

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:

October 15, 1999

X =

Y =

Farm =

\$n =

\$o =

State =

Dear :

This letter responds to your June 10, 1999 ruling request and subsequent correspondence submitted on behalf of X by you, X's president, concerning section 1362(d)(2) of the Internal Revenue Code.

The information submitted states that X incorporated as a C corporation on March 30, 1990, and has C earnings and profits as of March 31, 1999. X intends to elect to be an S corporation.

X is engaged in the business of leasing Farm. Under a lease agreement commencing on July 1, 1997, and ending on June 30, 2004, between X and Y, X is responsible for paying all of the real estate taxes and insurance costs. Further, under the lease agreement, X operates and maintains a waste and run-off water system located on Farm and therefore leased by Y. You represent that X must monitor and maintain the waste and run-off water system to meet the environmental standards set forth by State. In addition, X maintains equipment located on Farm.

During fiscal year ending March 31, 1999, X received rental income of \$n and incurred expenses of \$o.

Section 1362(d)(3)(C)(i) of the Code 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 1.1362-2(c)(5)(ii)(B)(1) of the regulations defines "rents" as 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) of the regulations provides that "rents" does not include rents derived in the 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).

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

Based solely on the information submitted and the representations made, we conclude that under § 1.1362-2(c)(5)(ii)(B)(2) of the regulations, the gross receipts that X receives from renting Farm to Y are income from an active

trade or business and are not passive investment income as described in §§ 1362(d)(3)(C)(i) or 1375(b)(3) of the Code.

Except as specifically set forth above, we express no opinion as to the federal tax consequences of the transaction described above under any other provision of the Code. Further, we express no opinion concerning X's election under § 1362(a) to be an S corporation, or X's qualification to be a small business corporation eligible to make an S election.

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

Sincerely yours,

J. THOMAS HINES
Senior Technician Reviewer
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and Special
Industries)

Enclosures: 2
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