

1972

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Repository Citation

Lee, John W., "Active Conduct" Distinguished from "Conduct" of a Rental Real Estate Business" (1972). *Faculty Publications*. 610.
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“ACTIVE CONDUCT” DISTINGUISHED FROM “CONDUCT” OF A RENTAL REAL ESTATE BUSINESS

*John W. Lee **

The term “trade or business” is used frequently in the Internal Revenue Code.¹ The Code also uses, though less frequently, the term “active conduct of a trade or business” and closely related terms.² Analysis of the difference between “active” conduct of a trade or business and conduct of a trade or business has occurred primarily under the active business requirement of section 355.³ Serious questions are presented as to the distinction between the two terms, and this distinction may be most significant in the area of rental real estate. In order to develop the distinction, we first discuss relevant authority as to the term “conduct of a trade or business” and we follow that discussion with similar authority as to the term “active conduct of a trade or business.”

Relevant Authority Concerning the Term “Conduct of a Trade or Business”

The various provisions using the term “trade or business” and cases interpreting them frequently employ a variety of verbs to express the concept of being in a trade or business: to engage in a trade or business,⁴ to operate a trade or business,⁵ to carry on a trade or business,⁶ or to conduct a trade or business.⁷ Because courts interpreting the basic trade or business phrase under any one of the sections using it frequently rely upon decisions under another of those sections,⁸ commentators

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¹ Variations of the term “trade or business,” including “active conduct of a trade or business,” are used in at least sixty different sections of the Internal Revenue Code of 1954. Saunders, *“Trade or Business”, Its Meaning Under the Internal Revenue Code*, SO. CAL. 12TH INST. ON FED. TAX. 693 (1960) (hereinafter cited as Saunders); A. SPADA & R. RUGE, PARTNERSHIPS-STATUTORY OUTLINE AND DEFINITION A-15 (Tax Management Portfolio #161, 1969) (hereinafter cited as SPADA & RUGE). The most familiar examples of the phrase trade or business are I.R.C. §§ 162, 165, 167, 172, 382, 446, 471, 482, 871(a)(1), 1221(2), 1231 and 1402.

² See, e.g., I.R.C. §§ 274(a), 346(b), 355(b), 864(c)(4)(B)(i), 921(2), 931(a)(2), 954(c), and 1372(e)(5)(B)(i).

³ See, e.g., *E. Ward King*, 55 T.C. 677, 696, 700 (1971); Saunders, *supra* note 1, at 742-51.

⁴ E.g., I.R.C. § 446(d). The phrase trade or business is ordinarily used with the verb to engage. Saunders, *supra* note 1, at 723.

⁵ E.g., § 122(d)(5) of the 1939 Code (similar to I.R.C. § 172(d)(4)).

⁶ E.g., I.R.C. § 162(a).

⁷ E.g., I.R.C. § 871(a)(1).

have concluded that the term has a common connotation.⁹ Indeed, one court has stated that where these sections have a similar purpose, the phrase should be given a consistent interpretation.¹⁰ Similarly, cases considering the phrase in conjunction with one verb form cite interchangeably cases in which the phrase is used with another verb form.¹¹ It is only when the adjective "active" or the adverb "actively," as the case may be, is added that a significantly different meaning may arise. Yet even on this point there is a split of authorities.¹²

The connotation of "trade or business" in the tax law invokes continuity, constant repetition and regularity of activities;¹³ however, investment activities alone, regardless of quantity or frequency, do not constitute a trade or business.¹⁴ In the specific context of rental real estate, a conflict developed early as to the extent of activity which was required in order for rental and management of residential property to achieve the status of a trade or business. One view, held principally by the Tax Court, was that the mere rental of a single piece of residential property constituted a trade or business.¹⁵ The other view, acknowl-

⁸ E.g., *Higgins v. Comm'r*, 312 U.S. 212 (1941); *Alvary v. United States*, 302 F.2d 790 (2d Cir. 1962); *Rosalie W. Post*, 26 T.C. 1055, 1060 (1956); *Anders I. Lagreide*, 23 T.C. 508, 512 (1954). But see *Workmen's Mutual Fire Ins. Soc'y, Inc. v. A'Hearn*, 286 F.2d 718, 721 (2d Cir. 1961) (distinguished case decided under predecessor to I.R.C. § 871(a) on grounds that it arose under a different statute than predecessor to I.R.C. § 1221).

⁹ Comment, *The Single Rental as a "Trade or Business" under the Internal Revenue Code*, 23 U. CHI. L. REV. 111, 113 (1955) (I.R.C. §§ 1221, 1231, 165 and 162) (hereinafter cited as Comment); Saunders, *supra* note 1, at 700-01 (I.R.C. §§ 1221, 1231, 172 and 167). But see 4A MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.08 (1966) (term may have different connotations when used in I.R.C. §§ 162, 165(c), or 1221) (hereinafter cited as MERTENS).

¹⁰ *Folker v. Johnson*, 230 F.2d 906, 908 (2d Cir. 1956); cf. *Warren R. Miller, Sr.*, 51 T.C. 755, 761 (1968) (the incorporation of one statute into another by cross-reference calls for practical and sensible interpretation in fitting the provisions of the adopted statute into the scheme of the adopting one).

¹¹ E.g., *Alvary v. United States*, 302 F.2d 790 (2d Cir. 1962); *Adolph Schwarcz*, 24 T.C. 733, 739 (1955); *Anders I. Lagreide*, 23 T.C. 508, 511 (1954).

¹² Compare *E. Ward King*, 55 T.C. 677, 696, 700 (1971) and *Isabel A. Elliot*, 32 T.C. 283 (1959) with *Parshelsky's Estate v. Comm'r*, 303 F.2d 14 (2d Cir. 1962) and *George Rothenberg*, 48 T.C. 369 (1967). See generally Saunders, *supra* note 1, at 742-51; SPADA & RUGE, *supra* note 1, at A-13.

¹³ See *Alvary v. United States*, 302 F.2d 790 (2d Cir. 1962); *McDowell v. Ribicoff*, 292 F.2d 174 (3d Cir. 1961).

¹⁴ *Whipple v. Comm'r*, 373 U.S. 193 (1963); *Higgins v. Comm'r*, 312 U.S. 212 (1941); *Comm'r v. Smith*, 203 F.2d 310 (2d Cir. 1953), *cert. denied*, 346 U.S. 816 (1953).

¹⁵ E.g., *Rosalie W. Post*, 26 T.C. 1055, 1060 (1956); *Adolph Schwarcz*, 24 T.C. 733, 739 (1955); *Anders I. Lagreide*, 23 T.C. 508, 511 (1954); *Leland Hazard*, 7 T.C. 372, 375-76 (1946); *John D. Fackler*, 45 B.T.A. 708, 713-15 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1943). The Tax Court has acknowledged that the determination that real estate devoted to rental purposes constituted use of property in trade or business regardless of whether it was the only property so used was made in these cases "without too much inquiry into the activity of the taxpayer in renting and managing the property." *Isabel A. Elliot*, 32 T.C. 283, 289 (1959). The Seventh

edged by most other courts, called for regular and continuous management or rental activities.¹⁶

The Tax Court's position appears to have been adopted as an equitable response to the fact that prior to 1942 depreciation and maintenance expenses were deductible only from property used in a trade or business. The Tax Court, and the Internal Revenue Service to a large degree, resolved this problem by adopting the theory that all rental property was used in a trade or business.¹⁷ After the Code was amended in 1942 to allow expenses and depreciation for property held for production of income, the Government implicitly acknowledged that its previous administrative position stretched the definition of trade or business by stating that "property held for the production of income, but not used in a trade or business, is not excluded from the term 'capital assets' even though depreciation may have been allowed with respect to such property under . . . the Internal Revenue Code of 1939 before its amendment by . . . the Revenue Act of 1942" ¹⁸

The Tax Court, however, declared in *Leland Hazard*¹⁹ that the Revenue Act of 1942 did not change the earlier rule, established in *John D. Fackler*,²⁰ that "where the owner of depreciable property devotes it to rental purposes and exclusively to the production of taxable income, the property is used by him in a trade or business. . . ." In the Tax Court's view, the Government's regulation was by its own terms inapplicable to rental property since the property was used in the taxpayer's trade or business. The court was, of course, ignoring the possibility that its earlier decisions, although equitable, were conceptually deficient, and that the equities no longer demanded that the deficiency be perpetuated.²¹ It may be noted in passing that a leading commentator observes that where the equities cut the other way, some courts may have been influenced to hold that the rental of real estate is not a trade or business.²² Indeed, one circuit court implicitly acknowledged this fact.²³

Whether the Tax Court still adheres to its *Hazard* position is not

Circuit also has adopted the Tax Court's view. See *Reiner v. United States*, 222 F.2d 770 (7th Cir. 1955). See generally Comment, *supra* note 9.

¹⁶ *Fackler v. Comm'r*, 133 F.2d 509 (6th Cir. 1943); *Bauer v. United States*, 168 F. Supp. 539 (Ct. Cl. 1958); *Grier v. United States*, 120 F. Supp. 395 (D. Conn. 1954), *aff'd mem.*, 218 F.2d 603 (2d Cir. 1955). See generally Comment, *supra* note 9.

¹⁷ Comment, *supra* note 9, at 114; B. BITTKER, FEDERAL INCOME ESTATE AND GIFT TAXATION 551 (3d ed. 1964); S. SURREY & W. WARREN, FEDERAL INCOME TAXATION 712 (1960 ed.) (hereinafter cited as SURREY & WARREN).

¹⁸ Treas. Reg. § 1.1221-1(b), substantially the same as Treas. Reg. 111 § 29.117-1 (1943); unchanged in Treas. Reg. 118 § 39.117 (a)(1)(b) (1953). See SURREY & WARREN, *supra* note 17.

¹⁹ 7 T.C. 372 (1946).

²⁰ 45 B.T.A. 708, 714 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1943).

²¹ See Comment *supra* note 9, at 116-17.

²² 3B MERTENS, *supra* note 9, at § 22.144.

²³ See *Reiner v. United States*, 222 F.2d 770, 773 (7th Cir. 1955).

altogether certain. Where the "trade or business" determination controls issues other than capital gains, trade or business losses and depreciation, it has followed the mainstream of authority by determining trade or business according to whether rental and management activities are considerable, continuous and regular,²⁴ giving only the slightest indication that the phrase trade or business has a possibly wider meaning in other Code provisions.²⁵ In addition, in several cases decided under section 1034, relating to sale or exchange of residence, it has held that the mere fact that the taxpayer rented his residence and claimed depreciation and expenses did not convert it into property held for the production of income,²⁶ even though the term "principal residence" is used in the statute in contradistinction to the concept of property used in a trade or business or held for production of income.²⁷ Moreover, in a very recent capital asset case, the Tax Court based its conclusion that rental properties were used in a trade or business, *i.e.*, that rental activities constituted a trade or business, on the presence of continual substantial rentals and on the fact that the taxpayer deducted expenses.²⁸

Even if the Tax Court has not yet adopted a degree-of-activity test for applying the trade-or-business requirements of sections 165, 172, 1221(2) and 1231 in real estate rental situations, any difference in result between its approach under these sections and that of the majority of other tribunals is probably minimal: the latter do not appear to require extensive activities to support the status of a trade or business, and they tend to view the ownership of more than one parcel of rental real estate as a trade or business.²⁹ However, there might be a variance where a net lease is involved. Since a lessor under such a lease is not obligated to maintain and operate the property, he would not meet the requirement

²⁴ See *Inez de Amodio*, 34 T.C. 894, 905 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962); (United States-Swiss Confederation tax convention); *Elizabeth Herbert*, 30 T.C. 26 (1958) (United States-United Kingdom tax convention); *Jan Casimir Lewenhaupt*, 20 T.C. 151 (1953), *aff'd*, 221 F.2d 227 (9th Cir. 1955) (I.R.C. § 871(a)); *cf.* *George Rothenberg*, 48 T.C. 369, 373 (1967) (Treas. Reg. § 1.761-1(a)(1)).

²⁵ *Elizabeth Herbert*, 30 T.C. 26, 34 (1958) (conclusion that taxpayer not engaged in trade or business relates only to interpretation of tax convention and not to possibly wider meaning in some Code provisions). However, it has been pointed out that despite the apparent limited scope of *Herbert*, the same principles should apply with respect to I.R.C. § 871(a) since the test of engaging in a trade or business under the convention was the same as the one contained in that provision. Garelik, *What Constitutes Doing Business within the United States by a Non-resident Alien Individual or a Foreign Corporation*, 18 TAX L. REV. 423, 443 (1963). See also Saunders, *supra* note 1, at 741 (same test should apply here as in other trade or business provisions).

²⁶ *Arthur R. Barry*, 30 TCM 757, ¶ 71,179 P-H Memo TC (1971); see *William C. Stolk*, 40 T.C. 345, 354 (1963), *aff'd per curiam*, 326 F.2d 760 (2d Cir. 1964).

²⁷ H.R. REP. No. 586, 82d Cong., 1st Sess. (1951), reprinted in 1951-2 C.B. 357, 436; *Robert W. Aagaard*, 56 T.C. 191, 202-03 (1971).

²⁸ *Stephen P. Wasnok*, 30 TCM 39, ¶ 71,006 P-H Memo TC (1971). Unlike the *Wasnok* court, the court in *Barry* did not find that claiming deductions for depreciation and expenses on the taxpayer's income tax returns was determinative.

²⁹ SPADA & RUGE, *supra* note 1, at A-12; Saunders, *supra* note 1, at 708-09.

of regular and continuous management activities.³⁰ While the Tax Court would, in the context of other Code provisions, probably hold that a lessor under a net lease was not engaged in a trade or business,³¹ the issue does not appear to have come before it in the areas of capital assets, trade or business losses or depreciation.

There may also be a question as to the sufficiency of management or rental activities if they are performed by an agent or independent contractor or if the taxpayer is merely a limited partner in a rental real estate business. The cases considering the use of management or rental agents have held that the taxpayer is engaged in a trade or business if the activities performed by the agent would, if conducted by the taxpayer, constitute a trade or business.³² It has been suggested that the basis for this rule is that an agent's management activities are imputed to his principal.³³ While under agency principles the acts of an independent contractor (such as a real estate management company) are not in all instances imputed to his principal,³⁴ an independent contractor may be an agent.³⁵ Furthermore, the cases draw no apparent distinction between an independent contractor and an employee, as illustrated by the numerous cases where European war refugees appointed resident nationals to manage and rent their properties,³⁶ losing any opportunity to exercise control over the "agent"—one of the hallmarks of a master-servant relationship.³⁷

On the other hand, some courts in applying section 1221(1) have distinguished between subdividing and selling activities performed by an agent on the one hand, and by an independent contractor on the other, refusing to impute to the taxpayer the activities of the latter.³⁸ Other cases apparently recognize that the activities of an independent contractor can be imputed to his principal, but see the issue in terms of selecting those activities which are properly attributable to him.³⁹ The

³⁰ *Union Nat'l Bank v. United States*, 195 F. Supp. 382 (N.D.N.Y. 1961).

³¹ See *Elizabeth Herbert*, 30 T.C. 26, 33 (1958) (tenant responsible for all repairs except structural; landlord responsible for interest and amortization, taxes, and insurance premiums).

³² *Reiner v. United States*, 222 F.2d 770 (7th Cir. 1955); *Gilford v. Comm'r*, 201 F.2d 735 (2d Cir. 1953); *Bauer v. United States*, 168 F. Supp. 539 (Ct. Cl. 1958) (dictum); *Adolph Schwarcz*, 24 T.C. 733, 739 (1955).

³³ *Saunders*, *supra* note 1, at 706, 741; see *Inez de Amodio*, 34 T.C. 894, 906 (1960), *aff'd*, 299 F.2d 623 (3d Cir. 1962).

³⁴ RESTATEMENT (SECOND) OF AGENCY § 250 (1957).

³⁵ RESTATEMENT (SECOND) OF AGENCY § 2(3) (1957).

³⁶ E.g., *Reiner v. United States*, 222 F.2d 770 (7th Cir. 1955); *Adolph Schwarcz*, 24 T.C. 733 (1955).

³⁷ RESTATEMENT (SECOND) OF AGENCY § 220 (1957).

³⁸ E.g., *Smith v. Dunn*, 224 F.2d 353 (5th Cir. 1955). See generally Libin, "Transactions Entered Into for Profit," "Regular Trade or Business," and/or "Investment": Some Distinctions and Differences, N.Y.U. 27TH INST. ON FED. TAX. 1209, 1216 (1969).

³⁹ E.g., *Voss v. United States*, 329 F.2d 164 (7th Cir. 1964).

Court of Claims, however, believes that these real estate decisions under section 1221(1) are *sui generis* for the reason that they have involved "liquidation" situations, *i.e.*, the taxpayer owns a parcel of raw land which he would prefer to dispose of in bulk but, finding that subdivision and sale are the only practical means of disposition, gives a real estate agent or developer broad authority to conduct that activity.⁴⁰ The Court of Claims has contrasted the failure to attribute the activities of the independent broker in these cases with the well recognized general principle that where a taxpayer engages in business through an agent, implicitly including an independent contractor, the sales activities of the agent for his benefit will be imputed to him. The real estate liquidation cases would perhaps be better justified under the rationale that where an owner of a tract gives a developer full, unfettered authority to subdivide and sell it, the substance of the transaction is a bulk sale by the owner to the developer,⁴¹ so that the developer's subsequent activities are not relevant in determining whether the owner held the property primarily for sale to customers in the ordinary course of a real estate business.⁴²

Courts have held that a partner is individually engaged in the trade or business of the partnership,⁴³ and no distinction is drawn between a general and a limited partnership in this regard.⁴⁴ Under some Code provisions, including those dealing with capital gains and involuntary conversions of property used in trade or business, the same result would obtain under a theory that the status of income or loss as related to a trade or business should be resolved at the partnership level, with the item retaining the same character at the partner level,⁴⁵ even though he is not engaged in the same trade or business. Indeed, the question whether realty owned by a partnership is primarily held for sale to customers in the ordinary course of business for the purposes of section 1221(1) is clearly determined at the partnership level.⁴⁶ However, a significant difference between the two approaches would arise in deter-

⁴⁰ *Nadalin v. United States*, 364 F.2d 431 (Ct. Cl. 1966).

⁴¹ *Estate of William D. Mundy*, 36 T.C. 703, 712 (1961).

⁴² CCH TAX ANALYSIS SERIES, SELLING A CORPORATE ASSET—TAX SOLUTIONS 113 (1969).

⁴³ *Harding v. United States*, 133 F. Supp. 461 (Ct. Cl. 1953); *Darwin O. Nichols*, 29 T.C. 1140, 1145 (1958); *Dwight A. Ward*, 20 T.C. 332, 343 (1953), *aff'd*, 224 F.2d 547 (9th Cir. 1955). *But see* Treas. Reg. § 1.471-5 (member of partnership which is a dealer in securities who buys and sells securities in his individual capacity is not a dealer in securities).

⁴⁴ *George A. Butler*, 36 T.C. 1097, 1106 (1961).

⁴⁵ *See* I.R.C. §§ 702(a)(2) and (3), 702(b); Treas. Reg. § 1.702-1(b). *See generally* Wolfman, *Level for Determining Character of Partnership Income—"Entity" v. "Conduit" Principle in Partnership Taxation*, N.Y.U. 19TH INST. ON FED. TAX. 287, 290-92 (1961).

⁴⁶ *E.g.*, *Barham v. United States*, 301 F. Supp. 43 (M.D. Ga. 1969), *aff'd mem.*, 429 F.2d 40 (5th Cir. 1970); *Hyman Podell*, 55 T.C. 429, 432-33 (1970); *Clyde W. Grove*, 54 T.C. 799, 804 (1970).

mining whether a partner is entitled to business bad debt treatment for loans made to the partnership.⁴⁷ It is in this context that the Tax Court has held that the business of the partnership is imputed to the partners,⁴⁸ thereby entitling them to business deductions for losses sustained with respect to their financing of that business.

It has been suggested that the Supreme Court's decision in *Higgins v. Commissioner*⁴⁹ is not consistent with the management activities test applied by most courts to determine the status of real estate rental activities as a trade or business.⁵⁰ *Higgins* held that continuous and extensive management of investments in securities (keeping records and collecting interest and dividends) did not constitute a trade or business. The Court, however, clarified the situation in *Whipple*⁵¹ by holding that such activities produce income distinctive to the process of investing because the income is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer. In a real sense then, *Higgins* is but a corollary of the well established tax principle that a corporation and its shareholders are distinct entities.⁵²

In noncorporate ownership of rental real estate, on the other hand, maintenance and rental activities and providing of services to tenants are either the activities of the taxpayer or, if the property is owned by a partnership, are imputed to him from it. Comparing ownership of securities with ownership of real estate from the point of view of the owner's activities, it may be noted that nothing further need be done in the case of securities in order to realize income, but that further action is required in the case of real estate. The latter will produce no income unless rented, used, or sold; thus, an owner of rental real estate is not a mere passive investor.⁵³ It is significant in this context that in both *Higgins* and *Whipple* the Government conceded that the rental real

⁴⁷ See I.R.C. § 166(d).

⁴⁸ *Nate Kazdin*, 28 TCM 432, ¶ 69,075 P-H Memo TC (1969); see *George A. Builer*, 36 T.C. 1097 (1961) (business loan to business partnership). Character of income to the partner and his trade or business status may well be separate questions, with the latter being determined by analogy to the agent cases and not on the basis of section 702.

⁴⁹ 312 U.S. 212 (1941), noted in 38 MICH. L. REV. 1354 (1940).

⁵⁰ Comment, *supra* note 9, at 114-17.

⁵¹ *Whipple v. Comm'r*, 373 U.S. 193 (1963).

⁵² See *Moline Properties v. Comm'r*, 319 U.S. 436 (1943); *New Colonial Co. v. Helvering*, 292 U.S. 435 (1934); *Burnet v. Clark*, 287 U.S. 410 (1932). The Tax Court in *S.E. Maitland Brenhouse*, 37 T.C. 326, 330 (1956), distinguished in the context of allowance of a business bad debt a partner from a shareholder on the grounds that a partner is taxed directly on the profits of his partnership whereas the business of a corporation is not that of the shareholder.

⁵³ Cf. *Cooper Tire & Rubber Co. Employees' Retirement Fund*, 36 T.C. 96, 101 (1961), *aff'd*, 306 F.2d 20 (6th Cir. 1962) (I.R.C. § 512(a)), leasing of tangible personal property); *Louis C. Meyers*, — TCM —, ¶ 71,268 P-H Memo TC (1971) (unlike real estate dealer an investor in securities does not actively engage in sales activities and generally he derives his gain from market conditions over which he has little control).

estate activities of the taxpayers constituted a trade or business. Indeed, in the former case the Court cited *Pinchot*⁵⁴ as support for the Government's concession that management of real estate for profit, requiring regular and continuous activity, constitutes a trade or business. Section 1402, in defining the term trade or business, expressly incorporates the term as used in section 162,⁵⁵ but also expressly excludes real estate rentals from trade or business income,⁵⁶ apparently on the theory that taxpayers usually hold such real estate for investment or speculation while receiving rentals therefrom.⁵⁷ Thus, this provision and the regulations implementing it implicitly assume that but for the statutory exclusion one could hold rental real estate for an investment and yet still be carrying on the business of renting the property.⁵⁸

In summary, it would appear on the basis of the case law applying the "trade or business" provisions, as contrasted with the "active trade or business" provisions discussed below, that rental income is income derived from conduct of a trade or business and, hence, is not investment income where continuous and regular management or rental activities are performed personally or through an agent (including presumably an independent real estate management company). In the Tax Court, it may not even be necessary to establish management or rental activity. The rental of real property under a net lease would not constitute a trade or business in those courts requiring some degree of management activity, and its status in the Tax Court is unclear.

"Active Conduct of a Trade or Business"

The term "active conduct of a trade or business" and closely related terms also appear frequently in the Code, but not to the same degree as the term "trade or business." The most extensive regulations construing

⁵⁴ *Pinchot v. Comm'r*, 133 F.2d 718 (2d Cir. 1940) (predecessor to I.R.C. § 871(a)) (continuous, regular management activities, including alterations and repairs, involved more than investment and reinvestment in real estate; it was the management of the real estate itself for profit). The Second Circuit also pointed out in *Pinchot* that its decision in *Higgins* did not touch the question of real estate management as a business.

