

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

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February 23, 1999

LEGEND

Company =

Partnership =

Center =

State =

City =

d1 =

d2 =

d3 =

x =

y =

z =

Dear

This responds to a letter dated October 29, 1998, and subsequent correspondence submitted by your authorized representative on behalf of Company, requesting a ruling that Taxpayer's rental income is not passive investment income under § 1362(d)(3)(C)(i) of the Internal Revenue Code.

## FACTS

Company was incorporated under the laws of State on d1, and intends on making an S corporation election effective for the taxable year beginning d2. Company, which has accumulated earnings and profits, is in the business of owning and operating the Center in City, State.

Company's income is derived from the leasing of space in the Center to tenants. In operating the Center, Company hires Partnership, a partnership owned by two of Company's shareholders to provide services to the Center. These services include property inspection, landscaping, snow removal, and maintenance and repair of building structures, utilities, and common areas.

Additionally, Company employs a non-shareholder employee that it pays x a week to provide services to the Center. These services include the oversight of the operation of the Center, supervision of the on-site manger, and the oversight of maintenance services. In d3, Company's rental income was y and their total relevant expenses were z. Company anticipates its future income and expenses from the operation of the Center will remain approximately the same.

## 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.

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) shall be terminated whenever the corporation (I) has accumulated earnings and profits at the close of each of three consecutive taxable years, and (II) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

Section 1362(d)(3)(C)(i) provides that except as otherwise provided in § 1362(d)(3)(C), 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).

### CONCLUSIONS

After applying the relevant law to the facts submitted and representations made we rule that the rental income described above that Taxpayer receives from leasing the Center is not passive investment income under § 1362(d)(3)(C)(i).

Except for the above ruling, we express no opinion on the federal tax consequences of the facts of this case under any other provision in the Code. We specifically express no opinion on Company's qualification for S corporation treatment under § 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 under § 469.

This ruling is directed only to the taxpayer who requested it. Under § 6110(k)(3), this ruling may not be used or cited as precedent.

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

Sincerely,

Jeff Erickson  
Assistant to the Branch Chief,  
Branch 3  
Office of the Assistant Chief  
Counsel  
(Passthroughs and Special  
Industries)

Enclosures (2)

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