

**Internal Revenue Service**

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:2 - PLR-144557-02  
Date:  
December 10, 2002

Legend

X =

Y =

Property 1 =

Property 2 =

Property 3 =

Property 4 =

Property 5 =

D1 =

a =

b =

c =

d =

e =

f =

City =

Operating Agreement =

PLR-144557-02

Tenants =

Dear :

This letter responds to a letter dated August 7, 2002, and additional correspondence, submitted on behalf of X, requesting rulings under § 1362(d)(3)(C)(i) of the Internal Revenue Code.

The information submitted states that X is a corporation which has elected to be treated as an S corporation effective D1. X has accumulated earnings and profits of \$a.

X operates four warehouse complexes, Property 1, Property 2, Property 3, and Property 4, and one other property, Property 5 (collectively, the Properties), located in City. X receives rental income on the Properties under an Operating Agreement with Y, its primary tenant. X receives additional rental income under separate lease agreements with Y and with its other tenants (the Tenants). X employs b full-time employees with regard to the Properties.

With regard to the Properties, X is obligated under the Operating Agreement and the separate lease agreements to undertake and complete capital improvement projects, including construction, painting, paving, and drainage. X is responsible for repair and maintenance, and owns or leases all necessary equipment. X is responsible for inspection and storage of the product stored by its tenants. X maintains all lighting and fire protection systems, and provides security and access for its tenants, which must have constant access to the stored product. X maintains a system of roadways connecting the various buildings within the Properties. Several of the buildings within Properties are maintained for the import of the product, and X is responsible for the paperwork connected with the import process. X has general responsibility for taxes and insurance on the Properties. X also has additional responsibility for other usual administrative functions involved in managing real estate.

PLR-144557-02

In 2001, X accrued approximately \$c in rents and incurred approximately \$d in relevant expenses on the Properties under the Operating Agreement and the separate lease agreements with Y and the Tenants. In the first half of 2002, X accrued approximately \$e in rents and incurred approximately \$f in relevant expenses on the Properties under the Operating Agreement and the separate lease agreements with Y and the Tenants.

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 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 § 1362(d)(3)(A) 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).

Based solely on the facts and the representations submitted we conclude that under § 1.1362-2(c)(5)(ii)(B)(2) of the regulations, the rental income that X receives under the Operating Agreement and the separate lease agreements with Y and the Tenants is income from the active trade or business of renting property and is not passive investment income as described in § 1362(d)(3)(C)(i) of the Code.

PLR-144557-02

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 be 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.

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 X's authorized representative.

Sincerely yours,

CAROLYN HINCHMAN GRAY  
Senior Counsel, Branch 2  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures: 2

Copy of this letter  
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