⁵⁵ I.R.C. § 1402(c).

⁵⁶ I.R.C. § 1402(a)(1).

⁵⁷ I.R.C. § 1402(a)(1) contains an exception to the exception for rentals received in the course of a trade or business as a real estate dealer; the regulations provide that "an individual who merely holds real estate for investment or speculation and receives rentals therefrom is not considered a real-estate dealer. . . ." Treas. Reg. § 1.1402(a)-4(a).

⁵⁸ Thus, the Second Circuit's cryptic hint that holding rental real estate as an investment does not constitute a trade or business although the owner employs agents to manage, collect rent from, and supervise maintenance of several parcels of rent producing property appears in error. See *Mercado v. United States*, 64-1 USTC ¶ 9209 (2d Cir. 1964) (order for supplemental briefs; taking under advisement overruling of *Gilford*, as inconsistent with *Grier*). But see *Union Nat'l Bank v. United States*, 195 F. Supp. 382 (N.D.N.Y. 1961) (no apparent inconsistency; both decisions applied a test of continuous, regular and substantial activity in management).

the former term are promulgated under section 355⁵⁹ and most of the litigation delineating the concept has arisen under this provision. Three major issues arise in application of the active business requirement to rental real estate: (1) whether there is a distinction between active conduct of a trade or business and mere conduct of a trade or business; (2) whether rental of real estate to a related party or ownership of real estate occupied by the owner in the operation of his trade or business constitutes the active conduct of a trade or business; and (3) whether the active business requirement is met where all the major real estate activities, *e.g.*, leasing, maintenance and operation, are performed by a real estate agent or an independent contractor, commonly a real estate management company.

In *E. Ward King*,⁶⁰ the Tax Court recently declared that cases decided under Code provisions not containing the qualification "active" are not authority upon the question of what constitutes the active conduct of a trade or business. In prior section 355 decisions, the court had distinguished such cases as *Fackler*⁶¹ and *Hazard*⁶² on their facts, or had simply dismissed them as inappropriate in construing that section.⁶³ The other extreme was manifested by the Second Circuit in *Parshelsky's Estate v. Commissioner*,⁶⁴ where it indicated that, absent the limitations of the regulations under section 355, the traditional trade or business cases would be authority upon the question of what constitutes the active conduct of a trade or business.⁶⁵ The regulations under section 355 provide in pertinent part as follows:

[F]or purposes of section 355, a trade or business consists of a specific existing group of activities being carried on for the purpose of earning income or profit from only such group of activities, and the activities included in such group must include every operation which forms a part of, or a step in, the process of earning income or profit from such group. Such group of activities ordinarily must include the collection of income and the payment of expenses. It does not include—

- (1) The holding for investment purposes of stock, securities, land

⁵⁹ Treas. Reg. § 1.355-1(c).

⁶⁰ 55 T.C. 677, 700 (1971).

⁶¹ *John D. Fackler*, 45 B.T.A. 708 (1941), *aff'd*, 133 F.2d 509 (6th Cir. 1943).

⁶² *Leland Hazard*, 7 T.C. 372 (1946).

⁶³ *Isabel A. Elliot*, 32 T.C. 283, 289 (1959) (in such cases the property was only used for rental to others); *Theodore F. Appleby*, 35 T.C. 755, 764 (1961), *aff'd mem.*, 296 F.2d 925 (3d Cir. 1962), *cert. denied*, 370 U.S. 910 (1962) (references to such cases inappropriate).

⁶⁴ 303 F.2d 14 (1962).

⁶⁵ § 112(b)(11) of the 1939 Code (in a spin-off no gain is to be recognized unless the spin-off corporation "was not intended to continue the active conduct of a trade or business after such reorganization . . ."). See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 13.02 (3d ed. 1971) (hereinafter cited as BITTKER & EUSTICE).

or other property, including casual sales thereof (whether or not the proceeds of such sale are reinvested),

(2) The ownership and operation of land or buildings all or substantially all of which are used and occupied by the owner in the operation of a trade or business, or

(3) A group of activities which, while a part of a business operated for a profit, are not themselves independently producing income even though such activities would produce income with the addition of other activities or with large increases in activities previously incidental or insubstantial.⁶⁶

The *Parshelsky* court held that the leasing of property to a related corporation would constitute an active trade or business, absent the limitations of this regulation.

In *George Rothenberg*,⁶⁷ the Tax Court itself relied upon the usual (*i.e.*, not "active") trade or business cases in construing a provision of the partnership regulations which states that co-owners who rent property may be partners "if they actively carry on a trade, business" or financial operation and divide the profit.⁶⁸ It drew a distinction between the active conduct of a rental business and the mere holding of property for investment and it supported this distinction by reference to cases requiring regular and continuous management and rental activities for trade or business status.⁶⁹ The proposed regulations dealing with excess investment interest also indicate that whether property is actively used in the conduct of a trade or business is to be determined by the usual trade or business test of section 162; thus, real property held in the conduct of renting real property is property actively used in the conduct of a trade or business.⁷⁰

In *King* the Tax Court stated that the *raison d'être* of the section 355 active business requirement was "to prevent the tax free segregation of passive investment-type assets into an inactive corporate entity,"⁷¹ but it failed to refer to those Tax Court decisions which hold that the mere renting of a single piece of residential property is a trade or business. It seemingly could have held that mere rental was a trade or business and that rental coupled with regular and continual management activities was an "active" trade or business, thereby preserving both the viability of the word "active" in section 355 and its own prior decisions. However, it is clear that the regulations, under section 355, go beyond

⁶⁶ Treas. Reg. § 1.355-1(c).

⁶⁷ 48 T.C. 369, 373 (1967).

⁶⁸ Treas. Reg. § 1.761-1(a)(1).

⁶⁹ *Fackler v. Comm'r*, 133 F.2d 509 (6th Cir. 1943); *Pinchot v. Comm'r*, 113 F.2d 718 (2d Cir. 1940).

⁷⁰ Proposed Treas. Reg. § 1.57-2(b)(2)(i), 36 Fed. Reg. 12023 (1971).

