

## Internal Revenue Service

## Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:2 - PLR-152415-02

Date:

March 25, 2003

### Legend

X =

EIN:

Partnership =

State =

Property 1 =

Property 2 =

Property 3 =

Property 4 =

Property 5 =

Property 6 =

Property 7 =

Property 8 =

Property 9 =

Property 10 =

Property 11 =

Property 12 =

Property 13 =

Property 14 =

Property 15 =

Property 16 =

Property 17 =

Property 18 =

Property 19 =

Property 20 =

Property 21 =

Property 22 =

Property 23 =

Property 24 =

Property 25 =

Property 26 =

Property 27 =

Property 28 =

Property 29 =

Property 30 =

Property 31 =

Property 32 =

Property 33 =

Property 34 =

Property 35 =

Property 36 =

Property 37 =

Property 38 =

Property 39 =

Year 1 =

Date 1 =

Date 2 =

\$x =

\$y =

Dear :

This responds to a letter dated September 18, 2002, and subsequent correspondence submitted on behalf of X, requesting a ruling that X's rental income from its commercial rental properties and X's interest income from its lending business is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

The information submitted states that X was incorporated in Year 1. X plans to make an election to be treated as an S corporation effective Date 1. X owns, leases, and manages 39 commercial properties: Property 1 through Property 39. Through X's employees, as well as through independent contractors, X represents that it provides various services to its tenants. Services provided by X include, but are not limited to, the following: maintaining exterior areas, including policing of grounds, window washing, painting, roofing, and landscaping, maintaining parking and driveway areas, maintaining heating, cooling, lighting, and electrical systems, and providing janitorial services. X also handles the usual marketing, leasing, and administrative functions involved in leasing and managing real estate, including tenant appeals and evictions, seeking and screening potential tenants, and negotiating leases.

In the fiscal year ending Date 2, X received or accrued \$x in rents and paid or incurred \$y in relevant expenses other than depreciation. X represents that it anticipates future amounts to be consistent with the income and expense amounts for prior periods.

Prior to making its S election, X plans to contribute Property 1 through Property 19 to Partnership, a State limited partnership, in exchange for a limited and general interest in Partnership. X will receive rental income from Property 1 through Property 39 through its interest in Partnership.

X as part of its business also is engaged in a lending business. Currently, X has two employees dedicated to servicing its borrowers, providing consumer loans, lines of credit, and loans to affiliate companies. X's lending activities represent an ongoing, regular, and continuous source of revenue.

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)(1) of the Income Tax Regulations provides that "passive investment income" does not include gross receipts that are directly derived in the ordinary course of a trade or business of (i) lending or financing; (ii) dealing in property; (iii) purchasing or discounting accounts receivables, notes, or installment obligations; or (iv) servicing mortgages.

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, 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 the rental income that X derives from Property 1 through Property 39 is not passive investment income as described in § 1362(d)(3)(C)(i). We also conclude that X's interest income derived from its lending activities will be gross receipts directly derived in the ordinary course of a trade or business described in § 1.1362-2(c)(5)(iii)(B)(1) and will not be considered passive investment income under § 1362(d)(3)(C).

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