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WHEN WILL RENTAL INCOME TERMINATE THE SUBCHAPTER S ELECTION? AN ARGUMENT IN FAVOR OF ABOLISHING THE PASSIVE INVESTMENT INCOME RESTRICTION

by

John D. Sawyer*

I. INTRODUCTION

Subchapter S of the Internal Revenue Code of 1954\(^1\) permits a properly electing corporation\(^2\) to have its income, with an exception for certain capital gains,\(^3\) taxed directly to its shareholders rather than to the corporation itself under the usual corporate rules.\(^4\) While some taxpayers mistakenly believe that the subchapter S status permits the electing corporation to be taxed as a partnership, a subchapter S corporation does not act as a conduit in precisely the same manner as a partnership. Under subchapter S, taxable income is calculated at the corporate level and then passed on to the shareholders without individual items of income and deduction retaining their character in the hands of the shareholders\(^5\) as they do in the case of partnerships.

The mechanics of subchapter S can be briefly summarized. First, all of the shareholders of a qualifying small business corporation\(^6\) must make a proper election as prescribed in section 1372 of the Code. Because the corporate tax provisions of the Code do not apply, corporate income is passed through directly to the shareholders, whether or not it is actually

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2. Id. §§ 1372(a)-(d). The corporation makes the election after each shareholder has consented. The corporation must make the election either during the first 75 days of the taxable year or anytime during the preceding taxable year.
3. Id. § 1378. To prevent corporations from making a subchapter S election for a one-time capital gain, § 1378 provides that, if the net capital gain of the corporation exceeds $25,000, the corporation is taxed on the excess unless the election has been in effect for three years or, if less than three years, if the election has been in effect since incorporation. Under usual corporate rules, income would be taxed both at the corporate level and again after distribution to the shareholders. Id. §§ 11, 63, 301.
4. One exception to this result is a stockholder's proportionate share of net capital gain to the extent of a distribution of current earnings and profit, is treated as a long-term capital gain under id. § 1375.
5. A qualifying corporation must be a domestic corporation that (1) is not a member of an affiliated group, (2) does not have more than 15 shareholders, (3) does not have a shareholder who is not an individual (except for certain trusts and estates), (4) does not have a nonresident alien shareholder, and (5) does not have more than one class of stock. Id. §§ 1371(a)(1)-(4).
distributed. Dividend treatment obtains for the shareholders under the general corporate distribution rules to the extent of the lesser of taxable income or current earnings and profits, except for a shareholder's pro rata share of net capital gain. Net operating losses of the electing corporation also are passed through directly to shareholders, but the amount allowable as a deduction is limited to the adjusted basis of the shareholder's stock, plus the adjusted basis of any indebtedness of the corporation to him.

Once made, a valid election continues until it is terminated either by the affirmative refusal of a new shareholder to consent to the election, by the consent of all shareholders, by the corporation's ceasing to qualify as a small business corporation, or by the corporation's deriving more than eighty percent of its gross receipts from sources outside the United States or more than twenty percent of its gross receipts from passive investment income. Since rents fall within the category of passive investment income, a corporation that leases real or personal property will lose its subchapter S status if its rental income exceeds the twenty percent limitation, unless it also provides significant services to the lessee as provided in the regulations.

In 1966 Congress attempted to mitigate the harsh results of the passive investment income restrictions on new corporations by adding a new subparagraph that prevents subchapter S termination when the twenty percent limitation is exceeded if the corporation is in its first or second year of active business and if the amount of passive investment income for the tax year is less than $3,000. Nevertheless, the passive investment income restrictions continue to produce harsh results.

Since the 1968 decision of Feingold v. Commissioner in which the IRS refused to allow a taxpayer to deduct his real estate corporation's net operating losses, section 1372(e)(5) and the regulations promulgated thereunder have proved to be a trap for the unsuspecting electing corporation whose passive rental income exceeds the twenty percent statutory limit. Because

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7. "Undistributed taxable income" is taxed to the subchapter S shareholders as a constructive dividend. Id. §§ 1373(b)-(c).
8. Id. §§ 301-307. Under § 301, the amount distributed to a noncorporate shareholder is the amount of cash distributed plus the fair market value of any property distributed plus the fair market value of any property distributed in kind to the shareholder less the amount of any liabilities of the corporation assumed by the shareholder or liabilities to which the distributed property is subject.
9. Id. § 1375(d).
10. Id. § 1374.
11. Id. §§ 1372(e)(1)-(5); for text of § 1372(e)(5), see note 25 infra.
12. Under I.R.C. § 1372(e)(5)(C), passive investment income consists of gross receipts received from royalties, rents, dividends, interest, annuities, and, to the extent of gain therefrom, sales or exchanges of stock or securities.
15. 49 T.C. 461 (1968). In this case, the election of the taxpayer's subchapter S corporation was terminated because of excess rental income, based on the court's conclusion that the furnishing of certain recreational facilities and services did not constitute a significant service within the meaning of the regulations. See text accompanying notes 47-55 infra.
termination of the subchapter S election is retroactive rather than prospective,\(^{16}\) double taxation will result if distributions are made during the year in which termination occurs.\(^{17}\) Therefore, termination also may result in locking previously taxed income\(^ {18}\) into the business,\(^ {19}\) in order to avoid a second level of taxation of income that would otherwise have been nontaxable to the extent of the shareholder’s basis in his stock.\(^ {20}\) Additionally, since the disqualifying event may be first discovered several years after it occurs, the tax deficiency may be substantial.

This Article examines the extent to which rental income constitutes passive investment income by a review of the legislative history of the subchapter S provisions and an analysis of the regulations, revenue rulings, and cases that interpret the passive investment income limitation. Secondly, this Article discusses various proposals for amendments to subchapter S. These proposals are an attempt to bring predictability and fairness to the current law that has often brought about harsh consequences by causing unintended termination of the subchapter S election. This Article concludes that the passive investment income restriction on rental income could be abolished and other methods could be used to effectuate the apparent goal of the restriction, the prevention of abuse of qualified pension and profit-sharing plans by funding with passive income.\(^ {21}\)

II. LEGISLATIVE BACKGROUND

Subchapter S was enacted into the Internal Revenue Code by the Technical Amendments Act of 1958.\(^ {22}\) The stated purpose of the provisions was to permit small businesses to select a form of business enterprise without having to consider major differences in federal tax consequences.\(^ {23}\) Because no hearings were held on the bill, the rationale for including the passive investment income limitation, and specifically the six individual

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16. Under I.R.C. § 1372(e)(5)(A), the election is terminated for the taxable year in which the excess passive income is received.
17. See Note 4 supra.
18. A shareholder’s share of previously taxed income is the accumulation of amounts taxed to him in prior years less loss deductions previously allowed him and previous distributions of previously taxed income. I.R.C. § 1375(d).
20. Id.
items of income\textsuperscript{24} constituting that category, is not entirely clear. Subsequently, Congress indicated that the passive investment income limitation\textsuperscript{25} was designed to "limit the availability of this [subchapter S] treatment to small businesses actively engaged in trades or businesses."\textsuperscript{26} Whether this pronouncement represents the real reason for the inclusion of the passive investment income provisions, however, is questionable. The legislative history of the subchapter S provisions strongly suggests that the prevention of funding of qualified pension and profit-sharing plans with income from incorporated investments might have been the primary aim of this restriction.\textsuperscript{27}

When the subchapter S provisions were enacted in 1958, the heading for section 1372(e)(5) was "Personal Holding Company Income." The current denomination, "Passive Investment Income," appeared in the 1966 revision.\textsuperscript{28} The personal holding company heading gave rise to litigation in which taxpayers argued against subchapter S termination even when a corporation had what was otherwise excessive passive investment income.\textsuperscript{29} Simply, the taxpayers maintained that since the corporation was actively engaged in the conduct of a trade or business, it did not fall within the

\textsuperscript{24} The six individual items of income are royalties, rents, dividends, interest, annuities, and proceeds from the sale or exchange of stock or securities. I.R.C. § 1372(e)(5)(C).

\textsuperscript{25} Id. § 1372(e)(5) reads as follows:
   (A) Except as provided in subparagraph (B), an election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is passive investment income. Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.
   (B) Subparagraph (A) shall not apply with respect to a taxable year in which a small business corporation has gross receipts more than 20 percent of which is passive investment income, if—
      (i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year; and
      (ii) the amount of passive investment income for such taxable year is less than $3,000.
   (C) For purposes of this paragraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Gross receipts derived from sales or exchanges of stock or securities for purposes of this paragraph shall not include amounts received by an electing small business corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the electing small business corporation owned more than 50 percent of each class of the stock of the liquidating corporation.


\textsuperscript{27} See Joint Committee Staff Recommendations, supra note 21.

\textsuperscript{28} Small Business Corporations Act, Pub. L. No. 89-389, § 3(a), 80 Stat. 111 (1966) (codified at I.R.C. § 1372(e)(5)).

\textsuperscript{29} Marshall v. Commissioner, 510 F.2d 259 (10th Cir. 1975); House v. Commissioner, 453 F.2d 982 (5th Cir. 1972); Zychinski v. Commissioner, 60 T.C. 950 (1973), aff'd, 506 F.2d 637 (8th Cir. 1974), cert. denied, 421 U.S. 999 (1975).
personal holding company provisions of the Code\textsuperscript{30} and, therefore, the subchapter S election should not terminate despite the character of the income. In view of the congressional substitution of "Passive Investment Income" for the "Personal Holding Company Income" heading, however, construction of the passive investment income provisions with reference to the provisions for personal holding companies is now inappropriate. The 1966 change no doubt indicated a congressional intent to establish a different test for determining whether a business is active within the meaning of the subchapter S provisions.\textsuperscript{31}

III. CURRENT LAW AND JUDICIAL INTERPRETATION

A. Regulations

While section 1372(e)(5)(C) of the Code includes all rents within the passive investment income restriction, the regulations have adopted a considerably more lenient approach. Under the regulations, rents do not include payments from an occupant to whom the lessor has rendered significant services.\textsuperscript{32} The significant services cannot be customary or usual services, such as heat and light, but must be additional amenities provided for the occupant's convenience, such as maid service.\textsuperscript{33}

B. Revenue Rulings

The Internal Revenue Service has issued numerous revenue rulings on rents as passive investment income, but they have added little to the understanding of what constitutes significant services. In one such ruling the Service has concluded that rental income derived under a share-farming arrangement, in which the lessor participated to a material degree by per-

\textsuperscript{30} I.R.C. §§ 541-547.
\textsuperscript{32} Treas. Reg. § 1.1372-4(b)(5)(vi), T.D. 7414, 1976-1 C.B. 266 provides:

\begin{quote}
Rents. The term "rents" as used in section 1372(e)(5) means amounts received for the use of, or right to use, property (whether real or personal) of the corporation. 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, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist homes, motor courts, or motels. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such services; whereas the furnishing of heat and light, the cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in an office building, etc., are generally "rents" under section 1372(e)(5). Payments for the parking of automobiles ordinarily do not constitute rents. Payments for the warehousing of goods or for the use of personal property do not constitute rents if significant services are rendered in connection with such payments.
\end{quote}

\textsuperscript{33} Id.
forming physical work or management activity in the production of the farm commodities, did not constitute rents for passive investment income purposes.\textsuperscript{34} According to the facts of that ruling, the president of the lessor corporation devoted most of his time to the share-farming activity, but the ruling provided no specific information on the amount of time involved or the president's salary as a percentage of corporate income or expenses. In this ruling and in others involving real estate leasing of space only, as opposed to space leased for occupancy, the IRS found significant services based only upon a showing of some services rendered, although it did not define the level of activity required nor did it give its reasoning for the holdings.\textsuperscript{35} Similarly, in rulings dealing with the leasing of personal property involving such items as barricades,\textsuperscript{36} golf carts,\textsuperscript{37} cranes,\textsuperscript{38} clothing,\textsuperscript{39} motor vehicles,\textsuperscript{40} television sets,\textsuperscript{41} and movies,\textsuperscript{42} as well as multiple items,\textsuperscript{43} the IRS has found that payments did not constitute rents when any additional services beyond mere leasing were provided.\textsuperscript{44} The only ruling in which the IRS held that passive investment income existed was one involving the leasing of space for which the lessor corporation undertook no other services besides the space rental.\textsuperscript{45} According to these rulings,\textsuperscript{46} the only apparent requirement for a finding of significant services involving the leasing of space or personal property is that a lessor render any service beyond the mere leasing itself.

\section*{C. Judicial Interpretation}

The issue of what constitutes significant services with respect to rental income was first addressed in \textit{Feingold v. Commissioner}.\textsuperscript{47} The petitioner's corporation owned and operated ninety-five rental bungalows for summer use by vacationers. The corporation fully furnished the units and con-

\begin{footnotes}
\item[34.] Rev. Rul. 61-112, 1961-1 C.B. 399.
\item[35.] Rev. Rul. 65-91, 1965-1 C.B. 431 (payments for grain storage with loading and protective services are not rents; payments for refrigerated warehouse storage with refrigeration, maintenance, and attendant services are not rents; payments for use of a parking lot where attendant parks cars are not rents). \textit{See also} Rev. Rul. 76-48, 1976-1 C.B. 265 (fees for use of a tennis and handball court with locker room, parking facilities, and lessons are not rents).
\item[36.] Rev. Rul. 65-83, 1965-1 C.B. 430, example 1.
\item[37.] \textit{Id.} example 2.
\item[38.] \textit{Id.} example 3.
\item[41.] Rev. Rul. 70-206, 1970-1 C.B. 177.
\item[42.] Rev. Rul. 75-349, 1975-2 C.B. 349.
\item[44.] As might be expected from the regulations' strict approach to office and apartment building rentals, no rulings dealing with rental services rendered in tenant-occupied real estate situations have been issued.
\item[45.] Rev. Rul. 65-91, 1965-1 C.B. 431 (payments for cotton warehouse storage with no additional services are rents).
\item[46.] The rulings are not analytical in scope because the Service used a categorization approach instead of applying the statute and regulations to the individual facts. Comment, \textit{Subchapter S Eligibility—Rental Income From Real Estate and the “Passive Investment Income” Limitation}, 43 U. COLO. L. REV. 323, 327-28 (1972).
\item[47.] 49 T.C. 461 (1968).
\end{footnotes}
RENTAL INCOME

structured a paved, lighted, and fenced-in patio as a common recreational area for tenants' use only. The corporation also provided tables, chairs, playing cards, and bingo games in the patio area and occasionally held parties for the children for which it supplied hats and prizes. Several times during the summer, the corporation held parties for the adults and supplied small amounts of food and beverages, although participants occasionally bought additional refreshments.

The court concluded that the services performed for the tenants were not significant within the meaning of the regulations. First, the court held that providing a furnished recreational area or recreational equipment did not constitute supplying services and that the mere right to use property was not equivalent to providing services. Moreover, the court found insufficient evidence to establish significant services of the corporation with respect to the bingo games or children's parties. While it did find that the corporation had sponsored several weekend parties each summer, the court concluded that such activities did not constitute significant services within the meaning of the regulations. This conclusion was based on a finding that the taxpayer had not demonstrated that the parties were an important factor in inducing rentals or in improving the tenants' vacations. The court further found that the evidence did not establish that many tenants had participated nor that such functions constituted a significant portion of the corporation's operations. To buttress this conclusion, the court noted that the proven yearly expenditures that did constitute services under the regulations amounted to only .15 percent of the corporation's annual receipts. While the court found this figure too low to establish significance, it gave no indication of the required percentage. The court's failure to define precisely what constitutes significant services is clearly unsatisfactory. Moreover, the inducement of rentals and improvement of tenants' vacations, which the court seemed to use as a new standard, are, at best, highly subjective and somewhat artificial tests because they do not describe the nature of the services, but rather emphasize a collateral consideration of the consequences of the services, an emphasis that is not found in the regulations.

Perhaps the most troublesome aspect of the decision is the court's statement that the services furnished by the corporation did not compare to those furnished by a hotel or motel, specifically maid service. Because summer rentals such as those in Feingold might differ from hotels or mo-

48. Id. at 466-67.
49. Id. at 465.
50. Id. at 466.
51. Id.
52. Id. at 467.
53. Id.
54. Id.
55. From the standpoint of corporate effort or expense, insignificant services might well stimulate rentals or improve the quality of occupancy, while highly significant services would not necessarily achieve these results.
56. 49 T.C. at 467; see note 32 supra.
tels with respect to length of guests' occupancy, number of occupants per unit, and number of unit facilities provided, the need for maid service could be considerably less than that in a motel or hotel. Not only is the maid service example of dubious relevance, but it also appears to represent an exclusive and dispositive reference to an example in the regulations that is offered for illustrative, rather than exhaustive, purposes. Instead of using an analytical approach to the language in the statute and the regulations, the court apparently chose to evaluate leased space dwellings against a standard that, in practical application, would virtually preclude a finding of significant services.

The concept of significant services related to leased space also was addressed in the case of Bramlette Building Corp. v. Commissioner, where the corporation's only income was from renting parking space and an office building that housed, in addition to other tenants, a barber shop, drug store, and lunch counter. To maintain the building, the corporation employed a ten-person staff, consisting of three maids, two porters, two elevator operators, a secretary, a night watchman, and a maintenance engineer.

In addition to the ordinary maintenance services normally provided by a lessor, the corporation allowed its maintenance engineer, when time permitted, to repair machines, furniture, and furnishings belonging to tenants.

The petitioner first contended that its efforts in obtaining leases with the barber shop, drug store, and lunch counter were for the convenience of its other tenants and not services usually or customarily furnished to tenants of office space. The court dismissed this argument, however, by stating that "the mere leasing of space to a third party, who performs services for the other tenants of the office building, does not constitute the providing of [significant] services within the meaning of the regulations." The court further concluded that services rendered to tenants by third party lessees could not be considered services rendered by the lessor.

Based on the facts in the case, the first conclusion is undoubtedly correct because the execution of the barber shop, drug store, and lunch counter leases was not primarily for the convenience of the other tenants. The holding concerning third parties, however, appears questionable. The principle that significant services must be furnished by the lessor rather than by a third party is without support in either the statute or the regulations. The regulations provide that "generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the

57. 52 T.C. 200 (1969), aff'd, 424 F.2d 751 (5th Cir. 1970).
58. The maids cleaned offices as well as common areas, and the porters assisted tenants in moving into the building as well as in changing offices within the building.
59. 52 T.C. at 204-05.
60. Id. at 205.
61. The regulations use the language "where significant services are also rendered to the occupant" and "services are considered rendered to the occupant." Treas. Reg. § 1.1372-4(b)(5)(vi), T.D. 7414, 1976-1 C.B. 266.
rental of rooms or other space for occupancy only.” 62 Therefore, the better reason for excluding the third party lessees’ activities from the significant services category in this case would be that such activities were not services as defined in the regulations because they were not rendered in connection with the rental but were merely incidental to the occupancy. 63 Not only does this approach appear to reflect the intent of the language of the regulations, but it also avoids uncertainty when a third party does render services in connection with the rental.

The petitioner’s alternative argument in support of a finding of significant services was based on the repairs of the tenants’ personal property. While the court conceded that the repairs on tenants’ machines and furniture were rendered in connection with the rental and were not usual or customary with respect to office space, it nevertheless concluded that the services were not significant. 64 With minimal discussion, the court ostensibly based this finding on a lack of evidence concerning the number of tenants benefiting from the repairs and the amount of time that the maintenance engineers spent on repairs. 65 In reality, the court simply inferred that the repair services were not substantial in nature:

In all probability they were insignificant because the maintenance engineer testified that he made such repairs only “when he had time.” And, in view of his other duties relating to the air conditioning, the heating, and the electrical equipment of the building, the inference we draw is that he had little time to devote to such repair services. 66

Unfortunately, the court gave no suggestion of the amount of repair services, either from the standpoint of employee time involved or aggregate tenant benefit, that would have warranted a finding of significant services.

One other aspect of the Tax Court’s decision deserves attention. In addressing the petitioner’s contention that a corporation owning and leasing office space in an office building is not precluded by either statute or regulation from making a subchapter S election, the court observed that “as a practical matter the gross receipts requirement of section 1372(e)(5) makes it very difficult for a corporation whose only asset is an office building to qualify for subchapter S treatment.” 67 While this statement is not patently incorrect, it does indicate a categorization approach 68 and an undue concern for the nature of the business involved, rather than the nature and extent of services rendered in accordance with the approach of the regulations. In fact the Fifth Circuit, in affirming the Tax Court’s decision, concluded that the repair services performed by the maintenance engineer were not services within the contemplation of the regulations because the

62. Id.
63. The court found that no portion of the other tenants' rentals was paid either for the corporation's efforts in obtaining the barber shop, drug store, or lunch counter or for the services supplied by those three tenants. 52 T.C. at 205.
64. Id.
65. Id.
66. Id.
67. Id. at 203.
68. See Comment, supra note 46, at 326.
language "speaks primarily of room services rendered by hotels, motels, and like businesses." Because, as a practical matter, lessors of office building space would rarely, if ever, furnish the same type of room services rendered by hotels and motels, the court of appeals' interpretation of the regulation is considerably more restrictive than that of the Tax Court, which holds that office building rental income can, in theory at least, avoid passive investment income characterization when significant services have been rendered.

Another case considering rental income as passive investment income is City Markets, Inc. v. Commissioner. The petitioner corporation owned a farmers' market, involving two long-roofed structures housing produce and flower vendors as well as other retail and service businesses. The corporation employed only two full-time employees, a maintenance man and his assistant, who maintained and repaired building equipment and common areas and made requested alterations to the tenants' booths, charging for materials only when the item repaired was not physically attached to the building. Additionally, the corporation furnished pest control services, listed its tenants' services in the Yellow Pages, and maintained a large advertising sign for the entire market, all without charge.

The court of appeals concluded that these services were not significant because they were either excluded by the specific language of the regulations or, in the case of pest control and occasional alterations, were so similar to those excluded by the regulations that they were deemed not significant by implication. The court prefaced its analysis of the significant services question with a reference to the hotel-motel room service language of the regulations and then concluded that the corporation's activities did not fit the definition of services contained in the regulations.

This rather formalistic approach, however, amounts to little more than a corporate activity test; a corporation must supply hotel or motel-type room services, as set forth in the regulations, in order to avoid characterization of its income as passive investment income. This approach not only fails to address the nature or extent of the services rendered, but effectively prevents office or commercial building rental activity from ever qualifying for subchapter S status. Moreover, this treatment militates against the language of the regulations that provides that although entire living unit or office space payments are generally rents for passive investment income purposes, an exception exists when the lessor provides significant services. Certainly, this language in the regulations should not be interpreted

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70. 28 T.C.M. (CCH) 1055 (1969), aff'd, 433 F.2d 1240 (6th Cir. 1970).
71. Treas. Reg. § 1.1372-4(b)(5)(vi), T.D. 7414, 1976-1 C.B. 266, excludes from the category of services rendered to the occupant such activities as the supplying of heat and light, the cleaning of common areas, and the collection of trash.
72. 433 F.2d 1240, 1242 (6th Cir. 1970).
73. Id. at 1241-42.
automatically to denominate office building rentals as passive investment income.

Another troubling aspect of the decision is the reliance of both the Tax Court\textsuperscript{75} and the court of appeals\textsuperscript{76} on the lack of a formal agreement for the performance of any services in support of their conclusions that significant services had not been rendered by the corporation. Such a requirement appears neither in the statute nor in the regulations. No rationale is offered for this conclusion, and none appears compelling. Significance of services, whether measured by the number of tenants benefited or the scale of services rendered, as suggested by the Tax Court,\textsuperscript{77} can be ascertained without reference to any formal contract. If the problem were simply one of lack of evidence, the mere production of formal agreements would not be dispositive of the significant services issue, but would serve as no more than a starting point for the inquiry.\textsuperscript{78} A determination of whether services that are not customary or usual are rendered to an occupant, primarily for his convenience, in connection with the rental cannot be made merely by reference to a formal contract.

Likewise, the Tax Court's analysis of the level of services provided by the corporation is not persuasive. In support of its conclusion that the scale of services rendered was not great, the court pointed out that only two maintenance men served the tenants' repair needs.\textsuperscript{79} As noted earlier, however, the corporation had only these two full-time employees. The fact that all of the company's employees, irrespective of their absolute numbers, participated in rendering a given service ought to have supported, rather than precluded, a finding of significance.

Furthermore, the court of appeals' decision to treat repairs of tenants' property and pest control spraying as excluded by the language of the regulations\textsuperscript{80} seems unjustified. Because the list of excluded items\textsuperscript{81} is obviously intended to be illustrative rather than exhaustive, the services here in question should not be excluded from the significant services category. The regulations appear to exclude services strictly on the basis of whether they are customary and usual for occupied space rentals. Because the opinion does not indicate whether these services were customary or usual for such rentals, the court should have found them insignificant simply because of insufficient evidence, rather than insignificant because excluded by the regulations.

Finally, while the court of appeals found that advertising in the telephone directory Yellow Pages and the maintenance of a common billboard

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\item \textsuperscript{75} 28 T.C.M. (CCH) at 1058.
\item \textsuperscript{76} 433 F.2d at 1241.
\item \textsuperscript{77} 28 T.C.M. (CCH) at 1058.
\item \textsuperscript{78} Under the Tax Court's test, the amount of the rental payment attributable to such services, the number of tenants involved, or the amount of employee effort would still need to be determined independently of the existence of a formal contract.
\item \textsuperscript{79} 28 T.C.M. (CCH) at 1058.
\item \textsuperscript{80} 433 F.2d at 1242.
\item \textsuperscript{81} Treas. Reg. \textsuperscript{81} § 1.1372-4(b)(5)(vi), T.D. 7414, 1976-1 C.B. 266. For text of regulation, see note 32 supra.
\end{itemize}
\end{footnotesize}
were not customary and usual services rendered with commercial office space, it merely stated, without further explanation, that "by themselves they cannot be of the 'significance' required by the Regulation." But unfortunately, taxpayers are left to speculate what additional services would be required to transform advertising and billboard maintenance into significant services.

In H. & L. Reid, Inc. v. United States, the corporation owned and leased an office building predominantly occupied by physicians and dentists. It provided, without additional charge, mail delivery service upon request, a lunch-break area for tenants' employees, emergency janitorial service, and extensive intra-office remodeling. Despite these services the court rejected the taxpayer's argument in favor of significant services and thus disallowed the subchapter S election. Although the court pointed out that very few maintenance men performed the services in question, emphasis on the absolute numbers of employees involved appears dubious because the opinion does not reveal how many employees were employed by the corporation. If, as in City Markets, all of a small number of employees rendered a service, that fact should support a finding of significance. Therefore, the appropriate inquiry ought to focus upon the percentage of employees, or perhaps the category of employees providing the service, rather than upon absolute numbers alone.

The court in Reid purportedly relied upon City Markets for its conclusion that the appropriate test for significant services is whether the corporation is "still primarily a landlord," but this language appears neither in the City Markets decision nor in the statute or regulations. Aside from its lack of legal support, this approach is encumbered with inherent difficulty of construction. The court does not indicate whether "primarily" means more than fifty percent or is to be determined by reference to the number or percentage of employees involved or by the ratio of service expenses to gross receipts. The taxpayer is left without a satisfactory answer to these questions and cannot determine with any certainty whether he is qualified to make or maintain the subchapter S election.

Perhaps the most disturbing aspect of the decision in Reid is the court's conclusion that "it is not the amount of services rendered, but the nature or type of services rendered that determines whether the services are 'substantial.'" In addition to its internal inconsistency, this proposition also fails because of a lack of support in the cases cited by the court. Bramlette should not be construed as holding that the amount of services rendered is

82. 433 F.2d at 1242.
84. Id. at 1101.
85. Id.
86. Id.
87. A service rendered only once or twice, or involving only a minimal expenditure of funds or employee effort, would arguably never be characterized as significant, simply because of its nature or type. Clearly, more than a minimal level of activity would have to exist.
irrelevant to the significant services inquiry. Instead, the court of appeals in Bramlette simply held, and correctly so, that the obtaining of leases with certain tenants did not constitute the rendering of services to the other tenants within the meaning of the regulations. Furthermore, the Tax Court's opinion in Bramlette strongly indicates that the quantum of services rendered is appropriate to the significant services inquiry, by emphasizing: "The record is silent as to how much time the maintenance engineer spent repairing the tenants' machines or furniture or how many tenants availed themselves of such services." Moreover, the other cases dealing with this issue, Feingold and City Markets both made clear that, in addition to the nature of the service, value and level of service were important factors in determining significance.

The issue of significant services was first presented in connection with personal property rental income in Winn v. Commissioner. The petitioners' corporation derived more than twenty percent of its gross receipts from leasing barges. The taxpayers argued that certain activities, ostensibly performed by the corporation, involving cleaning and maintaining barges in a seaworthy condition, the delivery of barges when needed, and the maintenance of cross-charter agreements and insurance, constituted significant services. According to the court, however, cross-charter agreements and insurance failed the significant services test simply because of evidentiary insufficiency. Additionally, the court held that cleaning and general barge repair were not significant services because expenditures for them, as a percentage of total barge charter income, were "certainly not significant," but the court offered no guidance as to the requisite level of expenditure. Moreover, the court concluded that the cleaning and repair activities and barge delivery services all failed the significant services test for the additional reason that they were neither rendered nor arranged by the corporation whose subchapter S status was at issue. In this instance, the court found that an affiliated corporation had made all significant barge rental arrangements, thereby precluding a finding of significant services by the lessor:

To comply with the regulations, a corporation must actively engage in the production of rentals; it must provide or make arrangements for significant services. Herein, the services provided or arranged for by Security [affiliate] cannot be attributed to Wagren [subchapter S corporation]. Significant services within the meaning of the regulations must be rendered by the corporation seeking to qualify under sub-

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88. See text accompanying notes 64-66 supra.
89. 424 F.2d 751, 753 (5th Cir. 1970).
90. 52 T.C. at 205.
91. See text accompanying notes 52-54 supra.
92. See text accompanying note 79 supra.
93. 67 T.C. 499 (1976), aff'd, 595 F.2d 1060 (5th Cir. 1979).
94. 67 T.C. at 515.
95. Id. Barge charter income for the tax year of termination amounted to $218,053, while the maximum amount shown in the record for barge cleaning and repairs totaled $7,960. Therefore, the expenditures for the services constituted approximately 3.7% of related income.
Although this prohibition against qualifying services being rendered by third parties apparently has become engrafted upon the subchapter S regulations, its validity remains questionable. As noted earlier, the third party services in *Bramlette* were not rendered in connection with the rental, but were at most incidental.97 Further, the lessees' activities that were said to benefit the other tenants resulted in no expense to the subchapter S corporation. To the contrary, in *Winn* the barge cleaning, repair, and delivery services were provided in connection with barge rentals, and the record showed that, while arrangements for these services were made by the affiliate, the expenses were borne by the subchapter S corporation.98 The Tax Court, however, gave only a cursory discussion of this point, concluding that "[t]he income earned and expense incurred by Wagren amounted to little more than intercompany book allocations made at the direction of petitioner, Mr. Flowers, and other employees of Security."99

In reality, the third party analysis in *Winn* misconstrued the *Bramlette* holding, which is correct on the facts of that case, and translated the limited proscription against third party services enunciated in *Bramlette* into an absolute prohibition against any third party services, even though the significant services in *Winn* were rendered by the affiliate under an agreement between the subchapter S corporation and the third party affiliate.100 In view of this working arrangement between affiliates, the court misconstrued the intent of the regulations by concluding that the services did not result from arrangements made by the lessor or that the activities of one corporation could not be attributed to another affiliated corporation.101

Interestingly, the court in *Winn* made no reference to Revenue Ruling 65-40102 or Revenue Ruling 76-469,103 discussing third party services in personal property leasing situations. In the first ruling, the electing corporation leased motor vehicles on a short-term basis, supplying some of the servicing through its own employees and some through independent repair shops.104 In the second ruling, the corporation leased motor vehicles on a long-term basis. In addition to attendant repair and leasing services performed by it, the subchapter S corporation arranged to have repairs performed by unspecified third parties.105 In each case, the Service concluded, without any mention of a third party services issue, that the lease

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96. *Id.* at 516 (citing *Bramlette Bldg. Corp. v. Commissioner*, 52 T.C. 200 (1969), aff'd, 424 F.2d 751 (5th Cir. 1970)).
97. *See* text accompanying notes 59-63 *supra*.
98. 67 T.C. at 505-06.
99. *Id.* at 516.
100. The pertinent language of the regulations simply provides that "[t]he term 'rents' does not include payments . . . where significant services are also rendered to the occupant." Treas. Reg. § 1.1372-4(b)(5)(vi), T.D. 7414, 1976-1 C.B. 266. No reference is made to who must provide these services.
101. 67 T.C. at 516.
102. 1965-1 C.B. 429.
payments did not constitute passive investment income. This apparent inconsistency between the holding in *Winn* and the Service's analysis in the above revenue rulings remains unclarified.

The significant services issue was subsequently addressed in the context of personal property leasing in *Lausmann v. Commissioner*, in which the subchapter S corporation was engaged in the financing, marketing, and sale of forest products. To facilitate the operation of the business of one of its customers, an affiliated corporation, the subchapter S corporation agreed to construct, lease, and operate a wood veneer drying machine on the customer's premises. Subsequently, the customer agreed to provide labor and supplies for the dryer's operation. While some of the customer's employees were utilized in operating the dryer, the foreman of the entire drying operation was at all times directly employed by, and responsible to, the subchapter S corporation.

When a dispute arose as to subchapter S qualification, the taxpayer and the Internal Revenue Service stipulated that amounts paid to the subchapter S corporation for drying were rents and that significant services had been rendered. The only issue to be decided was who had performed the services. The Tax Court rejected the Commissioner's argument that the subchapter S corporation did not render the services simply because employees of the customer actually operated the dryer. Based solely upon the foreman's total control over the drying operation and his undisputed employment by the subchapter S corporation, the court concluded that the subchapter S corporation, rather than the customer, had performed the significant services. In basing its conclusion solely on these facts the Tax Court in *Lausmann* apparently embraced its holding in *Winn* that proscribes significant services by anyone but the subchapter S corporation. *Lausmann* offers no insight into the level of activity required to qualify as significant services, because that fact was stipulated to by the parties.

Two recent cases, one dealing with leasing space and the other dealing with leasing personal property, exemplify the Tax Court's continued reluctance to find that significant services have been provided. In *McIlhinney v. Commissioner* the issue of significant services was raised in connection with rentals derived from a shopping mall. The taxpayer's contentions that significant services had been provided were rejected, causing termina-

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106. 37 T.C.M. (CCH) 1740 (1978).
107. The foreman directed placement of the veneer in the dryer, control and maintenance of the dryer, removal of the veneer from the dryer, as well as counting, grading, and packing the dried sheets of veneer.
108. 37 T.C.M. (CCH) at 1744.
109. 67 T.C. at 516. The *Lausmann* court noted: “If [the lessee corporation] performed the services, then the rental income [the subchapter S corporation] received is passive investment income.” 37 T.C.M. (CCH) at 1744. For a construction of the third party holding of the *Bramlette* decision similar to that offered by this writer, see Note, supra note 31, at 102. See also Wilson, *Passive Investment Income: When Will It Terminate Subchapter S Qualifications?*, 40 J. Tax. 54, 56 (1974).
tion of subchapter S status and preventing the pass-through of net operating losses to the shareholders. The Tax Court first concluded that such services as providing heating and air conditioning, snow and trash removal, and the cleaning and maintenance of public areas were excluded by the regulations, either directly or by implication, or were customary or usual to similar rental premises. The other services provided by the corporation, promotional activities involving car raffles, band concerts, and Santa Claus visits, were held not significant on the ground that the record did not establish that the services were other than customary or usual for malls. The court also noted that the record did not demonstrate the frequency of the activities or the amount of expenditures or employee efforts involved. Additionally, the taxpayers' providing of the security force and mall manager also was not significant because the court found that the taxpayers had failed to carry their burden of proof with respect to whether these services were actually rendered to the occupant as required by the regulations. Finally, the court noted that, for the tax year in question, the subchapter S corporation bore under the lease provisions approximately two percent of the mall's operating cost, including the cost of the security forces. The court concluded that "[w]e fail to see how SRSC's [subchapter S corporation] payment of approximately 2 percent of the cost of security services could in any way be considered significant." The court again failed to suggest what percentage of expenditure would have qualified as significant.

In Thompson v. Commissioner the subchapter S corporation rented prerecorded video cassettes to cable television stations. The petitioner argued that it had rendered significant services by shipping the cassettes to television stations. The court rejected this contention on the ground that the petitioner had failed to carry its burden of proof. In addition, the court emphasized: "[I]t is clear to the Court that this shipping service rendered by Cable Vision [subchapter S corporation] is a service that is 'usually and customarily' rendered in similar rental businesses. Thus, we conclude that Cable Vision did not render 'significant services' to G.E. in connection with the license agreement." The holding is clearly erroneous to the extent that the court based its finding of no significant services on its understanding that the services must not be usually and customarily rendered in similar rental businesses. As contained in the regulations,

111. Id. at 557.
112. Id.
113. Id.
114. Id. at 558.
115. Id.
116. 73 T.C. 878 (1980).
117. Id. at 892.
118. Id. (emphasis added).
119. The court apparently believed that the services should not be usual or customary because it stated:

Thus, if a corporation leases personal property and renders services primarily for the convenience of the lessee other than those "usually or customarily" rendered in connection with such a lease and such services are "significant" in
the language "usually and customarily" refers only to services rendered to
an occupant in connection with the rental of rooms or other space for oc-
cupancy only.120 Because the lessee of personal property cannot properly
be called an occupant of a room or other space, the court's interpretation
of the regulations is clearly incorrect. The regulations indicate that signifi-
cant services should be the only test for personal property rental income.
All of the decided cases dealing with personal property rental income have
so held,121 but the court simply misread Winn. Winn clearly adopted sig-
nificant services as the only test for services provided in personal property
rentals.122 The language in Winn cited by the court in Thompson123 is
actually a reference to the decision of the Fifth Circuit in Bramlette,124 a
case that dealt with real, not personal property. Accordingly, this portion
of the Thompson holding appears to be of questionable precedential value.

Nevertheless, the Thompson case does point out several glaring deficien-
cies in the regulations. The Commissioner permits looking behind the re-
cceipts to determine whether the business is active or passive only in cases
involving rental income, but not in cases involving other items that consti-
tute passive investment income under the Code.125 Further, for no appar-
et reason, the applicable standard distinguishes between real and
personal property. In the case of real property, an unexplained distinction
is made between the leasing of space only, such as for warehousing or
parking lot rentals, and space rented for occupancy. The "usual or cus-
tomary" standard does not apply to the leasing of space or personal prop-
erty, even though significance is supposed to be the appropriate test for all
categories. Moreover, no demonstrable relationship exists between
whether services are usual or customary and whether a business is active or
passive. Congress has stated126 that the rationale for the passive invest-
ment income restriction is based on the latter determination. An active
real estate corporation rendering otherwise significant services apparently
will not qualify for subchapter S status simply because similar businesses
render like services. While beyond the scope of this Article, these ques-
tions are raised to point out that, while the judicial decisions have failed to
apply the subchapter S statutory provisions and regulations adequately
and consistently, the interstices in the regulations themselves have given
rise to much of the uncertainty surrounding termination of the election
through excess rental income.

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121. See notes 93-109 supra and accompanying text.
122. 67 T.C. at 514.
123. 73 T.C. at 890.
124. 424 F.2d 751, 753 (5th Cir. 1970).
125. Royalties, dividends, interest, annuities, and sales or exchanges of stock or securities
are passive income items. I.R.C. § 1372(e)(5)(C).
126. S. REP. NO. 1007, 89th Cong., 2d Sess. 8 (1966); H.R. REP. NO. 1238, 89th Cong., 2d
Sess. 8 (1966).
IV. PROPOSALS FOR CHANGE

A. Alternative Tests for Passive Investment Income From Real Estate Rentals

Congress has stated that the passive investment income limitation was intended to prevent the utilization of subchapter S status by corporations not actively engaged in a trade or business. Therefore, if the regulations are to carry out the legislative intent, they should differentiate between those corporations that merely passively invest in real estate, without undertaking significant and ongoing rental activity, and those owning and actively managing rental real estate. Congress has shown no intent to preclude subchapter S status to active corporations, and no legitimate tax policy reason is apparent for a distinction between an active real estate business and any other active trade or business. Furthermore, the complexity of the termination provisions in conjunction with the vagueness of the decided cases makes termination highly probable if the subchapter S corporation's major activity is the renting of space for occupancy. Finally, this likelihood of unintended loss of subchapter S status may occur despite the fact that subchapter S real estate corporations are clearly permissible under the regulations if significant services have been rendered and despite the fact that the significant services test under the regulations is unaccountably less stringent for rents derived from personal property and warehousing activity than from rented real estate. If predictability of result in the application of tax laws is desirable, then the current version of the subchapter S provisions with respect to rental income from real estate has failed to achieve that goal. Accordingly, the proposals that follow are attempts to provide some degree of certainty of result, with the concomitant opportunity for informed tax planning.

One alternative to the significant services test utilized by the courts is that intimated in Feingold and Winn, that is, one based on an objective percentage of corporate receipts expended for related rental services. Specifically, business activity would be determined by reference to the ratio of cost of services rendered to the occupant within the meaning of the regulations to total rental receipts. If the qualifying expenses met or exceeded the prescribed figure, then significant services would have been provided, thereby precluding a finding of passive investment income and preventing termination of the election due to excess rental income. Nevertheless, evidentiary problems of whether the services were customary and usual and whether they were primarily for the occupant's convenience would remain. Therefore, an even more mechanical test would be desirable.

One commentator has suggested a test that would compare the total of

127. JOINT COMMITTEE STAFF RECOMMENDATIONS, supra note 21, at 11.
128. While derivation of the percentage is beyond the scope of this Article, the Commissioner might set such a figure in the regulations.
all business expenses to gross receipts\textsuperscript{130} in a manner analogous to the personal holding company provisions.\textsuperscript{131} This approach would tend to ensure that the corporation's activity as a whole constituted an active trade or business, thereby satisfying the congressionally stated purpose for the passive investment income limitation,\textsuperscript{132} and a factual inquiry into whether the rental services were rendered to the occupant would be unnecessary. If total corporate business expenditures met the required percentage,\textsuperscript{133} the rents would not constitute passive investment income. This test is relatively simple, and the tax consequences of the corporate business activities would be reasonably predictable. Although this test would ensure that the business as a whole was actively pursued, it would not prevent an otherwise active corporation from having a strictly passive real estate investment as part of its business activities, and for this reason, would no doubt be vigorously resisted by the Service.

Perhaps the test most clearly reflecting the stated legislative rationale for the passive investment income limitation would be a percentage standard only for rental receipts and service expenditures.\textsuperscript{134} For example, a percentage could be derived by comparing all rental service expenditures to gross rental receipts. If the percentage were at or above some minimum level to establish business activity,\textsuperscript{135} the passive investment income limitation would not be violated and a determination of significant services would not be required. The objective factors of a test of this type would permit reasonable certainty of result, while preventing a corporation from holding significant passive income investments in addition to its active trade or business.

Other approaches have been suggested,\textsuperscript{136} such as determining passive investment income strictly by reference to the personal holding company provisions, or determining significant services through a qualitative analysis of the activities of the business. Under the latter approach, for example, a certain activity would be deemed significant, even if it were customary or usual for similar rentals, when the corporation performed the activity frequently or used a large number of employees to conduct it. Neither approach, however, appears acceptable. The 1966 amendment to subchapter S clearly indicated that business activity for passive investment income purposes was not to be determined by reference to the personal holding company provisions, and this approach is therefore clearly incompatible with the legislative intent. Additionally, the qualitative method does not appear workable because it lacks objective factors and would not eliminate the current uncertainty. Although this approach would be superior to the

\textsuperscript{130} See Comment, supra note 46, at 330.
\textsuperscript{131} I.R.C. §§ 541-547.
\textsuperscript{132} Joint Committee Staff Recommendations, supra note 21, at 11.
\textsuperscript{133} Again, derivation of the appropriation minimum percentage is not suggested in this Article.
\textsuperscript{134} Expenditures necessarily would have to be limited to service expenditures in order to rule out strictly passive items such as taxes, loan carrying charges, and capital items.
\textsuperscript{135} See Comment, supra note 46, at 329.
\textsuperscript{136} Id.
significant services test now employed by the courts because it would actually focus on business activity, it would require resolution of the question on a case by case basis, thus affording little opportunity for tax planning.

B. Deletion of Rents From the Passive Investment Income Category

The legislative history of subchapter S offers no insight into why the particular items of passive investment income were selected for inclusion within that category. The most recent legislative pronouncement dealing with the passive investment income restriction indicated only that the provision was intended to limit subchapter S status to small but active trades or businesses not having large amounts of passive income. While the 1966 amendment dropped the heading “Personal Holding Company Income” and substituted “Passive Investment Income,” presumably because Congress deemed the latter the more appropriate test of whether a corporation was actively engaged in a trade or business, it did not indicate the rationale for inclusion of rents in the passive investment income.

One inconsistency in the formulation of the passive investment income limitation in the regulations can be seen readily from a brief examination of the six categories of proscribed income. While the mere receipt of royalties, dividends, annuities, or the proceeds from the sale or exchange of stock or securities generally involves no trade or business activity, the receipt of rental income, especially from real estate, does involve business activity. At a minimum, the lessor corporation would engage in bookkeeping and record keeping activity, check writing or cash disbursements, advertising and taxpaying, as well as maintenance and general management activity, unless paid management is retained to perform these services. Based upon these distinctions alone, rental income should not be treated as passive investment income as a matter of course. In fact, commentators generally agree that the rental of real estate constitutes a trade or business when considerable, continuous, and regular management or rental activities are performed. Real estate rentals may have been lumped into the passive investment income category simply because real estate is often held for investment, without any consideration of the fact that this type of activity has much of the indicia of an active trade or business. If the purpose of the passive investment income provision is solely to require business activity for subchapter S corporations, then the rents cate-

137. See text accompanying notes 22-31 supra.
139. The sixth category, “interest,” may also be distinguished from the other, clearly passive types. For example, in Marshall v. Commissioner, 60 T.C. 242 (1973), aff’d, 510 F.2d 259 (10th Cir. 1975), the corporation derived excess passive investment income from interest from its small loan business, thus terminating the subchapter S election. The corporation was quite active, however, in the small loans business during the tax year in question.
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category of proscribed income could be deleted without defeating the congressional purpose for the limitation.

Another inconsistency involves the language of the regulations that set forth the activities constituting significant services.\textsuperscript{141} Maid services constitute such services and therefore business activity, but the cleaning of common areas and the collection of trash do not.\textsuperscript{142} Moreover, while services rendered to occupants of office buildings and private residences must not be customary or usual in order to be significant, services provided in warehousing\textsuperscript{143} and space rental\textsuperscript{144} are not so restricted. Likewise, the "customary and usual" limitation does not apply to rentals from hotels, motels, and similar establishments.\textsuperscript{145}

While the language of the regulations dealing with rent appears more liberal than the statutory provision, which bars excess rents entirely,\textsuperscript{146} in fact, the regulations have only added to the confusion of the already complicated subchapter S provisions. The spate of litigation arising over unintended subchapter S terminations from rental income suggests that the regulations, in combination with the complexity of the statutory provisions, have misled taxpayers as to the propriety of real estate rental income under subchapter S.

While this problem has proved most acute for real estate rentals, passive investment income issues have also arisen for personal property leasing and for rents derived from non-occupied real estate, such as parking lot rentals and warehouse fees. Even though the question of significant services for these categories is rendered moot by the provisions of the regulations and revenue rulings, the issue of third party services, as illustrated by \textit{Winn}, remains. Therefore, deletion of personal property rents from the passive investment income limitation would remove the uncertainty that now exists.

\textbf{C. Repeal of the Passive Investment Income Provisions}

The most radical, yet most equitable, proposal for removing the deficiencies of the passive investment income restrictions would be to abolish those provisions entirely. The rationale for the limitation has been questioned almost from the inception of the subchapter S provisions. For example, one commentator has contended that personal holding companies have been excluded from subchapter S treatment, through the passive in-

\begin{footnotesize}
\begin{footnotetext}{141}{Treasury Regulation § 1.1372-4(b)(5)(vi), T.D. 7414, 1976-1 C.B. 266. For the full text of the regulation, see note 32 \textit{supra}.}
\end{footnotetext}
\begin{footnotetext}{142}{Treasury Regulation § 1.1372-4(b)(5)(vi), T.D. 7414, 1976-1 C.B. 266.}
\end{footnotetext}
\begin{footnotetext}{143}{Id.}
\end{footnotetext}
\begin{footnotetext}{144}{Id.}
\end{footnotetext}
\begin{footnotetext}{145}{Id. Maid service is usual and customary in such establishments. Yet according to Treasury Regulation § 1.1372-4(b)(5)(vi), maid services are significant. Inexplicably, the usual and customary language must not apply to hotels and motels.}
\end{footnotetext}
\begin{footnotetext}{146}{Under I.R.C. § 1372(e)(5)(C), rent is a category of passive investment income, with no exception provided. Treasury Regulation § 1.1372-4(b)(5)(vi), T.D. 7414, 1976-1 C.B. 266, however, excludes rents from passive investment income where significant services are rendered to the occupants.}
\end{footnotetext}
\end{footnotesize}
come restriction, simply because the Treasury Department has tradition-
ally desired to punish personal holding companies.147

Another writer, with a less extreme view, holds that abolishing the pas-
sive investment income provisions will enhance the effect of the personal
holding company provisions by ensuring that all income of the electing
corporation is taxed currently to the shareholders.148 A third commentator
has noted that because the distinction between active and passive invest-
ments is difficult to draw and because it serves no purpose within the sub-
chapter S framework, the passive investment income restriction should be
removed if employee fringe benefit abuse is otherwise precluded.149 An-
other argument against the passive investment income limitation can be
directed against the inclusive statutory list of only six categories of pro-
scribed income, with no apparent reason for limiting passive investment
income to these six items alone. A corporation that receives all of its in-
come from owning personal service contracts not permitted under the Per-
sonal Holding Company provisions150 of the Code would be a personal
holding company not actively engaged in the conduct of a trade or busi-
ness within the usual meaning of that term. Such a corporation, however,
apparently would be able to elect and maintain subchapter S status, simply
because personal service contract income is not listed under the categories
of passive investment income. Additionally, a corporation whose sole ac-
tivity is to hold real estate for resale apparently would also qualify for
subchapter S treatment because receipts derived from the sale or exchange
of real estate are not proscribed by section 1372(e)(5) or the regulations,
regardless of the level of activity of the corporation. Such distinctions be-
tween these types of income appear arbitrary and do not foster the under-
lying purpose of the subchapter S provisions.

