More v. Commissioner, 115 T. C. 125, 2000 U. S. Tax Ct. LEXIS 54, 115 T. C. No. 9 (2000)

Gains from the sale of pledged assets used as security for underwriting activities are portfolio income and cannot be offset by passive losses unless derived in the ordinary course of a trade or business.

Summary

Howard More, a Lloyd's of London underwriter, pledged his stock as security for a letter of credit to support his underwriting capacity. When the policies he underwrote incurred losses, the bank sold his stock, generating substantial gains. More reported these gains as passive income, attempting to offset them with passive losses from his underwriting. The Tax Court held that these gains were portfolio income under I. R. C. sec. 469(e)(1)(A) and could not be offset by passive losses. The court's reasoning hinged on the fact that the stock was not acquired as part of More's underwriting business but as a separate investment, and thus the gains did not fall within the exceptions for income derived in the ordinary course of a trade or business.

Facts

Howard More was an individual underwriter for Lloyd's of London. To demonstrate his capacity to cover potential losses (known as "show means"), More secured a letter of credit from Bank Julius Baer (BJB) with his preexisting stock portfolio. During 1992 and 1993, the syndicates in which More participated incurred losses, prompting BJB to sell More's pledged stock to cover these losses. The sales resulted in significant gains for More. More reported these gains as passive income on his tax returns and attempted to offset them with passive losses from his underwriting activities. The Commissioner of Internal Revenue disagreed with this treatment, asserting that the gains were portfolio income and could not be offset by passive losses.

Procedural History

The Commissioner issued a notice of deficiency to More for the tax years 1992 and 1993, asserting that the gains from the stock sales were portfolio income. More petitioned the United States Tax Court for a redetermination of the deficiencies. The case was fully stipulated and submitted to the court for decision.

Issue(s)

1. Whether the gain from the sale of stock pledged as collateral for a letter of credit, which guaranteed More's underwriting activities, is portfolio income under I. R. C. sec. 469(e)(1)(A) and cannot be offset by passive losses.

Holding

1. Yes, because the gain from the sale of the pledged stock was portfolio income under I. R. C. sec. 469(e)(1)(A) and could not be offset by More's passive losses, as it was not derived in the ordinary course of his underwriting business.

Court's Reasoning

The Tax Court applied I. R. C. sec. 469(e)(1)(A) and the applicable regulations, which define portfolio income as including gains from the disposition of property producing dividends, unless such income is derived in the ordinary course of a trade or business. The court found that More's stock was not acquired as part of his underwriting business but as a separate investment. The pledging of the stock to secure the letter of credit did not convert the stock into an asset used in the underwriting business. The court emphasized that for income to be excluded from portfolio income under the regulations, it must be derived from investments made in the ordinary course of a trade or business of reinsuring risks, which was not the case here. The court also analogized More's situation to the treatment of income from working capital investments, which is considered portfolio income despite being necessary for a business. The court concluded that More's gain was portfolio income and could not be offset by his passive losses.

Practical Implications

This decision clarifies that gains from the disposition of assets pledged as security for underwriting activities are generally treated as portfolio income, unless the assets were acquired in the ordinary course of the underwriting business. Attorneys and tax professionals should advise clients who engage in similar activities to carefully consider the tax treatment of gains from pledged assets. The ruling reinforces the principle that the passive activity loss rules are intended to prevent the offsetting of passive losses against portfolio income, thereby limiting tax sheltering opportunities. This case may impact how underwriters structure their financial arrangements and how they report gains and losses for tax purposes. Subsequent cases have applied this ruling to similar situations, emphasizing the need for a direct connection between the asset and the business activity to qualify for an exception to the portfolio income rule.

