

## Internal Revenue Service

## Department of the Treasury

Number: **200112035**  
Release Date: 3/23/2001  
Index Numbers: 1362.02-03

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B01-PLR-122440-00

Date:

December 20, 2000

X =

State =

Date 1 =

Date 2 =

Property =

a =

b =

c =

d =

e =

This letter responds to your submission of October 16, 2000, together with subsequent correspondence, in which X is requesting a ruling that the rental income received by X from the Properties is not passive investment income within the meaning of section 1362(d)(3)(C)(i) of the Internal Revenue Code.

### Facts

X was organized in State on Date 1, and intends to elect under section 1362(a) to be an S corporation effective Date 2. X has C corporation earnings and profits. X is engaged in owning, leasing, and operating and maintaining Property, an office building with an average of a tenants. X leases space to tenants under leases ranging in length from two to five years or under tenant-at-will arrangements. Tenants pay fixed minimum rental plus a percentage of operating expenses. They are responsible for keeping leased space in a safe and sanitary condition and for paying separately metered utilities. X is responsible for inspecting, maintaining, and repairing all structural

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portions of the building (including: the roof, walls, floors, ceilings, foundation, wiring, plumbing, HVAC, elevators, and similar equipment) except for equipment and alterations owned or made by the tenant. X is also responsible for all outside and common area maintenance and performs work for the tenants such as replacing light fixtures, painting, and replacement of carpeting. In addition to the services provided to tenants, X handles the usual leasing and administrative functions involved in managing real estate.

X's gross rental income for the 1999 and 2000 taxable years totaled b and c, respectively and its related expenses (excluding depreciation and amortization) totaled d and e, respectively.

### Law and Analysis

Except as provided in section 1362(g), section 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of section 1362, to be an S corporation.

Section 1362(d)(3)(A)(i) provides that an election under section 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 section 1362(d)(3)(C), section 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) 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).

### Conclusion

Based solely on the facts as represented by X in this ruling request, we conclude that the rents X received from Property, are not passive investment income under

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section 1362(d)(3)(C)(i).

The ruling in this letter is based on information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for ruling, it is subject to verification on examination.

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 X's eligibility to elect S corporation status. Further, the passive investment income rules of section 1362 are completely independent of the passive activity rules of section 469; unless an exception under section 469 applies, the rental activity remains passive for purposes of section 469.

This ruling is directed only to the taxpayer(s) 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's authorized representative.

Sincerely,  
**/s/David R. Haglund**  
Senior Technician Reviewer, Branch 1  
Associate Chief Counsel  
(Passthroughs and Special Industries)

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