items go into which baskets can have enormous consequences when it comes to the net dollar amount paid by a taxpayer for a particular year. Section 469 may not often be thought of in the context of the sale of a business, but the *Edelberg* decision points out that these rules can indeed play a part once a business has been sold and proceeds from the sale continues to be paid.

Although the facts in the *Edelberg* decision are somewhat complex, at the root of the decision was Mrs. Edelberg's sale for a contingent payment structure of a business in which she personally participated. After the sale for these contingent payments, she withdrew from the business. She treated the receipts as passive income because she was no longer associated with the business. Nonetheless, the Tax Court held the income not to be passive income but rather to be portfolio income. A little background about the case and its holding are in order.

Business Sale

Mrs. Edelberg formed an S corporation, Datamed Management Systems, Inc., to provide billing and collection services to physicians who specialized in providing medical treatment in emergency rooms. The physicians paid Datamed a fee for billing and following up with collection services as needed. Mrs. Edelberg's husband, Jay Edelberg, was a physician himself, and was the principal shareholder of Emergency Physicians, Inc. This entity was the principal client of Datamed. As such, Emergency Physicians, Inc. agreed to pay Datamed 14% of any payments actually collected from Emergency Physicians' patients.

In 1986, Datamed sold its interest in the Emergency Physicians account to a competitor under an agreement requiring the competitor to pay Mrs. Edelberg a fee of 80¢ for each patient of Emergency Physicians that was billed by the new owner, up to a maximum cumulative fee of \$450,000. Pursuant to the sale, Datamed ceased doing business and was dissolved in October of 1986.

In November of 1986, Mrs. Edelberg signed an agreement in her individual capacity denominated a "service agreement," to reflect the transfer of the Emergency Physicians account to the buyer. The agreement also called for a fixed per patient fee to be paid her by the buyer. Mrs. Edelberg had no obligation to perform any services for the business, and in fact did not render any personal or consulting services to the buyer, and was not an employee. However, as contingent purchase price, she received \$60,832 in 1988, \$88,940 in 1989, and \$96,304 in 1990, all from the buyer.

The Edelbergs on their return treated these fees received from the buyer as passive income. Not surprisingly, they offset this passive income with their unrelated passive losses. On audit, the IRS determined that the fees received from the buyer did not qualify as passive income and disallowed the claimed offset.

Tax Court Agrees

The Tax Court agreed with the IRS, concluding that Mrs. Edelberg was not engaged in a trade or business in any of the years in question with respect to the activity that gave rise to the income. Accordingly, said the Tax Court, the income did not qualify under Section 469(c)(1)(A) as passive income. The court rejected the Edelbergs' argument that a taxpayer would not have to be personally involved in the conduct of a trade or business—and certainly need not personally own an interest in an entity that is engaged in the conduct of a trade or business—to meet the "trade or business" requirement of Section 469(c)(1)(A).

Nonetheless, the court ruled that implicit in the language of the statute was the requirement that income must be received from or in connection with an activity of the taxpayer for it to be treated as passive income. Explained the court, "[i]f income is received by a taxpayer from a third party's trade or business as a result of some capital or other transaction entered into between the taxpayer and the third party's business, the income generally will be treated either as capital gain or as investment or portfolio income that will not be eligible to be offset by passive losses." This result is consistent with the Temporary Regulations under Section 469.

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It was the activity of the buyer, not of the Edelbergs, that gave rise to the payments to Mrs. Edelberg in the years 1988 through 1990, said the court. The court noted that the transaction giving rise to the payments in question appeared to constitute the sale by Mrs. Edelberg of the goodwill associated with the Emergency Physicians account, even though the service agreement happened to be executed after the dissolution of Datamed.

Conclusion

The result in *Jay W. Edelberg* is probably not surprising, given the Service's understandable predilection with portfolio income as opposed to passive income. However, the unfortunate result in the case should serve as a warning in contingent payment sales to evaluate in advance the likely classification of the stream of contingent payments and the important corollary: the taxpayer's need for particular classification *vis-a-vis* use of offsetting losses. ■

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