

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:3 / PLR-167259-03

Date:

October 29, 2004

Company:

Parent:

Shareholder:

Property:

State:

a:

b:

c:

d:

e:

f:

g:

h:

i:

k:

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Dear \_\_\_\_\_,

This letter responds to your letter dated November 12, 2003, as well as subsequent correspondence, requesting a ruling that the rental income received by Company from the Property is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

Company was incorporated under the laws of State on a and anticipates electing under § 1362(a) to be an S corporation effective b. It merged with Parent on c, with Company as the surviving corporation. It owns, leases, and manages the Property. Shareholder, doing business as a sole proprietor, is Company's tenant.

Effective d, Company entered into a new lease with its tenant, by which it undertook to provide all interior maintenance of the Property, in addition to Company's responsibilities under the prior lease.

Company employs e persons full time. Through these employees, as well as through outside contractors, Company provides various services to the Property in its real estate leasing and management activities. Company is responsible for the maintenance and repair of all areas of the Property, interior and exterior: building structural components, such as roofs, exterior walls, and foundations; all mechanical systems, such as water supply, sewer, plumbing, heating and cooling, and power; the sprinkler system and fire alarms; the grounds, including landscaping; parking lots; all furniture, fixtures, and equipment used in the tenant's business; and all signage. Company is responsible for providing all utilities, trash removal, pest control, building security, and on-call management services. In addition to the services provided to its tenant, Company handles the usual leasing and administrative functions involved in managing rental real estate.

Based on the new lease that became effective d, Company expects annually to receive or accrue approximately f in rents and to pay or incur annually approximately g in relevant expenses on the Property. For h, Company received or accrued approximately i in rents and paid or incurred approximately k in relevant expenses on the Property.

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 (l) has accumulated earnings and profits at the close of each

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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).

Based solely on the facts and representations submitted, we conclude that the rents Company receives from the Property are 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 the validity of Company's election to be an S corporation. Further, the passive investment income rules of § 1362 are independent of the passive activity rules of § 469.

Under a power of attorney on file with this office, we are sending copies of this letter to your authorized representatives.

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This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

*/s/*

JEANNE SULLIVAN  
Senior Technician Reviewer, Branch 3  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

enclosures: copy for § 6110 purposes

cc: