***Dirico v. Commissioner, 139 T. C. 396 (2012)***

In Dirico v. Comm’r, the U. S. Tax Court ruled that income from leasing telecommunication towers and land to an S corporation owned by the lessor was passive activity income, not subject to recharacterization as non-passive income under the self-rental rule. The court found that the S corporation’s use of the leased property was a rental activity, not a trade or business, and thus the income remained passive. The decision clarifies the boundaries between rental and trade or business activities under I. R. C. § 469, impacting how taxpayers classify income from related-party leases.

**Parties**

Francis J. Dirico and Jennifer Dirico (Petitioners) filed the case against the Commissioner of Internal Revenue (Respondent). The petitioners were the lessors of the property in question, while the respondent challenged the classification of the income derived from these leases.

**Facts**

Francis J. Dirico owned telecommunication towers and land, either individually or through grantor or nominee trusts. He leased these assets to his wholly owned S corporation, Industrial Communications & Electronics, Inc. (ICE), in exchange for 25% of the gross tower rent revenue. ICE, in turn, leased access to these towers to third parties, such as mobile telecommunication service providers. During the tax years in issue, 2004 and 2005, Dirico reported the net income from these leases as passive activity rental income under I. R. C. § 469(c)(2). The Commissioner challenged this classification, asserting that the income should be treated as non-passive activity income under specific regulations.

**Procedural History**

The Commissioner issued a notice of deficiency determining deficiencies in the Diricos’ federal income tax liabilities for 2004 and 2005. The Diricos filed a petition with the U. S. Tax Court, contesting the Commissioner’s recharacterization of their rental income. The Tax Court heard the case and rendered its decision on November 13, 2012.

**Issue(s)**

Whether the rental income paid to Francis J. Dirico by ICE for the use of telecommunication towers and land constituted income from a passive activity under I. R. C. § 469(c)(2) or income from a non-passive activity under 26 C. F. R. § 1. 469-2(f)(6)?

Whether the rental income from profitable rentals only should be recharacterized as non-passive activity income?

 

Whether income from land-only leases to ICE should be treated as non-passive activity income under 26 C. F. R. § 1. 469-2T(f)(3)?

**Rule(s) of Law**

Under I. R. C. § 469(c)(2), any rental activity is treated as a passive activity, regardless of the taxpayer's material participation. 26 C. F. R. § 1. 469-2(f)(6) provides that net rental activity income from property rented for use in a trade or business activity in which the taxpayer materially participates is treated as non-passive activity income. 26 C. F. R. § 1. 469-2T(f)(3) states that if less than 30% of the unadjusted basis of rental property is subject to depreciation, the net rental activity income from that property is treated as non-passive activity income.

**Holding**

The court held that ICE used the towers and associated land in a rental activity, not a trade or business activity, making Dirico's income from those leases passive activity income under I. R. C. § 469(c)(2). The court also held that the issue of recharacterizing only profitable rentals as non-passive activity income was moot due to the determination that all income from tower and land leases was passive. Finally, the court held that Dirico's income from land-only leases to ICE was non-passive activity income because less than 30% of the leased property's unadjusted basis was subject to depreciation.

**Reasoning**

The court reasoned that the leases between Dirico and ICE were for the use of tangible property (towers and land), making them rental activities under I. R. C. § 469(c)(2). The court rejected the Commissioner's argument that these activities were part of a trade or business, stating that the services provided by ICE (e. g. , maintenance) were typical of a lessor and did not transform the rental into a trade or business. The court further noted that ICE's grouping of all its activities as a single business activity was improper under 26 C. F. R. § 1. 469-4(d)(1), which prohibits grouping rental and trade or business activities unless specific conditions are met. The court also found that the self-rental rule in 26 C. F. R. § 1. 469-2(f)(6) did not apply because the property was used in a rental activity, not a trade or business. Regarding the land-only leases, the court applied the 30% test separately, finding that these leases were not grouped with the tower and land leases and thus were non-passive activity income under 26 C. F. R. § 1. 469-2T(f)(3).

**Disposition**

The court's decision was entered under Rule 155 of the Federal Tax Court Rules, indicating that further proceedings were necessary to compute the tax liability based on the court's holdings.

**Significance/Impact**

 

The Dirico case clarifies the distinction between rental and trade or business activities for purposes of I. R. C. § 469, affecting how taxpayers categorize income from leasing property to related entities. It emphasizes that the nature of the activity as defined by the statute and regulations, rather than the taxpayer's material participation or the grouping of activities on tax returns, determines the classification of income. The case also underscores the importance of applying the 30% test separately to different types of leases, which could influence tax planning strategies involving real and personal property rentals.

 