

**Internal Revenue Service**

Department of the Treasury

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**LEGEND:**

- X =
- a =
- b =
- c =
- d =
- e =
- f =
- g =
- h =
- i =

This letter responds to a letter, dated October 9, 1999, written on behalf of X, requesting a ruling under § 1362(d)(3) of the Internal Revenue Code that X's rental income from commercial and residential real properties is not passive investment income.

**FACTS**

X is a C corporation with accumulated earnings and profits that intends to make an election under § 1362(a) to be an S corporation. X constructs, acquires, develops and leases a commercial properties and b residential properties.

Through its employees or independent contractors X provides various services with respect to the leasing of most of its properties. These services include seeking and screening prospective clients and negotiating leases; ensuring that tenants understand and comply with lease terms; overseeing tenant improvements; landscaping; establishing rules and regulations for the safety, care, and cleanliness of common areas; providing and maintaining air conditioning, heating, plumbing, water and sewage systems; providing security guards and alarms, trash and snow removal, and janitorial and cleaning services; making routine inspections of the properties; and making major repairs to buildings, including roofs, structural components and facades,

and mechanical, heating, plumbing and electrical systems.

X received or accrued approximately c in rents and paid or incurred approximately d in relevant expenses for period e. The comparable figures for period f are g and h. X represents that these figures are consistent with the income and expense figures for prior periods. X has i employees.

### **LAW AND ANALYSIS**

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

Section 1362(d)(3)(A)(i) provides that an S corporation election shall be terminated whenever the corporation (I) has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and (II) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

Section 1375(a) imposes a tax on the income of an S corporation if the S corporation has (1) accumulated earnings and profits at the close of such taxable year, and (2) gross receipts more than 25 percent of which are passive investment income.

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 1.1362-2(c)(5)(ii)(B)(1) defines “rent” 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) provides that the term “rents” does not include rents derived in the active trade or business of renting property. Rents 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).

Section 1.1362-2(c)(5)(ii)(B)(4) provides that “rents” does not include compensation, however, designated, for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the taxpayer, if during the tax year the taxpayer is engaged in substantial development, manufacturing, or

production of real or tangible personal property of the same type.

### **CONCLUSION**

We conclude that X provides significant services and incurs substantial costs in its business. Accordingly, we conclude that X is engaged in the active business of renting property and that the rents X receives from its rental properties will not be passive investment income under § 1362(d)(3)(C)(i).

Some of X's rental income is net lease income, which is generally passive investment income. However, X's net lease income from properties X developed is not passive investment income because X continues to develop properties of that type. The remaining portion of X's net lease income is an incidental part of X's active rental business and will not be treated as passive investment income.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is an S corporation for federal tax purposes. Further, the passive investment income rules of § 1362 are completely independent of the passive activity rules of § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 469.

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

Pursuant to a power of attorney on file with this office, we are sending a copy of this letter to X.

Sincerely yours,  
William P. O'Shea  
Chief, Branch 3  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

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