

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2-PLR-125570-02
Date:
July 26, 2002

Legend

X =

\$a =

\$b =

\$c =

\$d =

Date 1 =

Date 2 =

Property =

Dear

This letter responds to your letter dated April 26, 2002, together with subsequent correspondence, submitted on behalf of X requesting a ruling that its rental income from Property is not passive investment income within the meaning of §1362(d)(3)(C)(i) of the Internal Revenue Code.

FACTS

According to the information submitted, X is a C corporation with accumulated earnings and profits that intends to elect under §1362(a) to be an S corporation. X owns, rents and manages Property, a building that has both commercial and residential tenants.

Through its employee owners and an independent contractor, X provides various services with respect to the leasing of Property. These services include marketing, seeking and screening prospective clients and negotiating leases; competitive market reviews; ensuring that tenants understand and comply with lease terms; overseeing tenant improvements; establishing rules and regulations for the safety, care, and cleanliness of common areas; providing and maintaining electrical service, heating, plumbing, water and sewage systems, sprinklers, and fire and smoke alarms; providing trash and snow removal, and janitorial and cleaning service; making routine inspections of the property and making major repairs to the building, including roofs, structural components and facades, and mechanical, heating, plumbing and electrical systems.

For its taxable year ending on Date 1, X accrued approximately \$a in rents and incurred approximately \$b in relevant operating expenses for Property. For its taxable year ending on Date 2, X accrued approximately \$c in rents and incurred approximately \$d in relevant operating expenses for Property. X further represents that the figures for the taxable years ending on Date 1 and Date 2 are consistent with the figures from prior years.

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 for the taxable year.

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)(2) of the Income Tax Regulations 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).

CONCLUSION

Based solely on the facts and the representations submitted we conclude that the rental income that X derives from Property is not 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) of the Code 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.

Sincerely yours,

Matthew Lay
Acting Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes