

## Internal Revenue Service

Department of the Treasury

Number: **200226025**  
Release Date: 6/28/2002  
Index Number: 1362.02-03

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B1-PLR-102759-02

Date:

March 25, 2002

### Legend

X =

D1 =

Property =

Year 1 =

Year 2 =

\$a =

\$b =

\$c =

\$d =

Dear

This responds to your letter dated, January 7, 2002, in which you requested a ruling that X's rental income from certain properties will not constitute passive investment income within the meaning of § 1362(d)(3) of the Internal Revenue Code.

### Facts

X elected to be treated as an S corporation, for federal tax purposes, effective D1. At the time that S elected S corporation status, it had C corporation earnings and profits.

X owns Property, which is a commercial facility. X's duties include the following with respect to the property: supervising contractors; performing landscape maintenance; sweeping sidewalks and the parking lot; repairing the exterior of the buildings, including the roof, downspouts, and the parking lot; maintaining the interior sprinkler system; maintaining the light fixtures in the parking lot; maintaining the perimeter fence; maintaining enclosed garbage areas; negotiating lease terms; maintaining books with regard to the property; securing new tenants; and engaging professionals as needed. Taxpayer employs individuals to perform the routine, day-to-day management of the property and maintains a management office on the property. Taxpayer's income from the properties during Year 1 totaled \$a and its nonreimbursed expenses related to the properties totaled \$b. During Year 2, taxpayer's income from the properties totaled \$c and its nonreimbursed expenses totaled \$d.

### Law and Analysis

Except as provided in section 1362(g), section 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of section 1362, to be an S corporation.

Section 1362(d)(3)(A)(i) provides that an election under section 1362(a) shall be terminated whenever the corporation (I) has accumulated earnings and profits at the close of each of three consecutive tax years, and (II) has gross receipts for each of such tax years more than 25 percent of which are passive investment income.

Section 1375(a) imposes a tax on the income of an S corporation if the S corporation has (1) accumulated earnings and profits at the close of such taxable year and (2) gross receipts more than 25 percent of which are passive investment income.

Section 1362(d)(3)(C)(i) provides that, except as otherwise provided, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities and sale or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(B)(1) of the Regulations provide<sup>1</sup> that "rents" means amounts received for the use of, or the right to use, property (whether real or personal) of a corporation.

Section 1.1362-2(c)(5)(ii)(B)(2) provides that the term "rents" does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of personal employed to provide the services and the types and

amounts of costs and expenses incurred (other than depreciation).

Section 1.1362-2(c)(5)(ii)(B)(4) provides that rents do not include compensation, however designated, for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the taxpayer, if during the taxable year the taxpayer is engaged in substantial development, manufacturing, or production of real or tangible personal property of the same kind.

### Conclusion

Based solely on the representations made and the information submitted we conclude that X's rental income from the properties, received during Year1 and Year2, is not passive income under § 1362(d)(3)(C)(i).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed regarding X's eligibility under § 1361 to be an S corporation or regarding whether X's rental income is passive income under § 469.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,  
David R. Haglund  
Senior Technician Reviewer, Branch 1  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)  
Copy of this letter  
Copy for § 6110 purposes  
cc: