

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:  
Telephone Number:

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Date:  
June 20, 2002

**Legend**

Company =

Trust =

A =

B =

State =

Date =

D1 =

D2 =

N1 =

N2 =

N3 =

N4 =

N5 =

Dear :

This letter responds to your letter dated August 30, 2001, submitted on behalf of Company, requesting a ruling that the rental income received by Company from its operations is not passive investment income within the meaning of §1362(d)(3)(C)(i) of the Internal Revenue Code.

## **STATEMENT OF FACTS**

Company, a State corporation, filed an election to be treated as an S corporation, effective for the tax year beginning Date. A and B, as trustees of Trust, a grantor trust, are the sole shareholders of Company. Company has subchapter C accumulated earnings and profits.

Company engages in the business of owning and renting real property. The properties owned and rented by Company are used for commercial and industrial purposes. Company owns and rents N1 square feet of land and N2 square feet of improvements. Company rents the N3 units to N4 different tenants. The majority of the leases are month-to-month and all of the tenancies are on a gross lease basis. Company's gross rental revenues for the year ending December 31, 2000, were D1 and its expenses related to the rental activities, net of depreciation, were D2.

Company employs N5 individuals including A and B who both work in Company's real estate operations. Company also engages independent contractors for the purpose of performing certain services to Company. Company does not employ a management agency. Among the services performed by Company's employees are lease negotiation, credit review of prospective tenants, collection of rent, evictions, inspecting the properties for safety and maintenance, vendor selection, resolution of tenant complaints, bill payment and arranging for insurance of the property. Company's employees also oversee the work of any outside vendors or contractors hired by Company for the provisions of services to Company.

## **LAW**

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 an 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.

Except as otherwise provided in § 1362(d)(3)(C), § 1362(d)(3)(C)(i) provides that 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)(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 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 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 submitted and representations made by Company, we conclude that the rents Company receives from its real estate rental activities are not passive investment income under § 1362(d)(3)(C)(i).

Except for the specific ruling above, we neither express nor imply any opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding Company's eligibility to elect to be treated as an S corporation. 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.

Under a power of attorney on file with this office, we are sending the original of this letter to you and a copy to the taxpayer.

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

Sincerely,  
Christine E. Ellison  
Branch Chief  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosure (1)