⁷¹ 55 T.C. 696 (1971).

this, and that the section 355 regulations have received judicial approval in several cases.⁷²

Thus, the *Parshelsky* approach may prove to be correct. The term "active" used with "trade or business" might in rental situations (aside from those in which section 355 or its regulations are expressly made applicable) require only continuous regular management or rental activities.⁷³ Support for the position that the section 355 concept of an active business applies only to those provisions which incorporate it by reference is found in the regulations under section 346 which state that the term "active conduct of a trade or business" as used in that section is to have the same meaning as in section 1.355-1(c) of the regulations.⁷⁴

On the other hand, subchapter S and the regulations thereunder⁷⁵ indicate that management and rental activities alone do not constitute the active conduct of a real estate business. It was the intention of Congress to limit subchapter S treatment to small businesses "actively engaged in trades or business," and it accordingly denied this treatment to corporations with large amounts of passive income, including rents.⁷⁶ By "active business" Congress meant to distinguish operating companies from mere incorporated investment activities.⁷⁷ In order to assure that those corporations which were actively engaged in a trade or business could obtain subchapter S treatment, Treasury defined "rents" so as to exclude payments for use or occupancy of property where "significant services are also rendered" to the user or occupant.⁷⁸ Maid services are an example of such services, but furnishing of utilities, cleaning of public area, collection of trash, etc., are not. Thus, payments for use or occupancy of private residences, apartments, offices, etc., generally constitute rental income,⁷⁹ *i.e.*, they are not considered active business income. In short, merely performing the normal activities of a landlord is not actively engaging in a trade or business for subchapter S purposes.⁸⁰ Essentially the same approach is taken in the regulations under section 1402, which for the purposes of the tax on self-employment income excludes real estate rentals from trade or business income. That

⁷² *Andrew Spheeris*, 54 T.C. 1353, 1362 (1970); *Patricia W. Burke*, 42 T.C. 1021, 1028 (1964).

⁷³ See SPADA & RUGE, *supra* note 1, at A-13; B. BITTKER & L. EBB, UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS 365 (2d ed. 1968) (hereinafter cited as BITTKER & EBB).

⁷⁴ Treas. Reg. § 1.346-1(c).

⁷⁵ I.R.C. § 1372(e)(5)(C); Treas. Reg. § 1.1372-4(b)(5)(vi). See generally Pennell, *Subchapter S—The Need for Legislation*, 24 THE TAX LAWYER 249, 271-73 (1971) (hereinafter cited as Pennell).

⁷⁶ S. REP. NO. 1007, 89th Cong., 2d Sess. 8 (1966), reprinted in 1966-1 C.B. 532; see *City Markets v. Comm'r*, 433 F.2d 1240, 1242 (6th Cir. 1970).

⁷⁷ H.R. REP. NO. 91-1737, 91st Cong., 2d Sess. (1970), reprinted in CCH 1971 STAND. FED. TAX REP. ¶ 4846J 20; Pennell, *supra* note 75, at 271.

⁷⁸ SPADA & RUGE, *supra* note 1, at A-13 - A-14.

⁷⁹ Treas. Reg. § 1.1372-4(b)(5)(vi).

⁸⁰ *City Markets v. Comm'r*, 433 F.2d 1240, 1242 (6th Cir. 1970).

section distinguishes rentals for living quarters where no services are rendered to the occupant from payments for use or occupancy where services are also rendered to the occupant—the latter being deemed not to constitute rentals from real estate.⁸¹ As in the subchapter S provisions, the apparent basis for special treatment of rental income is that without more it constitutes passive income, albeit derived from the conduct of a trade or business.⁸²

Under section 355, the ownership and operation of land or buildings all or substantially all of which are used by the owner himself in the operation of one trade or business is not itself another active trade or business.⁸³ However, operation of owner-occupied real estate does constitute conduct of a trade or business.⁸⁴

Where real estate is leased to a related party, the regulations under section 355 do not expressly deny active business status. However, commentators⁸⁵ and at least one court⁸⁶ are of the opinion that an otherwise passive operation, *e.g.*, operation of owner-occupied real estate, cannot be converted into an active business merely by channeling such activity through a separate, related leasing entity. Furthermore, one of the primary theories underlying the active business regulations of section 355—the requirement for independent production of income⁸⁷—is not achieved unless the property is leased to an unrelated party.⁸⁸

The question whether active conduct of a trade or business is present where the major rental activities, *e.g.*, leasing, repairing, and maintenance, are carried out through an agent or an independent contractor has arisen under many of the "active business" provisions of the Code. For example, the regulations under section 761, defining a partnership, provide as follows:

Tenants in common, however, may be partners if they actively carry on a trade, business . . . and divide the profits thereof. For example,

⁸¹ Treas. Reg. § 1.1402(a)-4(c)(2); See BITTKER & EUSTICE, *supra* note 65, at 8-42 n. 86.

⁸² See notes 57 and 58, *supra*, and accompanying text.

⁸³ Treas. Reg. § 1.355(c); accord, *Isabel A. Elliot*, 32 T.C. 283 (1959); Rev. Rul. 56-266, 1956-1 C.B. 184. See generally Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194, 1217 (1968) (hereinafter cited as Whitman).

⁸⁴ Saunders, *supra* note 1, at 746.

⁸⁵ Whitman, *supra* note 83, at 1219; Jacobs, *The Anatomy of a Spin-Off*, 1967 DUKE L. J. 1, 16 (hereinafter cited as Jacobs); Masee, *Section 355; Disposal of Unwanted Assets in Connection with a Reorganization*, 22 TAX L. REV. 439, 469 (1969) (hereinafter cited as Masee).

⁸⁶ *E. Ward King*, 55 T.C. 677, 700 n.9 (1971).

⁸⁷ Masee, *supra* note 85, at 459.

⁸⁸ *Henry Bonsall*, 21 TCM 820, ¶ 62,151 P-H Memo TC (1962), *aff'd*, 317 F.2d 61 (2d Cir. 1963); See also COHEN, CORPORATE SEPARATIONS—ACTIVE BUSINESS REQUIREMENT A-21 (Tax Management Portfolio # 224, 1969) (*Bonsal, Elliot and Appleby* each focus only on rental to outsiders implying a requirement of providing services to outsiders before a function can be considered an active business) (hereinafter cited as COHEN).

a partnership exists if coowners of an apartment building lease space and in addition provide services to the occupants either directly or through an agent.⁸⁹

Thus, co-owners of an apartment building actively carry on a trade or business even if they do not provide tenant services directly. However, the opposite conclusion may be drawn from other provisions. For example, in interpreting section 954(c)(3)(A), which excludes rents derived in the active conduct of a trade or business from foreign personal holding company income,⁹⁰ the regulations specifically deny that rents from real estate managed and operated by a real estate management firm are from an active business.⁹¹ The same regulations provide specific safe havens in which rents are considered to be derived from the active conduct of a trade or business, but they specifically deny such havens to otherwise qualified rental activities which are carried out through an independent contractor.⁹²

Similar rules are encountered in the statute dealing with taxation of a real estate investment trust (REIT).⁹³ The REIT provisions were carefully drawn so as to extend conduit tax treatment only to income from passive investments, as contrasted with income derived from the active operation of a real estate business.⁹⁴ Consequently, a REIT cannot flow through to its stockholders rent from real property if it furnishes or renders services to the tenants of such property, or manages or operates such property.⁹⁵ An exception is provided for such services if rendered by an independent contractor from whom the REIT itself does not derive or receive any income. As one commentator has pointed out:

The objective was fixed: only trusts limited to the receipt of predominantly *passive* income from the ownership of real estate should be favored. The taxation of revenues from the "active conduct of a trade or business" should remain the same—a tax upon the receipt at the corporate or "trust" level and again upon distribution to the shareholders. Consequently, the draftsmen of the REIT federal tax provisions labored to assure that no entity receiving substantial amounts of "active" income would qualify for the special tax treatment. . . . Ownership of real estate today is hopelessly encumbered

⁸⁹ Treas. Reg. § 1.761-1(a)(1).

⁹⁰ Such income is a component of foreign base company income (I.R.C. § 954(a)(1)), which in turn constitutes a component of subpart F income (I.R.C. § 952(a)(2)), of which a United States shareholder (I.R.C. § 951(b)) of a controlled foreign corporation (I.R.C. § 957(a)) must include his pro rata share (I.R.C. § 951(a)(2)) in his gross income. I.R.C. § 951(a).

⁹¹ Treas. Reg. § 1.954-2(d)(1)(ii)(c) *example* (4).

⁹² Treas. Reg. § 1.954-2(d)(1)(ii)(b)(3)(i).

⁹³ I.R.C. §§ 856-58.

⁹⁴ Kahn, *Taxation of Real Estate Investment Trusts*, 48 VA. L. REV. 1011, 1013 (1962); see Post & King, *Final REIT Regulations Adopted; The Changes and Effects*, 17 J. TAX. 54, 55 (1962).

⁹⁵ I.R.C. §§ 857 and 856(d)(3).

with management functions, as well as the duty to provide certain incidental services, and these management functions and services result in income, "active" income no less. . . . Recognizing that owners of real estate often use management concerns to handle the day-to-day management functions of supplying utilities and other services to tenants, the draftsmen of the REIT provisions reasoned that an "independent contractor" could be the entity to whom the tainted "active" income would pass (together with most of the risk of loss thereon) in return for "adequate compensation" from the real estate investment trust. . . .⁹⁶

The Tax Court has held in *W. E. Gabriel Fabrication Company*⁹⁷ that the section 355 requirement for the active conduct of a trade or business does not require that the business which is conducted immediately subsequent to the separation have been conducted by either the distributing corporation or the controlled corporation prior to the distribution. The trade or business may have been actively conducted during the five year period by some third party, such as a corporation not related to either the distributing or controlled corporations, or even by a sole proprietorship.⁹⁸ Thus, it may be argued that even the rigorous "active conduct of a trade or business" requirement of section 355 would not preclude the conduct of a real estate rental business through a management company.⁹⁹

Cases interpreting the requirement of section 921(2) for the active conduct of a trade or business indicate a similar result. A recurring issue in these cases is whether sales made by an export subsidiary of a United States manufacturing corporation constitute the active conduct of a trade or business where the subsidiary has no staff of its own, but instead relies upon the parent to supply salesmen and other staff.¹⁰⁰ The courts have uniformly held that the lack of a complete employee organization does not in and of itself preclude qualification.¹⁰¹ The active trade or business requirement has been held satisfied where the subsidiary paid a management fee for services rendered and the subsidiary had at least one employee who kept its books and reviewed all of its paper work.¹⁰² Thus, under this provision, the active business test

⁹⁶ Parker, *REIT Trustees and the "Independent Contractor,"* 48 VA. L. REV. 1048, 1050-51 (1962).

⁹⁷ 42 T.C. 545, 556 (1964).

⁹⁸ 42 T.C. 554-55 (1964).

⁹⁹ See COHEN, *supra* note 88, at A-5 - A-6. But see MARANS, PARTIAL LIQUIDATIONS A-22, A-24 (Tax Management Portfolio # 37-3d, 1971); Jacobs, *supra* note 85, at 15.

¹⁰⁰ See Tillinghast, *The Western Hemisphere Trade Corporation: Comparison with Locally Incorporated Entities: Its Utility; Its Future*, N.Y.U. 28TH INST. ON FED. TAX. 437, 445 (1970); BITTKER & EBB, *supra* note 73, at 364.

¹⁰¹ E.g., *Frank v. International Canadian Corp.*, 308 F.2d 525 (9th Cir. 1962); *A.P. Green Export Co. v. United States*, 284 F.2d 383 (Ct. Cl. 1960).

¹⁰² Note, *Western Hemisphere Trade Corporation: Reconsidered*, 9 WM. & MARY L. REV. 205, 212 (1967).

may be met if the business activities are performed by an agent. The crucial requirement here appears to be that the subsidiary must bear the economic risk of resale of the items exported.¹⁰³ Certainly, in the typical rental real estate arrangement, the economic risks rest with the owner, and not with the real estate management company.

