

Internal Revenue Service

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Person to Contact:

Telephone Number:

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Date:

June 10, 2003

X =

A =

State =

d1 =

d2 =

d3 =

d4 =

d5 =

property =

h =

i =

j =

k =

l =

PLR-159461-02

m =n =o =p =**Dear :**

This letter responds to a letter dated October 21, 2002, and supplemental correspondence, that X's authorized representative submitted on behalf of X requesting a ruling that the rental income X received is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

X was incorporated under the laws of State on d1. On d2, X elected to be treated as an S corporation for federal income tax purposes. X has accumulated earnings and profits.

X is engaged in the business of managing and operating property. X enrolled a part of the property in a federal conservation program.

X, through its shareholder A, provides significant services managing the property. The time spent providing the services to manage the property is approximately h hours in d3, i hours in d4 and j hours in d5. The significant services include weed control, cultivation of land, cultivation of trees, consultations with tenants, consultations with officials, guide services, and farmland inspection. In addition, X handles the usual administrative functions involved in the management, operation and leasing of farmland.

X received or accrued approximately k in rents for d3, l in rents for d4 and m in rents for d5. X paid or accrued approximately n in expenses for d3, o in expenses for d4, and p in expenses for d5. X represents that it has elected to have § 126 not apply to any of the rents received or accrued from the property enrolled in the federal conservation program

Section 1362(a)(1) provides that a small business corporation may elect 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)(3) of the Income Tax Regulations provides that for purposes of § 1.1362-2(c), subchapter C earnings and profits of a corporation are the earnings and profits of any corporation, including the S corporation or an acquired or predecessor corporation, for any period with respect to which an election under § 1362(a) was not in effect. The subchapter C earnings and profits of an S corporation are modified as required in § 1371(c).

Section 1.1362-2(c)(4)(i) provides that for purposes of § 1.1362-2(c), gross receipts generally means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income and is not reduced by returns and allowances, costs of goods sold or deductions.

Section 1.1362-2(c)(5)(ii)(B)(1) provides that in general, 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).

Based solely on the facts submitted and representations made, we conclude that the rental income X receives from the property is not passive investment income under § 1362(d)(3)(C)(i).

Except for the specific ruling above, we express or imply no 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 X'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.

PLR-159461-02

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 your authorized representative.

Sincerely yours,

Christine E. Ellison
Chief, Branch 3
Office of the Associate Chief Counsel
Passthroughs & Special Industries

Enclosure:

A copy of this letter