Assume the partnership wishes to specially allocate all depreciation to the limited partners, as shown:

		GP	*LP*
Beginning capital accounts		$ 100,000	$ 700,000
Income before depreciation	$ 20,000		
Gross income allocation	(30,000)		30,000
	$(10,000)	(5,000)	(5,000)
Depreciation			(160,000)
Ending capital accounts		$ 95,000	$ 565,000

This allocation would be inconsistent with the economic arrangement of the partners, as presented earlier. It is not possible under the regulations to sustain a special allocation of recourse depreciation along with priority returns to the same partner.

Conclusion

Some have criticized the regulations for failing to take into account appreciation on a year-to-year basis. If this were not the case, special allocations could be made in connection with the changes in fair market value. The ability to "police" such allocations from year to year would, in most cases, clearly be unmanageable. Nevertheless, until more guidance or case law is available, there may be an opportunity to avoid deficit restoration provisions and allocate losses based on how the economic arrangement between the partners affects the unrealized gain or loss in property owned by the partnership.

Regulations Section 1.704-1(b)(3) states that the determination of a partner's interest in a partnership is made by taking into account all facts and circumstances relating to the economic arrangements of the partners. If a credible showing could be made of fluctuation in value of partnership property, perhaps tax allocations applied consistently should be respected.[42] Unrealized gain or loss can quite often be manifested by bankable results for or against a partner's creditworthiness. Many times such side effects are quite subtle.

[42] This logic appears particularly appealing in a partnership owning property that is readily tradable in an open market.

S Corporations

RICHARD B. COMITER*

Recent Private Rulings Hold Shopping Mall Rents Are Not Passive Investment Income

In three recent private letter rulings (LTRs 8801013,[1] 8904012,[2] and 8906035[3] (collectively referred to as the "Rulings"), the Service held that shopping mall rents received by S corporation owner-operators were not passive investment income under Section 1362(d)(3)(D). This conclusion resulted in the avoidance of both a corporate-level tax on the rents under Section 1375 and a possible termination of the corporation's S election under Section 1362(d)(3). The Service's rationale for excluding the payments from the definition of rents was based on the degree of services the S corporations provided other than services that are customarily rendered to tenants for occupancy only.[4] Although the Rulings may be relied on only by the specific corporations requesting the Service's response, they indicate a more liberal attitude on the part of the Service that may allow a greater number of corporations holding rental properties to have safe passage in making a C to S conversion.

Problems Associated With Passive Investment Income

Section 1362(a) allows a small-business corporation to elect not to be subject to corporate-level taxes but instead to pass through its income (and loss) to its shareholders. There are two major exceptions to this general rule. First, an S corporation may be subject to a corporate-level tax on its net recognized built-in gains under Section 1374[5] or, as is relevant here, a corporate-level tax ("sting tax") on its excess net passive income provided such corporation has undistributed earnings and profits from prior C Corporation years (AE&P).[6] In addition to the sting

* Richard B. Comiter, of the Florida Bar, is a partner with the law firm of August & Comiter, P.A., in West Palm Beach, Florida.

[1] Oct. 8, 1987.

[2] Oct. 26, 1988.

[3] Nov. 2, 1988.

[4] There are two distinct lines of cases and rulings involving services: "significant" services and "pure" services. In the significant services cases, payments received or accrued for the use of property, although "rents," are not passive investment rents. In the pure service cases, payments are received or accrued for the performance of services, and the use of property is incidental thereto. Thus, the payments are not for the use of property. The focus of this column will be on "significant" services provided by S corporations that own and operate rental real estate—in particular, shopping centers and malls.

[5] See August, "Corporate-Level Taxes on S Corporations After the Tax Reform Act of 1986," 4 J. Partnership Tax'n 91 (1987).

[6] This corporate-level tax is applied against the lesser of the S corporation's excess net passive investment income

tax, if the S corporation continues to retain its AE&P for three consecutive years and has "passive investment income" in excess of 25 percent of its gross receipts for each of those years, its S status will be forfeited as of the first day of the following taxable year unless a waiver for an inadvertent termination can be obtained from the Service ("passive income termination rule").[7]

For purposes of the sting tax and the passive income termination rule,[8] the term "passive investment income" includes, among other things, gross receipts from rents.[9] Thus, the determination whether rents constitute passive investment income is one that can critically affect an S corporation that owns rental properties and has AE&P.[10]

Recent Private Letter Rulings

In each of the Rulings, S corporations that owned and operated shopping malls sought the Service's approval to maintain their S election despite having undistributed AE&P, on the grounds that gross receipts from rents did not constitute passive investment income in light of the amount of "significant services" rendered to mall tenants. In each of the Rulings, the corporation represented that it provided an extensive list of services to the tenants.[11] Among the separately listed services were

or its taxable income. See also Reg. § 1.1375-1A(b), which sets forth the formula to compute excess net passive income.

[7] Under former § 1372(e)(5) (the predecessor to § 1362(d)(3)), a Subchapter S corporation could not receive more than 20 percent of its gross receipts from passive investment income without terminating its Subchapter S status.

[8] The sting tax under § 1375(a)(1) and the passive income termination rule under § 1362(d)(3) were enacted pursuant to the Subchapter S Revision Act of 1982 (SSRA) because of the Service's concern that C corporations with accumulated earnings and profits would elect S corporation status and invest the accumulated earnings and profits in passive investments, thereby giving their shareholders the use of the accumulated earnings and profits while postponing the taxation of such accumulated earnings and profits at the shareholder level. See Pub. L. No. 97-354, 96 Stat. 1669 (1982).

[9] Section 1362(d)(3)(D) defines passive investment income to also include royalties, dividends, interest, annuities, and sales or exchanges of stock or securities to the extent of any gains from such sales.

[10] The most significant change in the area of passive investment income under the SSRA is probably that there are no passive investment income limitations to concern S corporations with no AE&P. An S corporation with AE&P must continue to carefully monitor its passive investment income unless it is able to strip out its AE&P prior to the close of its tax year.

[11] In LTR 8801013 (Oct. 8, 1987), an S corporation that owned three shopping malls represented that in connection with the leasing of space in the malls, it provided twenty-five listed services. In LTR 8904012 (Oct. 26, 1988), an S corporation that owned and operated five malls and three shopping centers represented that in connection with the leasing of space, it provided fourteen listed services. In LTR 8906035 (Nov. 2, 1988), an S corporation that owned and operated a shopping center represented that it performed approximately twenty services.

(1) tenant advertising, (2) promotional work, (3) maintenance, (4) management and consulting services, (5) conducting market surveys, (6) assisting in the sale of a tenant's business or obtaining financing from banks, (7) hiring a private agency to provide tenant security, (8) distributing newsletters and informational memoranda to possible customers, and (9) assisting tenants in hiring employees. Based on the scope and extent of such nonoccupancy-type services, the Service ruled in each instance that the rents received by the mall operators did not constitute passive investment income.

In its holdings, the Service curiously relied on a decision of the Ninth Circuit, *Delno v. Celebrezze*,[12] which interpreted the term "rent" under a similarly worded Social Security Administration regulation (Section 404.1052(a)(3)) instead of primarily focusing on existing precedent interpreting the regulations under Subchapter S.[13] In *Delno*, the opinion emphasized that a careful distinction must be made between services customarily rendered in connection with the rental of rooms or other space "for occupancy only," which are not significant services, and those services that are. In making this determination, the phrase "for occupancy only," contained in the Social Security Administration regulation (and in Subchapter S as well), must not be given an expansive interpretation.

Another decision cited in the Rulings was a self-employment tax case from the Tax Court, *Bobo v. Comm'r*.[14] There, the court held that income from a taxpayer's mobile home park constituted self-employment income for purposes of Section 1402(a)(1) and not rents as the taxpayer had contended, since the mobile home services were not for occupancy only. A similar conclusion was reached by the same court in *Johnson v. Comm'r*.[15] There, a taxpayer who received payments in connection with his leasing of boat sheds to lessees was held to be receiving self-employment income by virtue of rendering numerous related services to the tenants—services that were not essential for the conservation of the taxpayer's invested capital.[16]

Based on the Rulings and the precedent cited by the Service, it

[12] 347 F.2d 159 (9th Cir. 1965).

[13] See L. Bravenec, *Federal Taxation of S Corporations and Shareholders* 6-69 to 6-71 (2d ed. 1988), for a list by category of rental real property of cases and rulings involving the concept of significant services.

[14] 70 T.C. 706 (1978), *acq.* 1983-2 C.B. 1.

[15] 60 T.C. 820 (1973).

[16] The Service also cited Rev. Rul. 83-139, 1983-2 C.B. 150, and Rev. Rul. 81-197, 1981-2 C.B. 166, to support its position in the letter rulings. In Rev. Rul. 83-139, the Service adopted the rationale of Delno v. Celebrezze, 347 F.2d 159, and *Bobo* in determining whether services provided by an owner-operator of a mobile home park were substantial enough to avoid classifying rental payments as rental income within the meaning of Reg. § 1.1402(a)-4(c)(2).

appears that the Service will regard an S corporation that is engaged in the leasing of real property as not receiving gross receipts from rents where the corporation renders significant services that it can establish are not for occupancy only and are not directly related to the conservation and maintenance of the building itself.

Although the Rulings indicate that the Service will look to the number of services provided by S corporation mall owners to determine whether services rendered to tenants are significant, they do not provide any factual analysis of when such services become significant; nor do they provide any qualitative guidelines for making such a determination.[17]

[17] To make this type of determination, some courts have focused on the frequency of the activities and the fact that such activities are a significant part of the owner's operations in terms of efforts or money (the dollar value of the services in relation to rent). See McIlhinney v. Comm'r, T.C. Memo. 1979-473, *aff'd in an unpublished opinion* (3d Cir. 1981), and Feingold v. Comm'r, 49 T.C. 461 (1968), which stand for the proposition that services for tenants should be frequent or extensive to qualify as significant services for purposes of the prior regulations. Following *Delno*, the court in *Bobo* concluded 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.

Significant Services Exclusion

The applicable regulatory authority cited in the Rulings for excluding rental payments from the definition of rents is Regulations Section 1.1372-4(b)(5)(vi) (the Regulations) issued under former Section 1372(e)(5)(C).[18] The Committee Reports to the Subchapter Revision Act of 1982 (SSRA) imply that the definition of passive investment income, including rents, in the Regulations should continue to be applicable for purposes of defining rents under the sting tax provision and the passive income termination rule introduced by SSRA, until new regulations are promulgated.[19] The Regulations define the term "rents" to mean amounts received for the use of, or right to use, property (real or personal) of the corporation,[20] but do not include payments received for the use or occupancy of space, where significant services are also rendered to

[18] In interpreting § 1372(e)(5), the predecessor of § 1362(d)(3), the Regulations define rents for purposes of determining whether an S corporation's election could be terminated during any year in which passive investment income exceeded 20 percent of gross receipts.

[19] S. Rep. No. 640, 97th Cong., 2d Sess. 12 (1982); see Prop. Reg. § 1.1362-3.

[20] A comparable definition of rents is found in §§ 165(g)(3)(B), 1042(c)(4)(A)(i), and 1244(c)(1)(C). Cf. I.R.C. §§ 469(i)(1), 7707(e)(1)(E); Reg. §§ 1.167(j)-3(b)(2)(ii), 1.512(b)-1(c)(5), 1.864-6(b)(2)(i), 1.1402(a)-4(c)(2); Rev. Proc. 71-21, § 3, 1971-2 C.B. 549.

the occupant.[21] Thus, the Regulations utilize an "all-or-nothing approach" to define rents[22]; if significant services are present, all payments from tenants do not fall within the category of passive investment income.[23]

The Regulations list hotels and motels as examples of rental real estate in which gross receipts from tenants will not be characterized as rents because significant services are rendered to the occupants. However, rental payments for the use or occupancy of apartments in multifamily housing units and offices in office buildings are generally considered rents under the Regulations.

Under the Regulations, services are generally considered rendered to the occupant "if the services were primarily for his convenience and are other than those usually rendered in connection with the rental of rooms or other space for occupancy only."

The case law and revenue rulings cited by the Service in the Rulings have interpreted the phrase "services which are other than those usually rendered in connection with the rental of space for occupancy" to mean that any service not clearly required to maintain the property in condition for occupancy should be considered rendered to the occupant.[24] Services that go beyond those that are customarily and usually necessary for "mere occupancy" of space should not be considered to be rendered for the maintenance of property.[25] Moreover, the court in *Delno*[26] recognized that even maintenance

[21] On December 27, 1988, the Service issued proposed regulations under § 1362(d)(3)(D), which define rents for purposes of the sting tax and passive income termination rule.

[22] The "all-or-nothing approach" under the Regulations is that if payments from tenants fall within the category of rents, they are treated as passive investment income, but if payments are excluded from the definition of rents, they are treated as payments in return for significant services and not for rents.

[23] Another approach might be to bifurcate the ownership of rental real estate into two separate activities. For example, if an S corporation with AE&P owns and manages a profitable shopping mall, it could be treated as engaged in two separate activities. The gross receipts from such activities would be bifurcated between rents from the rental activity (to the extent such revenues are for the mere occupancy of space) and payments in return for managerial services (to the extent such payments are for services provided by the S corporation for the benefit of tenants). Query: Could the S corporation use this bifurcation argument to increase the amount of its rental income for purposes of the passive activity loss rules under § 469?

[24] See Delno v. Celebrezze, 347 F.2d 159 (9th Cir. 1965); Bobo v. Comm'r, 70 T.C. 706 (1978), *acq.* 1983-2 C.B. 1; see also Rev. Rul. 83-139, 1983-2 C.B. 150; Rev. Rul. 81-197, 1981-2 C.B. 166.

[25] *Id.*

[26] "The essential question remains whether the maintenance and repair is of a kind necessary to protect the property investment and maintain the space in condition for occupancy." Delno v. Celebrezze, 347 F.2d at 165-166; see also Bobo v. Comm'r, 70 T.C. at 710.

and repair services may go beyond what is customary and usual to maintain space in a condition for occupancy. Thus, by combining the words "customarily and usually" with the closing phrase "for occupancy only," the Rulings apparently will limit the types of services that the Service will consider as required to maintain property in condition for occupancy under the Regulations. Such narrowing of focus should increase the circumstances under which services will be considered significant to justify excluding rental payments from the definition of "rents."

The Service's position in these Rulings is consistent with other rulings that have held that gross receipts from rents paid to S corporations that own and actively operate rental projects do not constitute "passive investment income."[27] In Letter Ruling 8737074, the Service held that income from the rental of slips by a marina owner was not passive investment income because the marina owner was in the business of marina operations in addition to providing locations for the harboring of boats.[28] Similarly, in Letter Ruling 8802080, the Service held that payments received by an S corporation that owned and operated a commercial warehouse was not passive investment income.[29]

Although the Service's interpretation of the Regulations in the Rulings is consistent with the general line of authority distinguishing whether significant services have been provided, the Rulings did not discuss the Tax Court's decision in *McIlhinney v. Comm'r*.[30] There, gross receipts received by a Subchapter S corporation that owned a shopping mall were held to be passive investment income. The result in *McIlhinney* may be distinguished from the Rulings on the grounds that in *McIlhinney* the court found that (1) the taxpayer provided maintenance services that were no different from those normally required to maintain similar premises in good rental condition, and (2) no evidence was presented by the taxpayer as to whether the security and mall management services provided to the tenants were significant.[31] Until the Rulings were issued, many tax advisers may have been reluctant to attempt to limit the precedential value of *McIlhinney* strictly to its facts as a case in which the taxpayer failed to meet its burden of proof.

Proposed Regulations

On December 27, 1988, the Service issued proposed regulations under Section 1362(d)(3)(D), which define the term "rents" for purposes of the passive income termination rule of Section 1362(d)(3)(D) in the same manner as the Regulations define rents for purposes of the termination rule under former Section 1372(e)(5).[32] As with the current Regulations, the proposed regulations distinguish receipts from tenants that do not constitute passive investment income based on whether significant services are provided to the occupants. The proposed regulations continue to require that the types of services rendered by owner-operators of rental real estate be compared with the types of services generally rendered in connection with the maintenance of property for occupancy only, and that only those receipts for tenant services that are usual and customary for occupancy should fall into the category of "rents."

However, in order for rental payments to be excluded from the definition of rents, the proposed regulations specifically state that the corporation should perform the significant services, whereas the Regulations only require the significant services to be rendered to the occupants.[33] The legislative history of Subchapter S does not proscribe an S corporation from using an affiliated management corporation or even an unrelated management entity in providing the significant services to tenants. Indeed, the Service has permitted S corporations to provide significant services through an independent contractor, through supervision of lessee's employees, or through a related party.[34] However, where the lessee is reimbursed by the lessor (S corporation) for services provided by lessee's employees, the services

[27] This analysis appears to be consistent with legislative history, which indicates that the passive investment income limitations were intended to apply to corporations holding investment assets and not actively engaging in operations.

[28] June 17, 1987.

[29] Oct. 22, 1987. Similarly, in LTR 7832092 (May 12, 1978), the Service held that amounts received by a taxpayer for use of space in the operation of a mobile home park were not rents because of services provided by the operator of the mobile home park.

[30] T.C. Memo. 1979-473, *aff'd in an unpublished opinion* (3d Cir. 1981).

[31] See Feingold v. Comm'r, 49 T.C. 461, 465-467 (1968) (S corporation that was in the business of renting furnished bungalows failed to present evidence to establish that it performed significant services).

[32] Prop. Reg. § 1.1362-3.

[33] Compare the relevant language of the Regulations and proposed regulations. Under the Regulations, 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*. Under the proposed regulations, the term "rents" does not include payments received for the use or occupancy of property *if the corporation also performs significant services in return for such payments*.

[34] See LTR 8225141 (services provided by an independent contractor were held to be significant services); LTR 8312029 (services provided by an agent were held to be significant services); Lausmann v. Comm'r, T.C. Memo. 1978-420 (a corporation's employees' supervising of lessee's employees was held to be significant services); Winn, Jr. v. Comm'r, 67 T.C. 499 (1976), *aff'd on this issue*, 595 F.2d 1060 (5th Cir. 1979) (where services were performed by a related party with no evidence that such services were either performed or arranged for by the S corporation, the services were not significant); see note 13 *supra*.

have not been imputed to the corporation.[35]

Although most of the services in the Rulings were directly provided by the S corporations, the Rulings indicate that services may be provided by representatives of management and private agencies and through merchant associations in which the S corporation is a member. Although there is no specific acknowledgment in the proposed regulations that the Service purposely intended to narrow the significant services test for services rendered through a third party, the Service may use this ambiguity to attack efforts by S corporations to qualify rent receipts as nonpassive investmment income when services are not directly provided by their employees.

Significance of the Rulings

The Rulings are evidence of the Service's recent acquiescence to broadly defining rents as passive investment income, at least with respect to S corporations that own and operate shopping centers and malls and can demonstrate that a significant amount of nonoccupancy-type services are rendered to tenants. Accordingly, C corporations with AE&P that own and operate rental real estate and provide services to tenants may be given access to Subchapter S without the burden of the passive income penalties. Perhaps existing leases can be restructured (i.e., triple or double net leases) so that a corporate lessor that provides new or additional services to tenants may avoid rent characterization within the meaning of the Regulations.

The Service's Rulings may be a favorable development that will encourage S corporations to engage in rental activities. Nevertheless, the Service's narrow interpretation of the definition of rental income under Subchapter S may be consistent with its efforts to thwart lessors from generating passive activity income from rents under the passive activity loss rules.[36] The legislative history of Section 469 gives the Service the authority to narrowly define rents in regulations under the passive activity loss rules.[37]

The legislative history further provides that in determining whether an activity is a rental activity for purposes of the passive activity loss rules, prior law applicable in determining when an S corporation has passive rental income (as opposed to active business income) for purposes of continuing to qualify as an S corporation provides a useful analogy.[38] Thus, under both the passive activity loss rules and the passive investment income limitations, if significant services are provided to tenants, rental payments made to the owner-operators of rental real estate can be characterized as not rental income, even if such payments are made for the use of the property.[39]

Conclusion

The boundary line distinguishing rents that constitute passive investment income from those that do not is still unclear. At one end of the spectrum are payments for the use of hotel or motel rooms, which will generally fall outside the scope of passive investment income. One exception may be where management services in operating a hotel are provided by an S corporation through a third party. In such instances, the Service may challenge the imputation of such services to the S corporation/lessor. On the other hand, rents from office and apartment buildings will generally fall within the definition of passive investment income.

In the middle of the spectrum is the shopping mall owner who provides a number of services to tenants that are not directly related to occupancy. Based on the recent Rulings, receipts from mall tenants in such instances will not be passive investment income. Although the Rulings represent a favorable development for corporations seeking to avoid or reduce the potential impact of the sting tax or passive income termination rule, further guidance is needed in the forthcoming regulations to Section 1362 or via other judicial or administrative pronouncements to provide needed certainty and predictability in this area.[40] Due to the "all-or-nothing approach" used in characterizing gross receipts from rents, until such further guidance has been provided, tax practitioners should advise their clients to seek a ruling from the Service when the presence or absence of "rents" will be important for planning under the Subchapter S provisions.

---

[35] Where a lessee or an independent contractor of the lessee provided services and the lessee was reimbursed for performing or paying for such services, amounts received by the lessor were rent. However, in the second situation in Rev. Rul. 81-197, amounts received by the lessor were not rent because the significant services were performed by the lessor. Rev. Rul. 81-197, 1981-2 C.B. 166.

[36] I.R.C. § 469.

[37] S. Rep. No. 313, 99th Cong., 2d Sess. 740, 741 (1986).

[38] *Id.*

[39] The Service has recently promulgated Temp. Reg. § 1.469 under § 469, which lists six exceptions to the general rule that rental income is passive activity income when significant personal services are provided by the taxpayer. Query: Although the six exceptions in the Temporary Regulations construing § 469 clearly adopt a different set of criteria for defining a rental activity than do the Proposed Regulations under § 1362, could they be useful in determining when significant services are provided to occupants under § 1362?

[40] I.R.C. § 6110(j)(3). A private letter ruling is directed only to the taxpayer who requests it, and another taxpayer has no right to use or cite it as precedent.