

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Refer Reply To:
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Date:
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Legend

X =

Y =

State =

Date 1 =

Date 2 =

Date 3 =

Year 1 =

\$x =

\$y =

Dear :

This responds to a letter dated December 20, 2001, together with subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting a ruling that X's rental income from its commercial rental properties is not passive investment income within the meaning of §1362(d)(3)(C)(i) of the Internal Revenue Code.

Facts

X was incorporated in State on Date 1. X is a wholly owned subsidiary of Y and will file a consolidated return with Y for Year 1. X plans to make an election to be treated as an S corporation effective Date 2. X owns, develops, leases, and manages commercial and residential properties. Through X's ten full-time employees, as well as through independent contractors, X provides various services to its tenants. Services

provided by X include, but are not limited to, the following: keeping in good order, condition, and repair the foundations, exterior walls, exterior roofs, canopies, gutters, downspouts, air-conditioning system, and the heating system. Through third party contractors, X also provides the following services with respect to X's properties: security, landscape and grounds maintenance, irrigation installation, parking lot sweeping, striping and repair, refuse removal, electric, gas, water, and sewage service repair, replacement of roof. In addition to services provided to tenants, X handles the development, marketing, leasing, and administrative functions involved in managing real estate, including but not limited to, screening prospective tenants, negotiating leases, and negotiating all service contracts.

In the fiscal year ending Date 3, X received or accrued approximately \$x in rents and paid or incurred \$y in relevant expenses. X represents that it anticipates future figures to be consistent with the income and expense figures for prior periods.

Law

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under §1362(a) is in effect for the taxable year.

Section 1362(d)(2)(A) provides that an election under §1362(a) shall be terminated whenever (at any time after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(d)(3)(A) provides that an election under §1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and has gross receipts for each of such taxable years more than 25 percent of which are passive investment income. Any termination under this paragraph shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to above.

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 sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(B)(2) of the Income Tax Regulations provides that "rents" does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an 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 persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Analysis and Conclusion

Based solely on the facts and the representations submitted we conclude that the rental income that X derives from the properties is not passive investment income as described in §1362(d)(3)(C)(i).

Except as specifically set forth above, we express no opinion as to the federal tax consequences of the transaction described above under any other provision of the Code. Specifically, we express no opinion on whether X is a small business corporation eligible to make an S election. Further, the passive investment income rules of §1362 are completely independent of the passive activity rules of section §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.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely yours,
J. Thomas Hines
Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes