DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE SERVICE CENTER ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL - KANSAS CITY
(SMALL BUSINESS/SELF-EMPLOYED) CC:SB:5:KCY

FROM: Acting Assistant Chief Counsel (Employee Benefits)
CC:TEGE:EB

SUBJECT: Earned Income Credit and Rental Income

This Significant Service Center Advice responds to your memorandum dated October 23, 2000, regarding an inquiry you received from the Kansas City Service Center. Significant Service Center Advice is not binding on the examination and appeals functions and is not a final case determination. This document is not to be used or cited as precedent.

ISSUE

Whether rental income received by a taxpayer in situations 1 and 2 below is disqualified income for purposes of section 32(i) of the Internal Revenue Code.

CONCLUSION

In both situations, the rental income received by the taxpayer is disqualified income under section 32(i). It is disqualified income under section 32(i)(2)(C) if the rental activity is not a trade or business, and under section 32(i)(2)(E) if the activity is a trade or business.

FACTS

Situation 1. The taxpayer rents unimproved land to an unrelated party.

Situation 2. The taxpayer rents improved real property to a partnership in which the taxpayer is a partner.

DISCUSSION

Disqualified income. Section 32 allows a refundable earned income credit (EIC) to eligible individuals. The EIC is intended to benefit low-income workers. Therefore, the statute imposes various income requirements, including limitations on income from assets. One of these requirements is found in section 32(i), which denies the credit to individuals who have excessive investment income. The denial applies if the aggregate amount of the taxpayer's disqualified income for the year exceeds a stated amount.[1]

Section 32(i)(2) defines "disqualified income." Under section 32(i)(2)(C), disqualified income includes any excess of gross income from rents or royalties not derived in the ordinary course of a trade or business, over the sum of the deductions (other than interest) that are clearly and directly allocable to the gross income, plus interest deductions properly allocable to the gross income.

Under section 32(i)(2)(E), disqualified income includes any excess of the aggregate income from all passive activities for the taxable year (determined without regard to any amount included in earned income under section 32(c)(2) or described in a preceding subparagraph of section 32(i)(2)), over the aggregate losses from all passive activities for the taxable year (as so determined). For purposes of section 32(i)(2)(E), "passive activity" has the meaning given that term by section 469.

To determine whether the net rental income is disqualified income, first it is necessary to determine whether the rents are derived in the ordinary course of a trade or business. If they are not, the net rental income is disqualified income under section 32(i)(2)(C). If the rents are derived in the ordinary course of a trade or business, it is necessary to determine whether the net rental income is disqualified income under section 32(i)(2)(E).

Ordinary course of a trade or business. Whether a taxpayer is engaged in a trade or business is highly factual. Higgins v. Commissioner, 312 U.S. 212 (1941). To be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity, and the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify. Commissioner v. Groetzinger, 480 U.S. 23 (1987). Where it is clear from the facts that real estate is devoted to rental purposes, the courts have

[1]This amount is adjusted annually for inflation. For tax years beginning in 2000, the figure is $2,400; for tax years beginning in 2001, the figure is $2,450.

repeatedly held that such use constitutes use of property in a trade or business, regardless of whether or not it is the only property so used. Curphey v. Commissioner, 73 T.C. 766 (1980); Fegan v. Commissioner, 71 T.C. 791, 814 (1979); Elek v. Commissioner, 30 T.C. 731 (1968); O'Madigan v. Commissioner, 19 T.C.M. 1178 (1960); Lagreide v. Commissioner, 23 T.C. 508 (1954); Leland Hazard v. Commissioner, 7 T.C. 372 (1946). This result is not changed by the fact that the taxpayer leases property to the taxpayer's wholly owned corporation.[2]

In situation 1, the taxpayer rents unimproved land to a third party. In situation 2, the taxpayer rents improved real property to a partnership in which the taxpayer is a partner. In each situation, if the taxpayer leases the property with continuity and regularity and the taxpayer's primary purpose for engaging in the rental activity is for profit, the rental activity is a trade or business and the rentals are derived in the ordinary course of a trade or business. Consequently, the net rental income is not disqualified income under section 32(i)(2)(C). If, however, the taxpayer does not lease the property with continuity and regularity or the taxpayer's primary purpose for engaging in the rental activity is not for profit, the rental activity is not a trade or business and the net rental income is disqualified income under section 32(i)(2)(C).

Passive activity. Section 469(a) disallows passive activity losses and credits for individuals, estates, trusts, closely held C corporations, and personal service corporations. Section 469(c)(1) defines "passive activity" for purposes of section 469 as any activity that involves the conduct of any trade or business and in which the taxpayer does not materially participate. Generally, under section 469(c)(2) and (4), passive activity includes any rental activity without regard to whether the taxpayer materially participates in the activity.[3]

Under §1.469-4(a) of the Income Tax Regulations, a taxpayer's activities include those conducted through C corporations that are subject to section 469, S corporations, and partnerships. The activity in situation 2 involves the rental of property to a partnership in which the taxpayer is a partner. Thus, the taxpayer's activities include those conducted through the partnership.

Because the activity in situation 2 involves the rental of property to a partnership in which the taxpayer is a partner, the income from the activity may be subject to the self-

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[2]Rather, when the lessor and the lessee are closely related and there is no arm's-length dealing between them, the issue generally is what constitutes reasonable rental to determine whether the sums paid by the lessee are deductible. See, Clairton Slag, Inc. v. Commissioner, 39 T.C.M. 625 (1979) (allowing the corporation to deduct rental payments made to a closely related party equal to the fair market rental value). See also, Sparks Nugget, Inc. v. Commissioner, 458 F.2d 631 (9th Cir. 1972), cert. denied, 410 U.S. 928 (1973).

[3]Section 469(c)(7) provides a limited exception to the per se passive treatment of rental activities for taxpayers that qualify as real estate professionals under section 469(c)(7)(B).

rental recharacterization rule of §1.469-2(f)(6). Under that rule, the taxpayer's net rental income from the rental of property for use in a trade or business in which the taxpayer materially participates is treated as not from a passive activity. If the taxpayer materially participates in the activity conducted through the partnership under any of the seven tests of §1.469-5T(a), then the self-rental recharacterization rule applies. See generally, Connor v. Commissioner, 218 F.3d 733 (7th Cir. 2000); Fransen v. U.S., 191 F.3d 599 (5th Cir. 1999); and Schwalbach v. Commissioner, 111 T.C. 215 (1998).

The self-rental recharacterization rule does not treat the underlying rental activity as nonpassive. Rather, it operates only to treat net rental income from the rental of particular items of property as nonpassive. The First Circuit recently addressed this particular point in Sidell v. Commissioner, 225 F.3d 103 (1st Cir. 2000). The court held that, while the self-rental recharacterization rule applied to treat net rental income as nonpassive, a credit generated through the rental activity was properly treated as a passive activity credit.

When § 1.469-2(f)(6) was adopted, there was no thought of whether the self-rental recharacterization rule would apply to section 32(i)(2)(E), because that subparagraph had not been enacted. Section 1.469-2 was issued in 1992 and amended in 1993.[4] Section 32(i)(2)(E) was enacted in 1996.[5]

Thus the remaining question is whether, in interpreting "income from passive activities" in section 32(i)(2)(E), we look to section 469 and the regulations thereunder merely for the definition of "passive activity" or also to determine what constitutes "income from" such an activity. The latter approach would incorporate the self-rental recharacterization rule into section 32, with the result that the rental income in situation 2 would not be disqualified income. However, we believe the former approach is the better interpretation. The plain language of section 32(i) refers to section 469 for the definition of "passive activity" but not for anything else. Moreover, this conclusion is supported by the legislative history. When proposing the addition of subparagraph (E) to section 32(i)(2), the House Ways and Means Committee stated:

> The committee believes that individuals with substantial assets could use proceeds from the sale of those assets in place of the earned income credit to support consumption in times of low income. Transfer programs such as AFDC, food stamps, and Medicaid have asset tests for determining eligibility. Such programs also have caseworkers available to make determinations about the

[4]T.D. 8417, 5/11/92, amended by T.D. 8477, 2/22/93, and T.D. 8495, 11/3/93.

[5]Personal Responsibility and Work Opportunity Reconciliation Act of 1996, Pub. L. No. 104-193, §909(b) (1996).

> assets owned by a potential claimant. In the case of the earned income credit, the IRS does not have caseworkers to assess the balance sheets of millions of taxpayers, and it does not currently have information on most taxpayers asset-holdings. Therefore, in order to apply a proxy for an asset-based test, the recently enacted disqualified income test concentrates on the returns generated by those assets. Interest, dividend, and net rental and royalty income represent flows of income from assets that represent wealth of the taxpayer. The committee believes that net capital gains and other passive income represent other flows of income from assets that could be liquidated to support current consumption. The committee also believes that this threshold should be set in inflation-adjusted dollars, so it is indexing the threshold for inflation.[6]

Thus, Congress was primarily interested in the assets from which taxpayers derive income that could be converted into cash to support them in times of need. The property in situation 2 is such an asset. Because the disqualified income test of section 32(i) is intended to represent a proxy for an asset-based test, we believe that the statutory language referring to the aggregate income and losses from all passive activities means exactly what it says and does not exclude income from a passive activity that is treated as nonpassive income under section 469 or the regulations thereunder.

Thus, for EIC purposes, we need look only to the meaning given “passive activity” by section 469. Although disqualified income includes the net income from all passive activities, section 32(i)(2)(E) does not suggest that the disqualified income is the amount taken into account under the passive activity rules. Thus, for purposes of section 32(i), if an activity meets the definition of passive activity in section 469(c), the income from that activity is disqualified income under section 32(i)(2)(E).

Therefore, because the rental activities in both situations 1 and 2 meet the definition of passive activity, the income from both activities is disqualified income under section 32(i)(2)(E).

If you have any further questions, please call (202) 622-6080.

ALAN TAWSHUNSKY
By: MARK SCHWIMMER
Senior Technician Reviewer
CC:TEGE:EB

[6]H.R. Rep. No. 104-651, at 1485-86 (1996).