

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:  
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LEGEND

Company =

State =

Y =

Z =

d1 =

d2 =

d3 =

A =

B =

Properties =

Dear

This letter responds to a letter dated January 29, 1999, and subsequent correspondence written by your authorized representative on behalf of Company, requesting a ruling that Company's rental income from the Properties 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, Company was organized on d1 as a State business trust, and elected under § 1362(a) to be an S corporation effective d2. Company, which has accumulated earnings and profits, has two shareholders, A and B.

Company is in the business of owning, operating, and managing the Properties, which are commercial rental real estate. The Properties are used as office buildings, and for light industrial use. Through its owners and through a management company that Company subcontracts, Company provides various services in operating the Properties. These include maintenance and repair of the structures, grounds, roofs, and parking areas and HVAC; landscaping; janitorial services, and snow and rubbish removal. In addition to these customary services, Company provides additional services not ordinarily provided by commercial lessors. For example, Company will serve as an intermediary between tenants and their contractors in resolving disputes, and will assist tenants in planning the layout of their space.

In the fiscal year ending d3, Company received or accrued approximately Y in rents and paid or incurred Z in relevant expenses. Company represents that it anticipates future figures to be consistent with the income and expense figures for prior periods.

#### LAW

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 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).

After applying the relevant law to the facts submitted and the representations made, we conclude that the rents Company receives from the Properties are not 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's eligibility under § 1361 to be an S corporation. 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.

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

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

Sincerely yours,

William P. O'Shea  
Chief, Branch 3  
Office of the Assistant Chief  
Counsel  
(Passthroughs and Special  
Industries)

Enclosures (2):

Copy of this letter  
Copy for § 6110 purposes