

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:1-PLR-120239-02  
Date:  
June 18 2002

Legend:

- X =
- Y =
- State =
- D1 =
- D2 =
- a =
- b =
- c =

Dear :

This responds to your letter dated March 27, 2002, and subsequent correspondence, submitted on behalf of X, requesting a ruling that the rental income received by X in the course of its operations from commercial properties is not passive investment income within the meaning of § 1362(d)(3) of the Internal Revenue Code.

Facts

X is a subchapter S corporation incorporated in State. X owns a separate real properties in State. On D1, X entered into a separate lease agreements with Y under which X became responsible for the management of the real properties.

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In operating its properties, X is responsible for the furnishing of electricity, fuel, water, sewer, gas, oil and other utilities; pest control; cleaning of windows and exterior walls; trash and snow removal; landscaping and maintenance of the grounds; maintaining hazard, casualty, and liability insurances; fire alarm maintenance and annual inspection of the sprinkler system; parking lot maintenance; all real estate taxes and assessments levied against the properties; maintenance of the roofs, exterior walls and foundations; “on call” emergency property management; and other direct and indirect activities in support of the property management activity.

X estimates that it will receive or accrue approximately \$b in rental income and pay or incur approximately \$c in relevant operating expenses for its taxable year D2.

### 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 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.

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 for purposes of defining “passive investment income,” “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 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

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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 its properties will not be 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) 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,  
**/s/ Carolyn H. Gray**

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

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