

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

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Telephone Number:

Refer Reply To:

CC:DOM:P&SI:3 PLR-115161-98

Date:

January 21, 1999

Company A:

Shareholders:

Company B:

Property:

a:

b:

c:

d:

Dear

This letter responds to a letter dated July 21, 1998, as well as subsequent correspondence, submitted on behalf of Company by your authorized representative, requesting a ruling that Company's rental income from the Property is not passive

PLR-115161-98

investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code. Company represents the following facts.

Company A and its Shareholders elected under § 1362(a) to be an S corporation effective a. It has subchapter C earnings and profits.

Company A owns Property, which historically it has rented on a net lease basis to Company B, a related corporation. Company A intends to restructure its rental arrangement with Company B so that the lease no longer will be a net lease. The lease will be arm's-length.

Under the new lease, Company A will be responsible for janitorial service, snow removal, garbage pickup, grounds maintenance, and routine building maintenance. Company A will provide these services through its employee and through independent contractors. Company A will pay all bills relating to Property. It will approve, supervise, and pay for all major repairs and improvements.

Company A estimates that it will receive or accrue approximately b in rents and will pay or incur approximately c in relevant expenses on Property for d.

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 (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.

Except as otherwise provided in subparagraph (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

PLR-115161-98

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).

Based solely on the facts as presented in this ruling request, and viewed in light of the applicable law and regulations, we conclude that the rents Company A will receive from Property will not be passive investment income under § 1362(d)(3)(C)(i).

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding Company A's eligibility under § 1361 to be an S corporation or to retain its current fiscal year. 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.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

PLR-115161-98

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,

DONNA M. YOUNG  
Senior Technician Reviewer,  
Branch 3  
Office of the Assistant  
Chief Counsel  
(Passthroughs and  
Special Industries)

encl: copy for § 6110 purposes