

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

October 1, 2003

X =

Y =

Properties =

D1 =

D2 =

D3 =

\$x =

\$y =

Dear :

This letter responds to your letter dated May 16, 2003, and subsequent correspondence submitted on behalf of X, requesting a ruling that X's rental income from the Properties is not passive investment income within the meaning of §§ 1362(d)(3)(C)(i) and 1375 of the Internal Revenue Code.

The information submitted states that X was incorporated in D1 and elected to be treated as an S corporation effective D2. X has accumulated earnings and profits. X is engaged in the business of owning and operating commercial rental real estate. Management, a corporation related to X, manages the Properties.

Through Management and independent contractors, the services provided by X

include (not all services are provided to all properties): maintaining heating, cooling, lighting, and electrical systems; providing janitorial services; maintaining exterior areas, including policing of grounds, window washing, painting, roofing, landscaping, parking areas, and driveways areas; providing security personnel; and maintaining automatic elevator services.

In addition to the services X provides to tenants, X, through Management, performs the usual leasing and administrative activities involved in managing real estate. These activities include: purchasing and developing new properties; negotiating and drafting individual leases; showing properties to prospective tenants; and hiring and supervising personnel assigned to perform the property management functions.

In the fiscal year ending D3, X accrued approximately \$x in rents and incurred \$y in relevant expenses.

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 the 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 § 1362(d)(3)(A) 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 1375(a) provides that if, at the close of a taxable year, an S corporation has subchapter C earnings and profits and gross receipts more than 25 percent of which are passive investment income, a tax is imposed on the excess net passive income of the corporation.

Section 1375(b)(3) provides that the terms "passive investment income" and "gross receipts" have the same respective meanings as when used in § 1362(d)(3).

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).

Based solely on the facts and the representations submitted, we conclude that the rental income that X derives from the Properties is income from the active trade or business of renting property, and is not passive investment income as described in §§ 1362(d)(3)(C)(i) and 1375.

Except as specifically set forth above, we express no opinion as to the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express no opinion on whether X is otherwise eligible to be an S corporation nor on whether any of X's shareholders are eligible S corporation shareholders under § 1361(c)(2)(A). 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.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to X.

Sincerely yours,

J. THOMAS HINES
Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2

Copy of this letter
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