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The information submitted states that X was incorporated in Year 1. X made an election to be an S corporation beginning Date 2.

The information submitted states that X, in its capacity as owner, provides all utilities and communication services to the tenant of Property. X is responsible for all insurance and real estate taxes, ad valorem taxes, and special assessments with respect to Property. X's employees and officers will provide the tenant the following services in conjunction with the rental at X's expense: daily inspection of inventory and grounds; all repairs of the heating a cooling systems, plumbing fixtures, exterior walls and roofs; sidewalk and fencing maintenance; landscaping and grounds maintenance; window washing, security services, supervision of tenant improvements, receiving, handling and warehousing of inventory, and managing of the leasing and administrative functions involved in managing the property.

X's annual gross rental income for Year 1 and Year 2 was \$a and \$b, respectively. X's annual expenses excluding depreciation for Year 1 and Year 2 were \$c and \$d, respectively.

Section 1361(a)(1) defines "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

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) defines "passive investment income" as gross receipts from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5) of the Income Tax Regulations provides, in relevant part, that in general "passive investment income" means gross receipts derived from rent.

Section 1.1362-2(c)(5)(ii)(B)(1) provides that "rents" means amounts received for the use of, or 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).

Based solely on the facts and representations submitted, we conclude that the rental income X receives is not passive investment income as described in § 1362(d)(3)(C)(i).

Except for the specific ruling above, we express no opinion concerning the federal income tax consequences of the transactions described above under any other provision of the Code. Specifically, we express or imply no opinion on whether X is a small business corporation. Further, the passive investment income rules of § 1362 are independent of the passive activity rules of § 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) provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Bradford R. Poston  
Senior Counsel, Branch 2  
(Passthroughs & Special Industries)

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