In *H. L. Morgenstern*,¹⁰⁴ the Tax Court recently reached, in a section 346 decision, a result directly contrary to that in *Gabriel Fabrication*, decided under section 355, even though the regulations under section 346 expressly incorporate from the section 355 regulations the definition of active conduct of a trade or business. In *Morgenstern* the court held that "the business which is terminated must be operated directly by the corporation making the distribution."¹⁰⁵ *Morgenstern* is factually distinguishable from *Gabriel*. In the former decision, the business was not conducted on the distributing corporation's behalf by another entity; rather it had in earlier years transferred the active business to a subsidiary and argued that it continued to conduct the business by reason of its majority stock ownership of the subsidiary. Significantly, section 355 expressly provides that a corporation shall be treated as engaged in the active conduct of a trade or business if substantially all of its assets consist of stock in a subsidiary which is so engaged.¹⁰⁶ In any event, the broad holding in *Morgenstern* cuts against an argument that one who conducts business through an independent contractor, is himself actively engaged in business.

The above discussion shows that the requirements for an "active" rental real estate business may, in the context of some, but not all, of the "active" business Code provisions, vary widely from the requirements for a mere trade or business. The uncertainties in this area are primarily caused by the question of degree to which application of various active business provisions is to be determined by reference to case law and regulations under certain "active" business provisions or the section 162 test, if either, and by the conflict as to whether a business may be actively conducted through an agent or independent contractor.

Theoretically, these problems could be resolved by the Congress, the Treasury Department, or the courts. Congress, however, has manifested a reluctance to define the terms trade or business and "active" trade or business and has generally not used cross-references to existing Code sections to establish their scope in new provisions. On the other hand, Treasury regulations interpreting the term "active" business in one

¹⁰³ *United States Gypsum Co. v. United States*, 304 F. Supp. 627 (N.D. Ill. 1969), *rev'd on other grounds*, 71 USTC ¶ 9706 (7th Cir. 1971). *Barber-Greene Americas, Inc.*, 35 T.C. 365, 387-88 (1960).

¹⁰⁴ 56 T.C. 44 (1971).

¹⁰⁵ 56 T.C. 47 (1971).

¹⁰⁶ I.R.C. § 355(b)(2)(A).

instance¹⁰⁷ and the term trade or business in several instances¹⁰⁸ provide that the term in question is to have the same meaning as used in another Code section. For example, the regulations accompanying section 513, which defines an unrelated trade or business of a tax-exempt organization, provide that the phrase "trade or business" has the same meaning as in section 162 "and generally includes any activity carried on for the production of income from the sale of goods or performance of services."¹⁰⁹ These regulations also state that the term is not limited to integrated aggregates of assets, activities, and good will which comprise businesses for the purposes of certain other Code provisions, which appears to be a disclaimer of the section 355 "active" business requirement that the trade or business consist of a specific existing group of activities which include every operation forming a part of, or a step in, the process of earning income from the group.¹¹⁰

Unfortunately, other regulations dealing with trade or business concepts are seldom as well executed as the section 513 regulations. For example, the proposed regulations dealing with excess investment interest have confused the concepts of trade or business and "active" trade or business. Property held for investment, a key element in the excess investment interest provisions,¹¹¹ is not defined in the statute. This term is defined in the proposed regulations as property held for the production or collection of passive income, unless such income is "derived from properties actively used in the conduct of trade or business. . . ." ¹¹² This exception replaced one proposed earlier for income derived from the active conduct of trade or business.¹¹³ The proposed regulations further provide that property is not held for investment (and is thus implicitly actively used in the conduct of trade or business) if expenses in connection with it are deductible under section 162.

The courts in most instances have not directly addressed the questions

¹⁰⁷ Treas. Reg. § 1.346-1(c).

¹⁰⁸ Treas. Reg. §§ 1.513-1(b) and 1.1402(c)-1.

¹⁰⁹ Treas. Reg. § 1.513-1(b). The latter test appears to be taken from *Deputy v. DuPont*, 308 U.S. 488 (1940).

¹¹⁰ Treas. Reg. § 1.355-1(c). The purpose of this definition was not, however, to specifically disclaim the section 355 "active" business requirements as such, but rather was to reject the view that the unrelated business income tax was limited in application to business enterprises as whole units and did not extend to individual components of an enterprise. See Cooper, *Trends in Taxation of Unrelated Business Activity*, N.Y.U. 29TH INST. ON FED. TAX. (PART 2) 1999, 2006-08 (1971).

¹¹¹ I.R.C. §§ 57(a)(1), 57(b), 57(c), and 163(d).

¹¹² Proposed Treas. Reg. § 1.57-2(b)(2)(i), 36 Fed. Reg. 12023 (1971).

¹¹³ Proposed Treas. Reg. § 1.57-2(b)(2), 35 Fed. Reg. 19767 (1970). The earlier version was capable of the construction that the Service would presume that all interest connected with rental real estate was investment interest. McKee, *The Real Estate Tax Shelter: A Computerized Exposure*, 57 VA. L. REV. 521, 560 n. 101 (1971). The later version of the proposed regulations, on the other hand, implies that the excess investment interest provisions do not apply to most rental real estate. Wong, *Practical Real Estate Income Tax Planning*, 49 TAXES 650, 653-54 (1971).

of whether the scope of an "active" business requirement contained in one section can be determined by analogy to other active business Code sections,¹¹⁴ and whether a business can be actively conducted through an agent. If the terms trade or business and "active" trade or business should each possess common connotations in all provisions in which they are used, the case-by-case approach inherent in the judicial process places the courts in a less favorable position than the Treasury Department to effectuate uniformity. On the other hand, if these terms are not to be uniformly interpreted, a case law approach can produce certainty if the courts will consider the phrase before them in the context of the provision in which it appears but with an awareness of the development under other provisions.

CONCLUSION

While under present law the scope and requirements of a rental real estate trade or business appear fairly fixed, this is not true as to an "active" business of renting real estate. Until the fundamental question of whether the phrase "active" business in provisions unaccompanied by extensive regulations should be given the same meaning as "carrying on any trade or business" in section 162 or as the narrower term "active conduct of a trade or business" in section 355,¹¹⁵ uncertainty will continue.

¹¹⁴ A significant exception is *Parshelsky's Estate v. Comm'r*, 303 F.2d 14 (2d Cir. 1962), which indicates the phrase is not to be given the same meaning in other sections as in the section 355 regulations.

¹¹⁵ See BITTKER & EBB, *supra* note 73, at 365; SPADA & RUGE, *supra* note 1, at A-13.