What Services Render Property Rentals Not Passive?

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“Significant services” and “extraordinary personal services” both have been critical to income tax classifications of rental income at one time or another and for one type of taxpayer or another. Services have been relevant tax considerations, or at least argued to be so, in connection with personal holding company income, passive activity losses, unrelated business income of exempt or partially exempt organizations, subchapter S corporations, ordinary-loss small-business corporations, and the classification of rental income as self-employed income. Our emphasis in this article is on a recent Tax Court case dealing with passive activity losses and a private letter ruling dealing with rent as S corporation passive income, in both of which the critical question was whether the rent income was active or passive.

**Professional Office Building With Services**

Owning an office building in which one of the tenants is the law firm of the owner is hardly an unusual activity. The rent received by the property owner from her law firm, we have learned, will normally constitute active income if the rental produces an excess of income over expense and passive loss if that self-paid rent produces a loss. But what if the space rental also involves the provision of services not related to building occupancy, and especially the provision of services to other tenants? In Assaf F. Al Assaf et ux. v. Commissioner, T.C. Memo. 2005-14, Doc 2005-1943, 2005 TNT 20-5, the office building was owned by AGI Consulting LLC (AGI), which in turn was owned 50 percent by Assaf F. Al Assaf, M.D., whose medical office was in the building, and Rehab R. Assaf, Esq., whose law office was also in the building. AGI incurred losses of $34,090 in 1999 and $34,207 in 2000.

AGI owned and operated the office building. Over and above providing space, however, AGI’s principal activity was providing legal support services to attorneys to whom it leased space. It was also the vehicle for Dr. Assaf’s consulting services. Those consulting services included reviewing medical malpractice cases, serving as an expert witness, performing mock surveys, and providing training in quality assurance programs. Dr. Assaf’s primary professional activity, however, was not what he did for AGI, but serving as a professor at the University of Oklahoma Health Sciences Center.

Attorney Assaf, on the other hand, was both a tenant in the building and also the general manager of AGI. She managed its leasing activities and legal support services, in addition to conducting her own law practice. She supervised three clerical support people who provided AGI’s tenants, including Ms. Assaf herself, with such services as client intake, answering phones, taking messages, filing documents at the courthouse and state capitol, process serving, express mailing, binding briefs, conducting legal research, typing briefs and legal memorandums, taking dictation, managing a file room, photocopying, maintaining an updated law library, providing conference facilities, and coffee service. AGI also made available to tenants Dr. Assaf’s consulting services. Also, of course, AGI did those other things that a tenant expects from a landlord, including security service, trash removal, janitorial service, and general utilities.

**Passive Activity Loss?**

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2. A mock survey would be a review of a health care organization before and in preparation for an official review by the Joint Commission on the Accreditation of Healthcare Organizations. The survey team would typically include an administrator, nurses, and a doctor.
The IRS concluded that AGI’s losses were by their very nature passive, and disallowed them. Attorney Assaf then represented AGI in Al Assaf. She argued that AGI qualified for an exception from the passive loss rules because of the time she spent in managing AGI and the nature of the AGI services. That exception, which is in reg. section 1.469-1T(e)(3)(ii)(C), is for “extraordinary personal services . . . provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use).” Reg. section 1.469-1T(e)(3)(v) then defines “extraordinary personal services”:

For purposes of paragraph (e)(3)(ii)(C) of this section, extraordinary personal services are provided in connection with making property available for use by customers only if the services provided in connection with the use of the property are performed by individuals, and the use by customers of the property is incidental to their receipt of such services.

For example, the use by patients of a hospital’s boarding facilities generally is incidental to their receipt of the personal services provided by the hospital’s medical and nursing staff. Similarly, the use by students of a boarding school’s dormitories generally is incidental to their receipt of the personal services provided by the school’s teaching staff.

The key language here, of course, is “the use by customers . . . of the property is incidental to the receipt of such services.” Thus the challenge facing attorney Assaf was to persuade Tax Court Judge Diane L. Kroupa that the services AGI provided were the primary reason tenants rented space from it, and the use of the space, qua space, was “incidental to their receipt of such services.” No prior Tax Court case had ever found that office space rental was not passive for passive activity loss purposes. Only one other Tax Court case had even found that a taxpayer had rendered extraordinary personal services. That case involved a carpenter who contracted with movie production companies to construct movie sets. He also leased tools and equipment to the production companies. In Welch v. Commissioner, T.C. Memo. 1998-310, Doc 98-26383, 98 TNT 164-4, Tax Court Special Trial Judge Larry L. Nameroff held that “petitioner provided extraordinary personal services. The rental of the tools and equipment by the production companies is incidental to their receipt of petitioner’s services as construction coordinator. Therefore, we hold that petitioner’s activity was not a rental activity within the meaning of section 469(j)(8).”

Attorney Assaf produced witnesses who testified that AGI’s services to its tenants were unique and that they would not have moved onto the premises if the support services were not provided. Commented Judge Kroupa:

We find of particular significance that AGI performed legal research for its attorney-tenants. Overall, testimony established that the services were the crucial determinant in attorneys’ choosing to lease from AGI, and we found the testimony on behalf of petitioners credible and compelling. [citation omitted.] We therefore find the payments to AGI were principally for the services provided and not for the space leased. Consequently, the leasing activity is not a rental activity.

Lack of Contemporaneous Daily Time Records

Mrs. Assaf also had to satisfy the court that she met the 500-hour test for material participation. She had no contemporaneous time records breaking down her AGI activity, but Judge Kroupa noted, “Contemporaneous
daily time reports are not required if the extent of participation may be established by other reasonable means." Attorney Assaf introduced testimony and a good-faith estimate of her time spent supervising the office staff, meeting the business and legal needs of 9-10 tenant attorneys and other nontenant attorneys, handling the AGI payroll, accounts payable and accounts receivable, and maintaining the law library. Concluded Judge Kroupa:

Petitioner wife has shown, through exhibits and testimony, that she provided regular and substantial services to AGI's tenants. Petitioner wife was daily onsite and in charge of AGI’s leasing activities and legal support services during the years at issue. . . . Respondent contends that petitioner wife’s estimate was neither reasonable nor reliable. Petitioner wife counters that she still performs the same activities, which are at issue in this case, so the computations of time were not based on distant memories. . . . We have no doubt that petitioner wife spent substantial time on the leasing activities and legal support services. Although this Court has not always accepted a post-event narrative of participation, we find petitioner wife’s description of her participation, when combined with witness testimony and the objective evidence in the record, to be credible, and we therefore conclude that petitioner wife materially participated in the activity by participating for more than 500 hours during the year.

Other Situations Involving Services in Connection With Rentals

Besides section 469, other sections of the code that deal with rental income include 512 (unrelated business income), 543 (personal holding companies), 1244 (ordinary loss on small business stock), 1375 (S corporations), and 1402(a) (self-employment income). With sections 512 and 1402(a), the government will collect more tax if it can find some way to treat the amounts involved as not being rental income because of the services rendered in connection with the rental of real property. See reg. sections 1.512(b)-1(d)(5) and 1.1402(a)-4(c)(2).

With the others, the taxpayer would like to have the services rendered transmute the rental income from passive to active. Thus, it might be in the taxpayer’s interest to argue that the services rendered are significant and substantial enough to require not treating the amounts received for use of the property as rentals when applying the gross receipts test for a section 1244 small business corporation or in determining whether an S corporation has section 1375 passive income. The section 543 personal holding company situation once looked like it might fit into the same category as the section 1244 or section 1375 provisions, but fate, the Tax Court, and the Treasury conspired together and left personal holding companies with a quantitative test but no qualitative test.

Personal Holding Company Rents Coupled With Services

Whether there was a qualitative test as an alternative to the quantitative test for PHC rentals was the issue in Walt E. Eller Trailer Sales of Modesto, Inc, et al. v. Commissioner, 77 T.C. 934 (1981), 95 TNT 128-70, which also involved a number of other issues besides the IRS’s imposition of the personal holding company tax. The IRS contended that the taxpayer’s operation of a commercial shopping center and a mobile home park produced rent that was personal holding company income. The taxpayer stipulated that it did not meet both the 50 percent and 10 percent tests’ for exclusion of rental income from the category of

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3To not be personal holding company income, adjusted income from rents must be at least 50 percent of adjusted ordinary gross income, while nonrent personal holding company income, net of dividends paid by the corporation, must not exceed 10 percent of ordinary gross income.
personal holding company income, which is what we referred to as the quantitative test. Rather, imposition of the personal holding company tax hinged on whether the rents were to be removed entirely from the category of personal holding company income by virtue of a qualitative test of whether significant or substantial services were provided the tenants.

The IRS argued that there was no such test and that, in any event, the taxpayer's facts did not meet the "significant services" test if there was one. The taxpayer relied on prop. reg. section 1.543-12(d)(2), which stated that "the term 'rents' does not include payments for the use or occupancy of rooms or other space where significant services are also rendered to the occupant," and tracked the language of the regulations under 1244, 1375, and 1402(a). The Tax Court opinion started out by emphasizing that the proposed regulation was "only a proposed regulation, presumably still under consideration, which has not been formally adopted by the Treasury Department." The court found nothing in the statutory language or in the legislative history to suggest that there should be any distinction between "active" rental income and "passive" income in arriving at the personal holding company determination. Said the court, holding that the income received constituted PHC rental income:

The legislative history of section 225 of the Revenue Act of 1964 thus reveals Congress' continuing concern about the use of rents to shelter hard-core personal holding company income such as interest and dividends. Congress sought to alleviate this abuse not by attempting to distinguish between "active" and "passive" rents by creating a subjective "substantial services" (or similar) standard, but rather by utilizing objective criteria (the 50-percent and 10-percent tests) and employing "adjusted" income concepts. Nowhere in the legislative history is there even a suggestion that "rents" should be construed less expansively than before.

The proposed regulation was, it should be noted, never adopted, and the Eller holding on this point stands as the law to this day.

S Corporations

Under section 1375, an S corporation that has C corporation accumulated earnings and profits can incur a 35 percent tax on its excess net passive income. Excess passive income is the amount of passive income in excess of 25 percent of the corporate gross receipts for the year. If there is passive income in excess of 25 percent of gross receipts for three consecutive years, and the corporation has C corporation accumulated earnings and profits at the end of each of those years, the S corporation election terminates. Our question, of course, is whether rental income is always passive income, as in the personal holding company situation, or whether significant services to the tenants can remove it from the passive category. The question was answered under pre-1982 law when reg. section 1.1372-4(b)(5)(iv) concluded that, yes, significant services removed rental income from the S corporation category of passive income.

How would Walt Eller Trailer Sales have fared if the question had been the status of the trailer park rentals for S corporation rather than PHC purposes? LTR 9234012, 92 TNT 172-44, dealt with a corporation operating a mobile home park. The park provided its residents a wide array of facilities and services, including a clubhouse with full-service kitchen, free coffee and tea during clubhouse hours, meeting area and regularly scheduled events, games, piano, cable-equipped large screen television, a swimming pool, recreation room with two pool tables, coin-operated washers and dryers, car-wash facility, dog
exercise area, holiday parties and similar gatherings, and sponsorship of the intercommunity management association for residents.

The LTR emphasized the “significant services” test and noted that “income is considered ‘rentals from real estate’ unless the services provided for the convenience of the tenants are of such a substantial nature that compensation for them can be said to constitute a material part of the payments made by the tenants of the park,” citing Situation (2) of Rev. Rul. 83-139, 1983-2 C.B. 150, in concluding that the payments received from the mobile home park tenants were not rents for S corporation passive income purposes.

Rental Income as Passive Income Today

Current reg. section 1.1362-2(c)(5)(ii)(B)(2) had not yet been adopted when LTR 9234012 was issued. That regulation has changed the emphasis and broadened the types of rental income that will not be considered passive. Reg. section 1.1362-2(c)(5)(ii)(B)(2) now provides that:

“rents” does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Thus, LTR 200503016, 2005 TNT 14-44, Doc 2005-1306, considered a company that owned, operated, leased, and managed commercial real estate. Its services covered only the normal functions of a landlord in a first-class multitenant commercial property. It incurred substantial costs in carrying out those functions. The IRS ruled that “the rents Company receives from the Properties are not passive investment income” for S corporation passive income purposes. The ruling added, “the passive investment income rules of section 1362 are independent of the passive activity rules of section 469; unless an exception under section 469 applies, the rental activity remains passive for purposes of section 469.”

Conclusion

So what is “rent”? For income tax purposes, it may be active or passive income, with resulting consequences that may be good or bad for the taxpayer. It depends on the facts and on the particular code section for which the answer is being sought. Income that might be active for S corporation passive income purposes thus might be passive for passive activity loss purposes. The tax practitioner needs to refresh his or her memory as to the nuances of the particular meaning of rent for any given situation. But the tax practitioner also needs to impress upon the client the importance of being able to prove the facts that will provide the more favorable outcome. After all, the Assafs would not have obtained their loss deductions if attorney Assaf had not been able to persuade Judge Kroupa that AGI’s attorney-tenants rented office space to obtain the support services that AGI also provided.