

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

Number: **200439006**

Release Date: 9/24/04

Index Number: 1362.02-03

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B02 – PLR-102999-04

Date:

May 13, 2004

X =

Property =

A =

D1 =

D2 =

D3 =

\$y =

\$z =

Dear :

The letter responds to your letter dated December 29, 2003, and subsequent correspondence submitted on behalf of X, requesting a ruling that X's rental income from Property 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 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.

A, X's president, represents that X provides various services to Property. These services include, but are not limited to the following: engages all subcontractors for

repairs and maintenance on the property; inspects property for cleanliness and safety on a regular basis; makes repairs to and maintains the roofs and skylights of the building; investigates and pursues all claims for damage to the buildings from third parties; periodically inspects the exterior portions of the building for deterioration or damage and repairs the same when necessary; periodically inspects the basements, foundations, and exterior walls and paints, tuckpoints, or otherwise and repairs as necessary; periodically inspects the plumbing, electrical and HVAC systems in the building to ascertain that they are properly installed and maintained by the tenant; periodically inspects the fire alarms and sprinkler systems and the tenant's use of the buildings to make certain that there are no unsafe practices within the building; periodically inspects the elevator and its doors to make certain that the tenant is properly maintaining it; inspects and maintains the fencing around the building; coordinates with the city on any issues as to city services such as sewer and water and coordinates with the utility providers; inspects and maintains vehicle parking areas and exterior dock areas; and, negotiates the terms of all leases and renewals thereof with the tenant.

In the year ending D3, X accrued approximately \$y in rents and incurred \$z 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 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 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)(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, 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 that X derives from Property 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 expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. 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 investment activity rules of § 469; unless an exception under § 469 applies, the rental activity remains passive for the 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.

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

Sincerely,

Carolyn Hinchman Gray  
Senior Counsel, Branch 2  
Office of Associate Chief Counsel

(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

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