

**Internal Revenue Service**

Number: **200538025**

Release Date: 9/23/2005

Index Number: 1362.02-03

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

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PLR-166228-04

Date:

June 07, 2005

Legend:

X =

State =

D1 =

D2 =

a =

b =

c =

Dear :

This responds to the letter dated December 21, 2004, submitted on behalf of X, requesting a ruling that the rental income received by X from its real estate properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

**FACTS**

The information submitted discloses that, X was incorporated under the laws of State on D1. X intends to elect to be an S corporation for federal tax purposes, effective D2.

X is engaged in the active business of acquiring, financing, developing, constructing, leasing, managing, and selling commercial and residential real estate. X conducts these activities primarily through ownership in partnerships and limited liability companies.

X has approximately a employees. The services that X provides with regard to leasing and operating its properties include routine services, such as seeking and screening prospective clients, negotiating leases, overseeing tenant improvements, renovating and remodeling spaces for new tenants, cleaning and repairing common areas, establishing rules and regulations for safety, care and cleanliness of common areas, landscaping, snow removal, maintaining heating and air conditioning, ventilation, plumbing, wastewater, and electrical systems, etc. Financial information relating to X's most recent tax year indicates that X's relevant expenses approximated b% of its gross receipts relating to its commercial properties, and c% relating to its residential properties.

## **LAW AND ANALYSIS**

Section 1362(a) 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.

Section 1375(a) imposes a tax on the income of an S corporation if the S corporation has (i) accumulated earnings and profits at the close of such tax year, and (ii) gross receipts more than 25 percent of which are passive investment income.

Section 1362(d)(3)(C)(i) provides that 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)(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 amounts of costs and expenses incurred (other than depreciation).

### **CONCLUSIONS**

Based solely on the facts submitted and representations made, and viewed in light of the applicable law and regulations, we conclude that X provides significant services and incurs substantial costs in its business. Accordingly, we conclude that the rents X receives from its rental 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 satisfies the S corporation eligibility requirements of § 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) of the Code 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 mailed to your authorized representatives.

Sincerely,

/s/ David R. Haglund

David R. Haglund  
Senior Technician Reviewer  
Branch 1  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter  
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cc: