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Legend

X =

A =

B =

C =

Date 1 =

Date 2 =

State =

p =

\$q =

\$r =

Dear

This responds to a letter dated September 28, 2001, together with subsequent correspondence, submitted on behalf of X, requesting a ruling that X's revenues from its crop-sharing farming arrangement will not be classified as passive investment income within the meaning of §1362 of the Internal Revenue Code.

Facts

According to the information submitted, X was incorporated in State on Date 1 as a C corporation. X is in the business of crop share farming and timber harvesting. X owns p acres of farmland (the Property) in State, and participates in three separate crop sharing arrangements with A, B, and C with respect to the Property. X intends to elect to be treated as an S corporation effective Date 2.

X plans to enter into new, separate farm lease agreements with each of the three tenants listed above. The new leases state that A, B, and C must provide all labor, machinery, and equipment necessary to properly farm the land subject to each lease. Under the leases, X's expenses relating to the Property will include insurance, Ad valorem taxes, and other taxes. In addition, X and the lessees each will furnish one-half of all lime fertilizer needed and provide one-half of the funds for any expenditures incurred regarding land forming and irrigation.

X will receive, from A, B, and C, 20% of all crops, rebates, subsidies, and payments of any kind, the right to which arise from the Property and the farming thereon.

The leases provide that X participate in a number of management activities. Members of X's board of directors will attend monthly meetings at which decisions regarding the leased property are made. Furthermore, X, in its sole discretion, will make all decisions regarding: the types of crops to be planted, the acreage to be planted, the location of the planted crops, the marketing of its share of crops, and land forming and irrigation needs.

A full-time employee of X spends one-third of his time making daily visits to the Property and participates in the Property's day to day management decisions, including advising on crop production. Based on income and expenses from recent years, X expects to receive or accrue \$q in rents and to pay or incur \$r in relevant expenses with respect to the Property for its taxable year beginning Date 2.

Law and Analysis

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under §1362(a) is in effect.

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 "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, 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). See also Rev. Rul. 61-112, 1961-1 C.B. 399 (holding that amounts received by a corporation under share-farming agreements were not "rents" within the meaning of former section 1372(e)(5) where the corporation participated to a material degree in the production of farm commodities through physical work or management decisions, or a combination of both).

Conclusion

Based solely on the facts and the representations submitted, we conclude that the rental income that X derives from the Property will not be passive investment income as described in §1362(d)(3)(C)(i).

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) 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,
Matthew Lay
Senior Technician Reviewer, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes