

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:B1-PLR-152576-01
Date:
January 31, 2002

Legend

X =

State =

D1 =

D2 =

D3 =

D4 =

Y1 =

Y2 =

Y3 =

Y4 =

\$a =

\$b =

\$c =

\$d =

\$e =

\$f =

\$g =

\$h =

\$i =

\$j =

Dear

This responds to your letter of September 14, 2001, requesting a ruling that the rental income that X received from certain properties is not passive investment income within the meaning of § 1362(d)(3)(C) of the Internal Revenue Code, or alternatively seeking a ruling under § 1362(f).

Facts

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According to the information submitted, X was incorporated under the law of State on D1, and elected to be treated as an S corporation for its taxable year beginning on D2.

X's business consists of investment in and management of real estate. X owns a parcel of commercial real property in State. The property consists of land and a single tenant industrial warehouse.

The company participates in negotiating tenant's lease terms, lease extensions, and limited repair and maintenance of the building exterior and interior. These services required approximately h1, h2, and h3 hours in Y1, Y2, Y3, respectively. Company received \$a, \$b, and \$c of income, and incurred \$d, \$e, and \$f expenses with respect to the property during Y1, Y2, and Y3, respectively.

In Y4, X became aware that during Y1, Y2, and Y3 it had received income that was potentially passive investment income in excess of 25 percent of its gross receipts. At the close of each of the Y1, Y2, and Y3 tax years, X had \$g, \$h, and \$i of subchapter C earnings and profits, respectively.

X represents that it, and its shareholders, have consistently treated X as an S corporation since D2. Further, X represents that they do not believe that the rental income is passive investment income.

Law

Section 1361(a)(1) defines an S corporation, with respect to any taxable year, as a small business corporation for which an S election under § 1362(a) is in effect for such year.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) terminates whenever a corporation (I) has accumulated earnings and profits at the close of each three consecutive tax years, and (II) has gross receipts for each of such tax year of more than 25 percent of which are passive investment income.

Except as otherwise provided in subparagraph (C), section 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 Procedure and Administration Regulations provides that "rents" means amounts received for the use or, or the right to use, property of the corporation.

Section 1.1362-2(c)(5)(ii)(B)(2) provides that "rents" does not include rents

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derived in the active trade or business of renting property. Rents received by a corporation are derived in the active trade or business of renting property only if 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 a 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 (excluding depreciation).

Section 1362(f) of the Internal Revenue Code provides, in relevant part, that if: (1) an election under § 1362(a) by any corporation was terminated under paragraph § 1362(d)(3); (2) the Secretary determines that the circumstances resulting in the termination were inadvertent; (3) no later than a reasonable period of time after discover of the circumstances resulting in the termination, steps were taken so that the corporation is a small business corporation; and (4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Conclusion

Based solely on the representations made and the information submitted, we conclude that the rental income X received is passive investment income under §1362(d)(3)(C). Accordingly, X's S election terminated on D3, because X had subchapter C earnings and profits at the close of each of three consecutive tax years, beginning in Y1, and had gross receipts for each of those years, of which more than 25 percent was passive investment income.

We further conclude that termination of X's S election was an inadvertent termination within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation beginning Y3, and thereafter, unless X's S election is otherwise terminated under § 1362(d), provided that the following conditions are met. X must make a distribution of its retained subchapter C earnings and profits no later than 30 days from the date of this letter. As an adjustment under § 1362(f)(4), X must send a payment of \$j with a copy of this letter to the following address: Internal Revenue Service, P.O. Box 9940, Mail Stop 6271, Ogden, UT 84409. X must send this payment no later than D4. If these conditions are not met, then this ruling is null and void. Furthermore, if these conditions are not met, X must send notification that its S election has terminated to the service center with which X's S election was filed.

Except as expressly provided herein, no opinion is expressed or implied

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concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether X's S corporation election was valid under § 1362.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

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

Enclosures (2)
A copy of this letter
A copy for § 6110 purposes