INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Company =

Shareholders=

Tenant =

ISSUES:

1. Is Company's activity of providing property as described below a rental activity within the meaning of section 469(j)(8)?

2. Assuming Company's activity of providing property constitutes a rental activity for purposes of section 469, may Company group the rental activity with its trade or business activity for the years in issue

CONCLUSIONS:

1. Company's activity of providing property is a rental activity within the meaning of section 469(j)(8).

2. Company may not group the rental activity with its trade or business activity for the 1993 and 1994 tax years. Company may group the rental activity with its trade or business activity for the 1992 tax year.

FACTS:

Company, a subchapter S corporation, is in the business of selling petroleum products. During the years at issue, Company also leased parcels of property from its shareholders on which were located full service stations, credit card only fuel outlets, and convenience stores selling fuel. At issue presently are the properties on which the convenience stores were located.

Company did not enter into written lease agreements with its shareholders. Rather, under oral leases, Company was entitled to use the properties in return for payment of all of the shareholders' out of pocket expenses associated with the properties. In turn, Company subleased the relevant parcels to an unrelated third party, Tenant, which had an established convenience store line of business. Tenant then constructed the convenience stores, which under the terms of the leases, would remain the property of Tenant and would be demolished at the end of the lease. The sublease agreements provided for both a base rent and a supply agreement. Under the supply agreement, Company would supply all of the gasoline sold at the convenience store locations and Tenant would remit to Company its costs and half of the gasoline sales profits.

The examining agent has argued that Company is engaged in two separate activities, the trade or business activity of selling petroleum products and a rental activity associated with its leasing of these convenience store properties. Because Company's costs in renting these properties exceed the revenues generated from the base rents, the examining agent has indicated that the rental activity is generating a loss which should be treated as a passive activity loss to Company's shareholders.

In response, Company asserts that it could appropriately group its rental and trade or business activities. Company claims that its rental and sales activities constitute an appropriate economic unit. Company further asserts that in the years in issue, the gross income generated by its rental activities represents less than 20 percent of its

overall gross income. The examining agent has not contested this figure, but maintains that the properties have required five times as much capital investment as the nonrental activities.

After a conference of right on the grouping issue, Company raised an alternative theory that it was involved in a joint venture with Tenant and that its provision of property for use in the joint venture would not be considered a rental activity by virtue of § 1.469-1T(e)(3)(ii)(F) and § 1.469-1T(e)(3)(vii). Company and Tenant have never filed a partnership return.

LAW AND ANALYSIS:

Section 469(a) of the Code disallows deductions for passive activity losses for the taxable year for individuals, estates, trusts, closely-held C corporations, and personal service corporations. Section 469(c), for the tax years in question, defined the term passive activity as any activity that involves the conduct of any trade or business in which the taxpayer does not materially participate, and any rental activity.

ISSUE ONE:

Section 469(j)(8) defines rental activity as any activity where payments are principally for the use of tangible property. Section 469(c)(2) and (4) indicate that, for the years in issue, a rental activity is treated as a passive activity regardless of whether a taxpayer materially participates in the activity. Section 1.469-1T(e)(3)(i) of the temporary regulations provides in general, that an activity is a rental activity for a taxable year if (A) during the taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and (B) the gross income attributable to the conduct of the activity during the taxable year represents amounts paid principally for the use of the tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

Section 1.469-1T(e)(3)(ii) provides instances where an activity involving the use of tangible property will not constitute a rental activity. If Company's activity meets any of the tests under § 1.469-1T(e)(3)(ii), then the activity is deemed a trade or business activity and is not a rental activity. In particular, § 1.469-1T(e)(3)(ii)(F) indicates that the provision of property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not treated as a rental activity under § 1.469-1T(e)(3)(vii). Section 1.469-1T(e)(3)(vii) states that if a taxpayer owns an interest in a partnership, S corporation, or joint venture conducting an activity other than a rental activity, and the taxpayer provides property for use in the activity in the taxpayer's capacity as an owner of an interest in such partnership, S corporation, or joint venture, the provision of such property is not a rental activity. Thus, if a partner contributes the use of property to a partnership, none of the partner's distributive share

of partnership income is income from a rental activity unless the partnership is engaged in a rental activity. In addition, a partner's gross income attributable to a payment described in § 707(c) is not income from a rental activity under any circumstances (see § 1.469-2T(e)(2)). The determination of whether property used in an activity is provided by the taxpayer in the taxpayer's capacity as an owner of an interest in a partnership, S corporation, or joint venture shall be made on the basis of all of the facts and circumstances.