If the primary purpose for enacting subchapter S were to eliminate con-
sideration of federal income tax consequences when choosing a form of
business, then the complexity of the termination provisions and the uninten-
tended terminations by themselves would weigh in favor of the repeal of
the passive investment income restrictions.151 One thoughtful analysis of
the subchapter S passive investment income restriction maintains that the
only real reason for its inclusion has nothing to do with passive investment
income per se, but relates to the prevention of funding of qualified pension

147. Borsook, Few Personal Holding Companies Will Qualify for Subchapter S Election,
148. Driscoll, Subchapter S—Its Role in the Tax Laws, 3 Tax Revision Compendium
1723, 1730 (1959).
149. Price, Subchapter S—Some Policy Questions, 3 Tax Revision Compendium 1731,
1732 (1959).
151. While this Article deals primarily with rents as passive investment income, litigation
has also proliferated over unintended subchapter S termination through receipt of the other
forms of passive investment income as well. See, e.g., Swank & Son v. United States, 362 F.
Supp. 897 (D. Mont. 1973) (oil and gas royalties), aff'd, 522 F.2d 981 (9th Cir. 1975); Zychin-
ski v. Commissioner, 60 T.C. 950 (1973) (sale of securities), aff'd, 506 F.2d 637 (8th Cir.
1974), cert. denied, 421 U.S. 999 (1975); House v. Commissioner, 29 T.C.M. (CCH) 533
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and profit-sharing plans with passive investment income. This assertion seems to be well-founded because no passive investment income limitation appeared in the unsuccessful 1954 subchapter S proposal, which required all shareholders to be active participants in the business. Moreover, the 1954 proposal provided that subchapter S shareholders were ineligible for qualified pension and profit-sharing plans. The conclusion is further supported by a recent congressional staff report that maintains that prevention of abuse of qualified pension and profit-sharing plans by funding them with passive income is probably the real reason for the passive investment income limitation.

Elimination of the passive investment income provisions would require the amendment of certain other provisions of the Code to ensure that the subchapter S shareholder-employees do not receive preferential treatment over partner-employees or sole proprietors and also to prevent abuse of the fair market distribution rule. Since certain of the pension and profit-sharing plan requirements of the Code are less strict for subchapter S employees than for partners or sole proprietors, abolishing the passive investment income restriction might encourage the incorporation of individual investment activities, followed by election of subchapter S status. Therefore, section 1379 of the Code dealing with subchapter S qualified pension, stock, bonus, and profit-sharing plans would have to be amended to provide for an earned income requirement similar to that for partners and sole proprietors, as contained in section 401(c)(2) of the Code.

Furthermore, since the provisions for certain corporate statutory fringe benefits under the Code are not available to sole proprietors or most partners, they would have to be amended in order to avoid undue prefer-

154. Id. at 5098.
155. See JOINT COMMITTEE STAFF RECOMMENDATIONS, supra note 21, at 11.
156. Id. at 19.
157. Under I.R.C. §§ 401(c)(3), (d)(11), an earned income requirement is provided in the case of sole proprietors and partners with more than a 10% interest in order for them to avail themselves of qualified pension and profit-sharing plans.
158. An alternative to this approach, as suggested in JOINT COMMITTEE STAFF RECOMMENDATIONS, supra note 21, at 20-21, would be to permit contributions to plans as long as corporate passive investment income does not exceed the 20% termination level currently in effect. If passive investment income exceeds 20% of gross receipts, then allowable contributions are reduced by the percentage of passive investment income. The staff recommendation permits an exception when passive investment income is less that $3,000 in the first or second taxable year of the corporation in a manner analogous to the exemption of I.R.C. § 1372(e)(5)(B).
159. I.R.C. § 79 provides for the exclusion from gross income of the cost, up to the first $50,000, of group-term life insurance purchased by employers for employees. Id. § 101(b) provides for the exclusion from gross income of certain employee death benefits. Id. § 105 provides for the exclusion from gross income of certain amounts received by employees under accident and health plans. Id. § 106 provides for the exclusion from employees’ gross income of employer contributions to accident and health plans. Id. § 119 provides for the exclusion from employees’ gross income of the value of meals or lodging furnished for the employer’s convenience.
ence to subchapter S corporations, by providing that they do not apply to shareholder-employees of subchapter S corporations. Since elimination of the passive investment income restriction would permit passive investment income assets to be distributed tax free as a return on basis with a fair market value basis under section 301(d) of the Code, potential for abuse would arise. Therefore, section 1375 of the Code relating to distributions of elective corporations would require amendment to provide that a subchapter S corporation would recognize gain on nonliquidating distributions of property unrelated to its trade or business. If these measures, and the previously discussed measures, were enacted, Congress could repeal the somewhat meaningless, and often discriminatory and harsh, passive investment income restriction by addressing only the real dangers for abuse against which the restriction should protect.

V. Conclusion

The passive investment income restrictions on rental income have proved to be an unwarranted discrimination against corporations owning and leasing tenant-occupied real estate, such as commercial, office, and apartment buildings. Despite the level of activity inherent in such businesses, the cases construing section 1372(e)(5) of the Code make it virtually impossible for such corporations to qualify for subchapter S status. In view of the inconsistencies and ambiguities in the cases construing the passive investment income provisions, tax planners cannot predict either the type of activity or level of activity that would qualify as significant services within the meaning of the regulations. In effect, owners of tenant-occupied real estate, other than hotels, motels, and other similar examples, must

160. Alternatively, the Code could provide that the fringe benefits are unavailable to subchapter S shareholders only when the amount of passive investment income in any taxable year would cause termination of the election under the current rules. Therefore, if passive investment income is 20% or less of gross receipts or if passive investment income for the tax year is less than $3,000 during either the first or second year in which the corporation commences an active trade or business, the preferential tax benefits would be available to subchapter S shareholder-employees. See Joint Committee Staff Recommendations, supra note 21, at 21.

161. Under the general provisions of I.R.C. §§ 301, 306, actual distributions of cash or property to subchapter S shareholders are treated as dividends to the extent of current or accumulated earnings and profits. Under § 301, the basis of the property received and the amount of the distribution to a noncorporate distributee are the fair market value of the distribution. Amounts distributed in excess of current and accumulated earnings and profits are treated first as a reduction of stock basis, a nontaxable return of capital, and then, for amounts in excess of basis, as gain from the sale or exchange of property. Therefore, after current and accumulated earnings and profits have been exhausted, the subchapter S shareholder can receive tax free, except for recapture in certain cases, nonbusiness capital assets at a stepped-up basis to the extent of his remaining stock basis. Furthermore, gain is not recognized to the corporation. If the shareholder then holds his reduced basis stock until his death, his heirs will avoid tax through the stepped-up basis rule of I.R.C. § 1014. See Joint Committee Staff Recommendations, supra note 21, at 19.

162. Recognizing that this potential for abuse also exists for § 1231 business assets, the Joint Committee Staff Recommendations would provide for recognition of gain at the corporate level on nonliquidating distributions of § 1231 property as well. Joint Committee Staff Recommendations, supra note 21, at 19.
choose some other form of business organization in order to obtain conduit treatment and predictability of federal tax consequences.

The only substantive reason for the passive investment income restriction appears to be the prevention of abuse of certain qualified employee benefit plans by funding them with income derived from passive investments since partner-employees or sole proprietors do not have this option. Therefore, if subchapter S is intended to simplify election of the form of business organization, any restrictions on qualification ought to be sufficiently narrow to address only the real potential for abuse. The current subchapter S provisions, however, entail a broad and unnecessary dragnet, needlessly including actively derived income in several cases, yet inexplicably excluding certain other forms of passive income. From their inception, the passive investment income restrictions have been overly broad in scope. For unwary taxpayers, this arbitrary selection of proscribed income categories has proved a quagmire that may result in the termination of subchapter S status even though considerable business activity exists or the amount of passive investment income is minimal.\textsuperscript{163} Since the employee pension and profit-sharing plan loophole can be closed, and other tax preferences to subchapter S shareholder-employees prevented, the passive investment income limitation should be abolished.

\textsuperscript{163} For example, a subchapter S corporation that is beyond the first two years of its active conduct of a trade or business, thus losing the $3,000 protective ceiling, and that is operating at a loss, might have its election terminated by receipt of small amounts of passive investment income when gross receipts from its active businesses are also small, because of the gross receipts test of § 1372(e)(5).