

## Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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July 29, 1999

### Legend

Company =

m =

n =

o = —

p =

q =

State =

Date 1 =

Date 2 =

Year =

This letter responds to your letter dated May 3, 1999, together with subsequent correspondence, submitted on behalf of Company, requesting a ruling that the rental income received by Company from certain properties is not passive investment income within the meaning of section 1362(d)(3)(C)(i) of the Code.

### Facts

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Company was incorporated in State on Date 1. Company elected under section 1362(a) to be treated as an S corporation effective on Date 2.

Company owns a parcel of commercial real property in State. The property consists of land and buildings which are divided into m store spaces (collectively, the "Property"). Each store space is rented to a tenant, resulting in rental income.

The president of Company is involved in all material decisions regarding the leasing and management of the Property. Company engages a property manager to maintain and manage the Property, including ice, snow, and debris removal; the repair, rebuilding, and maintenance of the parking area, sidewalks, and other common areas; the planting, replanting and replacing of landscaping; and the payment of premiums for fire, liability, property damage and worker's compensation. Company is responsible for certain exterior maintenance and the payment of insurance premiums covering certain leasehold improvements on the Property. The president's services require approximately n hours per week. The property manager's services require approximately o hours per month.

Company received or accrued approximately p in rents and paid or incurred approximately q in relevant expenses with respect to the Property for Year.

### 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 subparagraph (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) 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

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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).

### Conclusion

Based solely on the facts as presented in this ruling request, and viewed in light of the applicable law and regulations, we conclude that the rents Company receives from the Property are not passive investment income under section 1362(d)(3)(C)(i).

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding Company's eligibility under section 1361 to be an S corporation. 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.

In accordance with the power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to the taxpayer who requested it. According to section 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

**Signed/David R. Haglund**

David R. Haglund  
Senior Technician Reviewer, Branch 1  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)  
Copy of this letter  
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