

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

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Refer Reply To:
CC:PSI:1-PLR-102174-02
Date:
April 18, 2002

Legend:

X =

A =

B =

D1 =

D2 =

P1 =

P2 =

P3 =

P4 =

P5 =

P6 =

P7 =

P8 =

P9 =

P10 =

P11 =

P12 =

P13 =

P14 =

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P15 =P16 =P17 =P18 =P19 =a =b =

Dear :

This responds to your letter dated January 4, 2001, submitted on behalf of X, requesting a ruling that the rental income received by X in the course of its operations from the properties P1 through P19 is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

Facts

X made an election to be treated as an S corporation effective as of D1 under § 1362(a).

P1 through P16 are owned by partnerships in which X is a general partner. P17 is partially owned by X as a tenant in common. P18 and P19 are wholly owned by X.

X employs A to manage P1-P5, P7, P8, P10, and P13-P19. In addition, A employs B to provide services for P6, P9, P11, and P12.

The services provided by A and B include, but are not limited to, periodic inspection, repair, and maintenance of roofs, foundations, plumbing, electrical systems, heating/air conditioning systems, interior and exterior walls including painting of walls and trims; maintenance and repair of parking and pavement spaces; landscape maintenance, repair, and supervision of contractors including mowing, trimming, shrubbery maintenance, seasonal flowers, and sprinklers; periodic inspection for decay, dry rot, insect, termite, and other pest damage; telephone services and other electronic equipment and services for use of tenants; periodic inspection and maintenance of fire alarm, sprinkler system, and security system; engagement and supervision of contracted janitorial and cleaning services; inspection, repair, and maintenance of exterior signs; security guards for building and tenants; maintenance of fire and extended coverage insurance on premises; resolution of tenant complaints; garbage collection and water services; collection of rents; seasonal decoration and displays for

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building on holidays; solicitation of tenants, maintenance of lease files; negotiation of leases, or consultation with leasing agents; and review of property expenses and preparation of property reports.

X performs the following operational and managerial tasks. X reviews daily cash flows; reviews monthly operational and financial statements for each property; discusses with property management all exceptions noted on operational statements and details on all rental activities; approves large expenditures; reviews summarization of monthly cash transfer activity between properties; assists in routine accounting and tax matters, including preparation of fixed asset records and depreciation schedules for properties and the majority of partnership tax returns; obtains financing and refinancing for properties; facilitates annual appraisal of properties; reviews liability and property insurance coverage and terms; participates in the resolution of any legal matters that arise in connection with the properties; assists in strategic planning involving the properties and the partnership holdings; participates in decisions on all significant rental activities, including review of all purchases, sales, and exchanges and the relevant documents.

For the tax year ending D2, X received \$a in rental income and paid or incurred \$b in relevant operating expenses.

Law and Analysis

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

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) terminates 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 receipt derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(B)(1) of the Income Tax Regulations provides that “rents” means amounts received for the use of, or the right to use, property (whether real or personal) of the corporation.

Section 1.1362-2(c)(5)(ii)(B)(2) provides that “rents” does not include rents derived in the active trade or business of renting property. Rents received by a

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corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provided 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 persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Conclusion

Based solely on the facts as presented in this ruling request, and viewed in light of the applicable law and regulations, we conclude that the rents X receives from the rental of the properties P1 through P19 are not passive investment income under § 1362(d)(3)(C)(i).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed concerning whether X otherwise satisfies the S corporation eligibility requirements under § 1361. Further, the passive investment income rules of § 1362 are completely independent of the passive activity rules of § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 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 the taxpayer.

Sincerely,
Carolyn Gray
Acting Assistant to the Branch Chief, Branch 1
Office of Associate Chief Counsel
(Passthroughs and Special Industries)