

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:

October 15, 1999

X =

Y =

A =

\$n =

\$o =

\$p =

\$q =

\$r =

\$s =

State =

Dear :

This letter responds to the April 29, 1999 ruling request and subsequent correspondence submitted on behalf of X by X's authorized representative concerning section 1362(d)(2) of the Internal Revenue Code.

The information submitted states that X, an S corporation since January 1, 1989, owns agricultural real property in State. X leases the real property to Y, a State C corporation, pursuant to a Farm Lease dated November 1, 1990, and Addendum to Farm Lease dated November 7, 1990.

Pursuant to the lease, Y pays X twenty percent of gross crop proceeds received by Y from the leased property during each crop year plus twenty percent of any payments made to Y under any State support program with respect to the leased property. Y consults with X concerning the timing of planting and harvesting, the types of crops to grow, the rotation thereof, and the general management of any crops grown on the leased premises. X consults with Y using its best efforts and experience to assist Y in the preparation of the soil, planting of the crops, and the care and harvesting thereof. X and Y are jointly responsible for the marketing of the crops until fully divided. X periodically inspects the crops and makes suggestions to Y as to the proper care and management. Further, any contract for sale of the crops requires X's approval.

X pays real property taxes and assessments and the water district taxes. Further, the processing charges related to X's portion of the crop and the co-op charges to X are paid from X's crop share.

For taxable years 1996, 1997, and 1998, X's gross rents from leasing the real property were \$n, \$o, and \$p respectively while operating costs totaled \$q, \$r, and \$s respectively.

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 its agricultural real property 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.

In accordance with the power of attorney submitted, we are sending a copy of this ruling to X's authorized representative.

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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