

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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CC:DOM:P&SI:3 PLR-121908-98

Date:

April 1, 1999

Company:

Shareholders:

Properties:

State:

Type:

a:

b:

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c:

d:

e:

f:

g:

h:

Dear

This letter responds to your letter dated October 21, 1998, and received November 9, 1998, as well as subsequent correspondence, submitted on behalf of Company, requesting a ruling that the rental income received by Company from the Properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code. Company represents the following facts.

Company and its Shareholders elected under § 1362(a) to be an S corporation effective a. It has subchapter C earnings and profits. Company also elected under § 1361(b)(3)(B)(ii), effective the same date, to treat its subsidiaries as qualified subchapter S subsidiaries (QSSSs).

Company constructs Type buildings for sale to customers as well as constructing such buildings on its own land for rental, all within State. Company employs b persons in this business, all but one of whom are full-time. Approximately half of the employees' time is spent on each activity: construction and real estate rental.

Through its own employees, as well as through independent contractors, Company provides various services with respect to the leasing of most of the Properties. These services include maintenance and repair of building exteriors, structural components, and systems, including roofs, walls, and floors, electrical wiring, plumbing, sprinklers, and elevators; common area maintenance; routine periodic maintenance, such as pavement resurfacing and striping, painting, patching, and replacement or refurbishment of exterior lights, locks, windows, and doors; handling of tenant complaints; construction of tenant improvements; assistance with space design and utilization; landscaping; pest control; trash collection; and the monitoring

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of security services. In addition to the services provided to tenants, Company handles the usual marketing, leasing, and administrative functions involved in managing real estate.

Company received or accrued approximately c in rents and paid or incurred approximately d in relevant expenses for e on the Properties. The comparable figures for f are g and h. Company represents that its rental income and expenses for the current and future years are expected to be consistent with the figures above.

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 § 1362(d)(3)(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 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 the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Section 1.1362-2(c)(5)(ii)(B)(4) provides that "rents" does not include compensation, however designated, for the use of, or right to use, any real or tangible personal property developed,

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manufactured, or produced by the taxpayer, if during the tax year the taxpayer is engaged in substantial development, manufacturing, or production of real or tangible personal property of the same type.

After applying the applicable law and regulations to the facts as presented in this ruling request, 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 income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding the validity of Company's election to be an S corporation as well as its elections to treat its subsidiaries as QSSSs. 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 you the original of this letter and a copy to the taxpayer.

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,

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

encl: copy for § 6110 purposes