Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: John R. Reis
Senior Program Analyst
(Small Business/Self-Employed)

from: Michael Swim
Senior Technician Reviewer
Employment Tax Branch 1
Office of Associate Chief Counsel
(Employee Benefits, Exempt Organizations, and Employment Taxes)
CC:EEE:EOET:ET1

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subject: Application of I.R.C. §§ 469(c) and 1402(a)(1) to Short-Term Rentals from Real Estate

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

1) Whether the characterization of an activity as a "rental activity" under § 469(c)(2) determines whether the activity is "rentals from real estate" excluded from net earnings from self-employment ("NESE") under § 1402(a)(1) for Self-Employment Contributions Act ("SECA") tax purposes.

2) In situations not involving a real estate dealer, when are rentals of living quarters considered "rentals from real estate" excluded from NESE under § 1402(a)(1).

CONCLUSIONS

1) No, whether an activity is a "rental activity" under § 469(c)(2) is not determinative of whether the exclusion in § 1402(a)(1) applies.

2) In situations not involving a real estate dealer, net rental income from the rental of living quarters is considered "rentals from real estate" excluded from NESE when no services are rendered for the occupants. However, if services are rendered for the occupants and the services rendered (1) are not clearly required to maintain the space in a condition for occupancy, and (2) are of such a substantial nature that the compensation for these services can be said to constitute a material portion of the rent, then the net rental income received is not excluded under § 1402(a)(1) and is included in NESE.

FACT SITUATIONS

You have asked for advice on the following general fact patterns:

1) The taxpayer is an individual who directly and solely owns and rents, in the course of a trade or business,[1] a fully furnished vacation property via an online rental marketplace.[2] The taxpayer is not a real estate dealer within the meaning of Treas. Reg. § 1.1402(a)-4(a).[3] The taxpayer provides linens, kitchen utensils, and all other items to make the vacation property fully habitable for each occupant. In addition, the taxpayer provides daily maid services, including delivery of individual use toiletries and other sundries, access to dedicated Wi-Fi service for the rental property, access to beach and other recreational equipment for use during the stay, and prepaid vouchers for ride-share services between the rental property and the nearest business district. For the year at issue, the average period of customer use of the vacation property is seven days, and therefore the activity is not considered a rental activity for purposes of § 469 pursuant to Treas. Reg. § 1.469-1T(e)(3)(ii)(A) In addition, the taxpayer materially participates in the activity within the meaning of § 469(h)(1) and Treas. Reg. § 1.469-5T and, therefore, the activity is not a passive activity within the meaning of § 469(c).

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[1] Assume, in both examples #1 and #2, sufficient other facts exist so that each example rises to the level of a § 162 trade or business. See Treas. Reg. § 1.1402(c)-1. The facts provided are not intended to be used for purposes of analysis of whether the taxpayer is engaged in a trade or business under § 162 or any other provision of the Code.

[2] Assume, in both examples #1 and #2, that the taxpayer does not use the property for "personal" purposes, as defined in § 280A(d)(2).

[3] Treas. Reg. § 1.1402-4(a) states that an individual who is engaged in the business of selling real estate to customers with a view to the gains and profits that may be derived from such sales is generally a real-estate dealer.

2) The taxpayer is an individual who directly and solely owns and rents, in the course of a trade or business, a fully furnished room and bathroom in a dwelling via an online rental marketplace. The taxpayer is not a real estate dealer. Occupants only have access to the common areas of the home to enter and exit the room and bathroom and have no access to other common areas such as the kitchen and laundry room. The taxpayer cleans the room and bathroom in between each occupant's stay. For the year at issue, the average period of customer use of the vacation property is seven days, and therefore the activity is not considered a rental activity for purposes of § 469 pursuant to Treas. Reg. § 1.469-1T(e)(3)(ii)(A). In addition, the taxpayer materially participates in the activity within the meaning of § 469(h)(1) and Treas. Reg. § 1.469-5T, and, therefore, the activity is not a passive activity within the meaning of § 469(c).

LAW AND ANALYSIS

Under § 469(c), a passive activity is generally any trade or business activity in which the taxpayer does not materially participate or any rental activity. Treas. Reg. § 1.469-1T(e)(3)(ii)(A) provides that an activity involving the use of tangible property is not a rental activity for a taxable year if for the taxable year the average period of customer use for the property is seven days or less. Under § 469(h), a taxpayer materially participates in a trade or business activity only if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis. In the case of individuals, Treas. Reg. § 1.469-5T provides seven tests for material participation. In particular, Treas. Reg. § 1.469-5T(a)(1) provides that an individual will generally be treated as materially participating in an activity for a taxable year if the individual participates in the activity for more than 500 hours during such year.

Treas. Reg. § 1.469-1T(d)(1) provides that the characterization of items of income or deduction as passive activity gross income or passive activity deductions does not affect the treatment of items of income or deduction under provisions of the Code other than § 469. Therefore, whether amounts are passive activity gross income under Treas. Reg. § 1.469-2T(c) or passive activity losses under Treas. Reg. § 1.469-2T(b) is not determinative of whether those amounts are rentals from real estate under § 1402(a)(1) and Treas. Reg. § 1.1402(a)-4. However, under Treas. Reg. § 1.469-1T(d)(3) a deduction that is disallowed for a taxable year under § 469 and the regulations thereunder is not taken into account as a deduction that is allowed for the taxable year in computing the amount subject to any tax imposed by subtitle A of the Internal Revenue Code.

Section 1401 imposes tax on the self-employment income of individuals. Section 1402(b) defines self-employment income by reference to net earnings from self-employment, with certain modifications. Section 1402(a) provides that the term "net earnings from self-employment" ("NESE") means the gross income derived by individuals from any trade or business they carry on, less the deductions that are

attributable to such trade or business. However, under § 1402(a)(1), rentals from real estate, together with deductions properly deductible and attributable to the rentals from real estate (collectively, "net rental income"), are excluded from NESE, unless these amounts are received in the course of a trade or business as a real estate dealer.[4]

Treas. Reg. § 1.1402(a)-4(c)(1) provides that rentals from living quarters, where no services are rendered for the occupants, are generally considered rentals from real estate under § 1402(a)(1), except in the case of real estate dealers. However, Treas. Reg. § 1.1402(a)-4(c)(2) provides,

> Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant . . . are included in determining net earnings from self-employment. 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.

Treas. Reg. § 1.1402(a)-4(c)(2) lists examples of situations where services are rendered for the convenience of occupants, such as hotels, boarding homes, warehouses, and storage garages.

In Rev. Rul. 57-108, 1957-1 C.B. 273, the IRS ruled that a landlord who rented furnished vacation beach dwellings and rendered services "for the comfort and convenience of his guests in connection with their recreational activities"—including maid services, swimming and fishing instruction, mail delivery, furnishing of bus schedules, and information about local churches—rendered services primarily for the occupants' convenience. Consequently, the net rental income from the vacation beach dwellings was included in the landlord's NESE because the § 1402(a)(1) exclusion did not apply.

In Bobo v. Commissioner, 70 T.C. 706 (1978), acq. 1983-2 C.B. 4, the Tax Court considered a mobile home park that provided leased trailer park units with utility hookups, sewage facilities, and laundry facilities. The Tax Court held that the net rental income from the rental of the trailer park units was excluded from the owners' NESE under § 1402(a)(1). The court relied on Delno, infra, in setting the standard for when services are considered *not* rendered for the occupant,

> [Section 1402(a)(1)] should be applied to exclude only payments for use of space, and, by implication, such services as are required to maintain the space in condition for occupancy. If the owner performs additional services of such

[4] This memorandum does not address nor is intended to address arrangements between an owner or tenant and another individual which provides that the individual shall produce agricultural or horticultural commodities on the land covered, or the agricultural and horticultural exception contained in section 1402(a)(1).

> substantial nature that compensation for them can be said to constitute a material part of the payment made by the tenant, the "rent" received then consists in part of income attributable to the performance of labor which is not incidental to the realization of return from passive investment.

Bobo at 709 (citing Delno v. Celebrezze, 347 F.2d 159, 166 (9th Cir. 1965) (relating to parallel Social Security eligibility provisions). Again relying on Delno, the Tax Court first determined that the phrase, "'usually or customarily rendered' . . . must be read with emphasis upon the closing phrase 'for occupancy only.'" Bobo at 710. The court reasoned that an analysis of whether services are rendered solely for the convenience of the occupants pursuant to Treas. Reg. § 1.1402(a)-4(c))(2) is a question of fact based on "whether [the services rendered] are required to maintain the space in condition for occupancy and, if not, whether [the services rendered] are substantial." Id. at 710-11; see also Johnson v. Commissioner, 60 T.C. 829, 832-33 (1973) (stating, "any service not clearly required to maintain the property in condition for occupancy be considered work performed for the tenant, and not for the conservation of invested capital," in support of a narrow construction of the exclusion from NESE for rental real estate).

Ultimately, the court determined that, even though the trailer park furnished laundry services that were "clearly rendered for the convenience of the tenant and not to maintain the property in condition for occupancy," the tenants' payments for the laundry services were not "substantial enough to classify all the tenants' [rental] payments as received for 'services to the occupants.'" Id. at 711 (citing Treas. Reg. § 1.1402(a)-4(c)(2)). Accordingly, the court held the payments at issue were rental from real estate excluded from NESE.

In Rev. Rul. 83-139, 1983-2 C.B. 150, the Service relied on the Tax Court's analysis in Bobo (as it applied the holding in Delno) in distinguishing between two factual situations. Situation (1) involved a trailer park owner and operator who operated a trailer park that provided similar services to those provided in Bobo. Situation (2) involved a trailer park owner and operator who provided a trailer park that provided all the services as the trailer park in Bobo, but also operated "a recreation hall, consisting of a card area, pool room, kitchen, auditorium, stage, and library." The Service determined, citing to Delno and Johnson, supra, that only situation (2) gave rise to substantial services for the convenience of the occupant, stating:

> The Service agrees with the court in Bobo that each case turns upon the facts presented and whether the services provided by the trailer park owner are services rendered for the convenience of the tenants as opposed to services required to maintain the space rented to tenants in condition for occupancy. When determining whether service is for the maintenance of property, the courts have emphasized that the rental exclusion must be read narrowly and that any service not clearly required to maintain the property in condition for occupancy is considered work performed for the tenant.

Rev. Rul. 83-139, 1983-2 C.B. 150. Finding that the services were of such substantial nature that the compensation for them could clearly be said to constitute a material part of the payments made by the tenants, the Service ruled that the § 1402(a)(1) exclusion for rental real estate did not apply in situation (2), and the income received was includible in computing NESE.[5]

In Hopper v Commissioner, 94 T.C. 542, 548 (1990), the Tax Court held that net rental income from storage units where the landlord also provided a soft drink machine and sold locks, packaging materials, pallets, and insurance, was excluded from the owners' NESE under § 1402(a)(1) because the services provided for the convenience of the occupants of the storage units were not substantial. Even though Treas. Reg. § 1.1402(a)-4(c)(2) uses warehouses and storage garages as examples of activities that are not rentals from real estate, the "nomenclature of the examples used" in Treas. Reg. § 1.1402(a)-4(c)(2) does not impact the analysis. Id. at 547. Rather, the § 1402(a)(1) analysis depends on the facts and circumstances of each specific case. See id. Specifically,

> Whether services are considered as rendered to the occupant within the meaning of section 1.1402(a)-4(c)(2), Income Tax Regs., raises a question of fact. This question can be resolved by determining whether such services are required to maintain the space in condition for occupancy. If the answer is yes, then the services are not considered as rendered to the occupant. In this regard, the services listed in section 1.1402(a)-4(c)(2), Income Tax Regs., as those which are required to maintain the space in condition for occupancy are only illustrative.

Id. at 547 (relying on Delno, 347 F.2d at 163, and Bobo, 70 T.C. at 710).

Fact Situation 1

The net rental income in Fact Situation 1 is not excluded from NESE under § 1402(a)(1) because the taxpayer provides substantial services beyond those required to maintain the space in a condition suitable for occupancy. See Bobo, 70 T.C. at 710; Rev. Rul. 83-139. Whether services are considered rendered for the occupant is based on the particular facts and circumstances in each case. See Hopper, 94 T.C. at 548 (1990). Here, the payments made to the taxpayer for these services are for the convenience of the property's occupants. The services go beyond those clearly required to maintain the space in a condition for occupancy and are of such a substantial nature that the compensation for these services can be said to constitute a material portion of the rent. Thus, the payments are not excluded under § 1402(a)(1) but rather are

[5] The Social Security Administration ("SSA") interprets its eligibility provisions using the reasoning from Bobo and Rev. Rul. 83-139. See Net Earnings from Self-Employment-Rentals from Real Estate-Servs. to Occupants of Mobile Home Parks, SSR 86-12 (S.S.A. 1986).

included in NESE.[6] The characterization of this activity as not a passive activity within the meaning of § 469(c) does not affect whether the activity is excluded from NESE under § 1402(a)(1).[7]

Fact Situation 2

The net rental income from Fact Situation 2 is excluded from NESE under § 1402(a)(1) because the taxpayer does not provide substantial services beyond those required to maintain the space in a condition suitable for occupancy. See Bobo, 70 T.C. 706 at 710; Rev. Rul. 83-139. Services the taxpayer provides to clean and maintain the property to bring it to a suitable condition for occupancy are not relevant in applying Treas. Reg. § 1.1402(a)-4(c)(2) because such services are not furnished primarily for the convenience of the property's occupants. See Hopper, 94 T.C. at 547. Further, services provided for the convenience of occupants must be substantial, and whether provided services are substantial depends on the facts and circumstances of each case. See id. at 548. Specifically, the services provided for the convenience of the occupants must be of such a substantial nature that compensation for them can be said to constitute a material part of the payments made by the occupants. See id. at 546 (citing Delno, 347 F.2d at 166). No such services are provided in Fact Situation 2. The characterization of this activity as not a passive activity within the meaning of § 469(c) does not affect whether the activity is excluded from NESE under § 1402(a)(1).

Please call Mikhail Zhidkov of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes) at (202) 317-4774 (not a toll-free call) if you have further questions relating to section 1402. If your question relates to section 469, please call Marla M. Borkson of the Office of Associate Chief Counsel (Passthroughs & Special Industries) at (202) 317-6850 (not a toll-free call).

[6] Rev. Rul. 57-108 suggests that, in the case of vacation property, the services for the convenience of the occupants must be substantial, such as maid services, swimming and fishing instructions, and furnishing local transportation schedules. Here, similar services are provided for the convenience of the occupants. Thus, the exclusion under § 1402(a)(1) does not apply, and the net rental income is included in NESE.

[7] If the activity were a rental activity under Treas. Reg. § 1.469-1T(e)(3) and, therefore, a passive activity under § 469(c), a loss generated by this activity would still be limited for purposes of computing NESE under § 1.469-1T(d)(3).