This exception is illustrated in § 1.469-1T(e)(3)(viii), *Example (8)*, where a taxpayer makes farmland available to a tenant farmer pursuant to an arrangement designated a "crop-share lease." Under the arrangement, the tenant is required to use the tenant's best efforts to farm the land and produce marketable crops. The taxpayer is obligated to pay 50 percent of the costs incurred in the activity (without regard to whether any crops are successfully produced or marketed), and is entitled to 50 percent of the crops produced, or 50 percent of the proceeds from marketing the crops. Despite their characterization of the arrangement as a "crop-share lease," the taxpayer and the tenant farmer have actually entered into a joint venture. Therefore, the taxpayer in the example will not be treated as participating in a rental activity.

Company claims that it was providing the convenience store properties for use in a joint venture and that such activity does not constitute a rental activity within the meaning of § 1.469-1T(e)(3)(i). Company claims that while Company and Tenant formalized their arrangement as a lease, they were not in a landlord/tenant relationship, but rather were involved in a joint venture to sell petroleum products. Company contends that the base rents provided for by the lease agreements were actually § 707 guaranteed payments. It is necessary then, to determine whether the relationship between Company and Tenant was that of co-venturers or lessor/lessee. Based on the facts presented, it appears that the dominant nature of the relationship was that of lessor and lessee.

Sections 761(a) and 7701(a)(2) of the Code provide that the term "partnership" includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. Under §§ 1.761-1(a) and 301.7701-2(c)(1), the term "partnership" is broader in scope than the common meaning of partnership, and may include groups not commonly called partnerships.

In Commissioner v. Culbertson, 337 U.S. 733 (1949), the Supreme Court stated that a partnership exists for federal tax purposes when

> considering all the facts -- the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and

> capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent -- the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. Id. at 742.

In Podell v. Commissioner, 55 T.C. 429 (1970), the Tax Court stated that the elements of a joint venture are:

> (a) A contract (express or implied) showing that it was the intent of the parties that a business venture be established; (b) an agreement for joint control and proprietorship; (c) a contribution of money, property, and/or services by the prospective joint venturers; and (d) a sharing of profits, but not necessarily of losses. Id. at 431.

Under the lease agreements in the present situation, Company would supply the petroleum products sold at the convenience store properties. Tenant would reimburse Company for all costs associated with supplying the petroleum products, and all profit would be divided equally between Tenant and Company. These facts are consistent with the existence of a joint venture to sell petroleum products, however, these facts must also be viewed in the context of the complete relationship between Tenant and Company.

The lease agreements between Company and Tenant primarily detail Tenant's desire to lease property for use in its convenience store activity. The agreements concerning the supply of petroleum products and the division of the profits were contained in a subsection of the lease documents and are specifically identified as further consideration for the lease. Tenant had an established line of business operating convenience stores, and Tenant used the property in that line of business. Company did not share in the costs of constructing or operating the convenience stores, nor was there a mechanism for Company to share in any profits of the convenience stores. The facts of the present situation are distinct from the facts of § 1.469-1T(e)(3)(viii), *Example (8)*, where there was a complete sharing of costs and profits. Thus, it does not appear that the parties intended (as required under Culbertson) to form a joint venture with regard to the convenience store operations. Therefore, Company was not providing property for use in its joint venture, but rather Company was leasing property to Tenant that Tenant then used in its own business activity. Company's activity of providing property to Tenant constitutes a rental activity under § 1.469-1T(e)(3)(i), and the exception under § 1.469-1T(e)(3)(ii)(F) and § 1.469-1T(e)(3)(vii) does not apply.

ISSUE TWO:

Company has asserted, in the alternative, that if it was engaged in a rental activity, that it would be proper for Company to group the rental activity with its trade or business activity of petroleum product sales. Under the general rules of § 1.469-4(c), activities may be treated as a single activity if they constitute an appropriate economic unit for the measurement of gain or loss for purposes of § 469. Whether activities constitute an appropriate economic unit depends on all the relevant facts and circumstances. In addition, § 1.469-4(d)(1) indicates that even where a trade or business activity and a rental activity constitute an appropriate economic unit, they may be grouped together only under limited circumstances. In the present case, in order for Company to group its rental and non-rental activities, the two activities must constitute an appropriate economic unit, and the grouping must satisfy the requirements of § 1.469-4(d)(i)(A), (B), or (C).

Section 1.469-4(c)(2) lists five nonexclusive factors which are to be given the greatest weight in determining whether activities constitute an appropriate economic unit: (i) Similarities and differences in types of trades or businesses; (ii) The extent of common control; (iii) The extent of common ownership; (iv) Geographical location; and (v) Interdependencies between or among the activities. Based on these factors, the petroleum sales and the rental activities appear to constitute an appropriate economic unit. Because the two activities are undertaken within the same S corporation, there is common control and ownership. Under the lease agreements, Tenant is also a customer of the wholesaling activity, therefore there is a high degree of interdependency (as well as a common location). The two activities appear to be dissimilar, but § 1.469-4(c)(3), *Example 2*, indicates that dissimilar activities may constitute an appropriate economic unit where common control and sufficient interdependencies exist. In the example, a taxpayer's wholesaling and trucking businesses constituted an appropriate economic unit where they were under common control, and the predominate portion of the trucking business was transporting goods for the wholesaling activity, and the taxpayer was not involved in any other trucking business. Similarly, in the present case, the two activities are under common control and rental activity is in furtherance of the wholesaling activity. Based on these factors, it appears that the two activities (sales and leasing) constitute an appropriate economic unit for purposes of § 1.469-4(c).

Section 1.469-4(d)(1)(i) provides that even where a rental activity and a trade or business activity constitute an appropriate economic unit, they may be grouped together only if: (A) The rental activity is insubstantial in relation to the trade or business activity; (B) The trade or business activity is insubstantial in relation to the rental activity; or (C) Each owner of the trade or business activity has the same proportionate ownership in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity. The third exception requires that the rental activity involve the rental

of property for use in the trade or business activity with the same ownership and so is not applicable here where the property is provided for use in Tenant's convenience store activity. Therefore, Company may group the two activities together only if one activity is insubstantial to the other.

Thus, Company must rely on the insubstantial rule of § 1.469-4(d)(1)(i)(A) or (B). Presently, there is no bright-line test as to what constitutes "insubstantial." Under a similar rule in the original temporary regulations, nonrental and rental operations could be grouped together if less than 20 percent of the combined undertaking's gross income was attributable to either the nonrental or rental operations. Section 1.469-4T(d)(2)(ii) and (iii). Under § 1.469-11(a)(2) and (b)(2), a taxpayer may apply the standards of the temporary regulations to the first taxable year that ends after May 10, 1992, but begins on or before that date. Company reports on the calendar year, and so its first taxable year ending after May 10, 1992, began on January 1, 1992. Therefore, for the 1992 tax year, Company may group its rental and nonrental undertakings because the rental undertaking would be treated as insubstantial under § 1.469-4T(d)(2)(ii). However, as the preamble to the final regulations indicates, the term "insubstantial" as used in § 1.469-4(d)(1)(i)(A) and (B) refers to factors other than gross income. T.D. 8565, 1994-2 C.B. 81 at 82. Therefore, for the 1993 and 1994 tax years, the reference to gross income will not be conclusive in determining whether one activity is insubstantial to the other.

While gross income is a logical starting point for the analysis of insubstantiality, the regulatory change in 1992 represents an awareness that the single standard of gross income does not always produce an appropriate result. For instance, a rental activity might appear insubstantial when compared to a trade or business activity that has high gross income and little net income. Similarly, in this instance, while the rental activity appears to be insubstantial under the gross income test, the rental activity actually required a greater capital investment and has greater value. Thus, in this case, the rental activity cannot be considered to be insubstantial within the meaning of § 1.469-4(d)(1)(i)(A). Also, because the business activity generates over 80 percent of

Company's gross income, it cannot be considered insubstantial within the meaning of § 1.469-4(d)(1)(i)(B). Therefore, because neither activity may be treated as insubstantial to the other, it is inappropriate to treat the two activities as a single activity for purposes of § 469.

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