INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

August 01, 2007

Third Party Communication: None
Date of Communication: Not Applicable

Number: **200747018**
Release Date: 11/23/2007
Index (UIL) No.: 469.00-00, 469.03-03
CASE-MIS No.: TAM-106440-07

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:

Year(s) Involved:

Date of Conference:

LEGEND:

SH =

SCorp =

QSub1 =

QSub2 =

Y1 =

Y2 =

Y3 =

City1 =

City2 =

ISSUES:

1) Whether the truck leasing activity conducted by QSub1 is a separate rental activity under § 469 of the Internal Revenue Code?

2) If the truck leasing activity conducted by QSub1 is treated as a separate rental activity, whether it may be grouped with the non-rental activities conducted by the other QSubs of SCorp under § 1.469-4(d) of the Income Tax Regulations?

CONCLUSION(S):

1) The truck leasing activity conducted by QSub1 is a separate rental activity under § 469.

2) The truck leasing activity conducted by QSub1 may be grouped with the non-rental activities conducted by the other QSubs of SCorp under § 1.469-4(d).

FACTS:

For the years at issue (Y1, Y2, and Y3), SH owned 100% of SCorp, an S corporation. SCorp owned several qualified subchapter S subsidiaries (QSubs), including QSub1 and QSub2. QSub2 and the QSubs other than QSub1 generally sell new and used heavy trucks and trailers, and have locations in City1 and City2. QSub1, located in City1, primarily leases heavy trucks and trailers via leveraged net leases. QSub1 and QSub2 are located in the same building. QSub1 maintains its own set of accounting records, computer accounting programs, and books and records.

The lease terms of QSub1 are typically 30 to 60 months. QSub1 acquires the equipment it leases primarily from QSub2. Such sales are made at retail value. QSub1 also makes purchases from unrelated third parties if the customer wants a model that QSub2 does not carry. QSub1 has a master lease agreement for motor vehicles and another master lease agreement for equipment leases. The master lease agreements call for various items, such as rent, security deposits, owner's right of inspection, equipment to remain in the U.S., lessee to maintain insurance, no vehicle to be marked or permanently altered without owner's permission, lessee to pay for all repairs not under warranty, and lessee to be responsible for maintenance and conforming leased property to federal, state, or local government requirements. Lessee must also pay all personal property, excise, sales, and/or use taxes. Upon termination of the lease,

lessees must generally return the property to the lessor. Some of the leases also contain “Terminal Rental Adjustment Clauses” (TRAC), which provide that upon termination of the lease, the equipment will be sold and the proceeds distributed as follows: (1) reimburse lessor for cost of putting leased equipment in condition to be sold, sales commissions, and other expenses of sale; (2) balance to lessor up to a stated residual value; and (3) any remaining amount to lessee as an adjustment to rent previously paid. If the proceeds are less than the residual value and expenses of sale, lessee shall pay to lessor the deficiency as additional rent, but in any event not more than the residual value. The amount paid by lessee is classified as a terminal rent adjustment. Alternatively, the lessee can sell the item to avoid having to pay sales commissions and other costs, but QSub1 is paid the residual value.

For the years at issue, SCorp has grouped all of the activities conducted by the QSubs into one activity for purposes of § 469 and has consistently used this grouping through the years. SH reported consistently with the grouping of activities shown on the K-1s issued by SCorp. The combined activities of SCorp represent an appropriate economic unit under § 1.469-4(c).

LAW AND ANALYSIS:

Section 469(a)(1) disallows passive activity losses to individual taxpayers for the taxable year.

Section 469(c)(1) provides that the term passive activity means any activity which involves the conduct of a trade or business in which the taxpayer does not materially participation. Section 469(c)(2) provides that the term passive activity includes any rental activity. Section 469(c)(4) provides that § 469(c)(2) shall be applied without regard to whether or not the taxpayer materially participates in the activity.

Section 469(d)(1) provides that the term “passive activity loss” means the amount by which the aggregate losses from all passive activities for the taxable year exceed the aggregate income from all passive activities for such year.

Section 469(j)(8) provides that the term “rental activity” means any activity where payments are principally for the use of tangible property.

Section 1.469-1T(e)(3) provides that an activity is a rental activity for a taxable year if during such taxable year, tangible property held in connection with the activity is used by customers or held for use by customers, and the gross income attributable to the conduct of the activity during such taxable year represents amounts paid principally for the use of such tangible property (without regard to whether the use of the property by customers is pursuant to a lease or pursuant to a service contract or other arrangement that is not denominated a lease).

Section 1.469-4(a) provides that § 1.469-4 sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of § 469. A taxpayer's activities include those conducted through C corporations that are subject to § 469, S corporations, and partnerships.

Section 1.469-4(b)(1) generally provides that trade or business activities are activities, other than rental activities, that involve the conduct of a trade or business (within the meaning of § 162). Section 1.469-4(b)(2) provides that rental activites are activities that constitute rental activities within the meaning of § 1.469-1T(e)(3).

Section 1.469-4(c)(1) provides that one or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of § 469. Section 1.469-4(c)(2) provides that, except as otherwise provided in § 1.469-4, whether activities constitute an appropriate economic unit depends upon all the relevant facts and circumstances.

Section 1.469-4(d) provides that the grouping of activities is subject to several limitations. Section 1.469-4(d)(1)(i) provides that a rental activity may not be grouped with a trade or business activity unless the activities being grouped together constitute an appropriate economic unit under §1.469-4(c) and (A) the rental activity is insubstantial in relation to the trade or business activity; (B) the trade or business activity is insubstantial in relation to the rental activity; or (C) each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.

Section 1.469-4(d)(5) generally provides that an S corporation must group its activities under the rules of § 1.469-4. Once the S corporation groups its activities, a shareholder may group those activities with each other, with activities conducted directly by the shareholder, and with activities conducted through other entities, in accordance with the rules of § 1.469-4. A shareholder may not treat activities grouped together by an S corporation as separate activities.

The Temporary Regulations under § 1.469-4(d) contained a bright line test whereby an activity would be considered insubstantial if it earned less than 20 percent of the gross income of the combined activity. The final regulations, however, removed this bright line test. The preamble to the final regulations explain this removal as follows:

> "Several commentators requested clarification of the rule that trade or business activities may be grouped together with rental activities only if one is insubstantial in relation to the other. Some comments

> suggested specifying the term "insubstantial" refers to factors other than gross income. Other commentators suggested adopting a bright-line test or safe harbor gross revenue test. Because the regulations already adopt a facts and circumstances test that looks at all of the pertinent factors, it is not necessary to specify that the term insubstantial refers to factors other than gross income. In addition, to avoid complex and mechanical rules, the final regulations do not adopt a bright-line or safe harbor or gross revenue test." T.D. 8565.

In addition, the legislative history to § 469 provides that the determination of what constitutes a separate activity is to be made in a realistic economic sense. See S.Rep.No. 99-313, at 740 (1986).

Issue 1

SH and SCorp argue that the activity of QSub1 is a trade or business activity and not a rental activity. First, SH and SCorp argue that the activity of QSub1 is a financing trade or business. Because QSub1 receives a guarantee from the lessee in order to minimize the risk associated with the condition and market value of the property at the end of the lease term, the leases are treated under GAAP as finance leases. That is, QSub1 is treated as having sold the asset to the lessee and simply retains an interest as a creditor. Generally, the tax accounting of this transaction would be the same as GAAP (treatment as disguised sale), but because of § 7701(h) and the insertion by SCorp of a TRAC in the agreements, the code allows SCorp to treat a financial lease as an operating lease regardless of the underlying sale that has occurred (for purposes of depreciation). Thus, SH and SCorp contend that the exception contained in § 7701 should not change the substance of the transaction for purposes of § 469, and QSub1 should be treated as engaged in a financing trade or business rather than a rental activity. However, the fact that a lease may be treated as a finance lease for book purposes does not control its tax treatment. Section 7701(h) specifically states that a lease with a TRAC will be treated as a lease for all purposes of the Code, and that the lessor will be treated as the owner of the leased property. Accordingly, the activity of QSub1 constitutes a rental activity for purposes of § 469, rather than a financing trade or business activity.

SH and SCorp also rely upon case law that states that a trade or business activity exists for purposes of § 162 if: (1) taxpayer enters into and carries on an activity with a good faith intention to make a profit; and (2) the activity is engaged in with some regularity and continuity. Because the activity of QSub1 meets these requirements, SH and SCorp believe that the activity conducted by QSub1 is a trade or business activity rather than a rental activity for purposes of § 469. Section 1.469-4(b)(1) provides that trade or business activities are activities, other than rental activities, that involve the conduct of a trade or business (within the meaning of § 162). Thus, although QSub1's activity may constitute a trade or business activity within the meaning of § 162 and the

judicial doctrine thereunder, the definition of trade or business for purposes of § 469 specifically excludes activities which are rental activities. Because the activity of QSub1 is one in which property is held for use by customers and the income earned represents amounts paid principally for the use of such tangible property, the activity is a rental activity for purposes of § 469, regardless of whether it also satisfies the trade or business requirements of § 162.

Finally, SH and SCorp argue that it is inappropriate to break out the truck leasing activity conducted by QSub1 as a separate activity, as the "car dealership" activity should be viewed as one integrated activity. That is, SH and SCorp believe that the activity conducted by QSub1 is a part of the overall trade or business of selling vehicles. At the end of a lease, the customer can either return the vehicle, at which time the car dealership trade or business will sell the vehicle, or the customer can purchase the vehicle. Thus, SH and SCorp argue that leases are merely an alternative way to sell a vehicle and they go hand in hand with a car dealership trade or business activity. This argument also fails because of the structure of § 1.469-4, which excludes rental activities from the definition of a trade or business activity. That is, given the definition of trade or business activity in § 1.469-4(b)(1), a trade or business activity cannot have as one of its components a rental activity.

Therefore, the truck leasing activity conducted by QSub1 is a rental activity for purposes of § 469 and may be grouped with the non-rental activities conducted by the other QSubs of SCorp only if the activities satisfy the requirements of § 1.469-4(d).

Issue 2

The truck leasing activity conducted by QSub1 may be grouped with the activities of the other QSubs under § 1.469-4(d)(1)(A). It is conceded that the activities of QSub1 and the other QSubs constitute an appropriate economic unit under § 1.469-4(c). In addition, based upon all of the facts and circumstances, the rental activity of QSub1 is insubstantial in relation to the trade or business activities conducted by the other QSubs of SCorp.

CAVEAT(S):

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

No opinion is expressed herein as to any other issues raised in the technical advice request or that may be raised based on the facts of this case.