

**Internal Revenue Service**

Department of the Treasury

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Date:  
October 26, 2001

X =

D1 =

D2 =

D3 =

\$x =

\$y =

State =

Dear . :

This letter responds to a letter dated July 25, 2001, submitted on behalf of X, requesting a ruling that X's rental income from its commercial rental properties is not passive investment income within the meaning of §1362(d)(3)(C)(i) of the Internal Revenue Code.

Facts

X was incorporated in State on D1 as a C corporation. X made an election to be treated as an S corporation effective D3. X had accumulated earnings and profits as of D3. X leases commercial rental properties to various tenants. Through X's employees, as well as independent contractors, X provides various services to its tenants. Services provided by X include, but are not limited to, the following: maintenance and repairs of the roof, structural components, plumbing, elevators, fire alarms, electrical systems, facade, and parking lot. Moreover, X is responsible for landscaping around the building, including maintenance of the sprinkler system, daily cleaning of tenant offices and

common areas, supervision of development and construction on the properties, regular monitoring and inspection of the properties, and removal of snow from common areas. In addition to services provided to tenants, X handles the usual marketing, leasing, and administrative functions involved in managing real estate, including but not limited to, screening prospective tenants, negotiating leases, and negotiating all service contracts.

In the fiscal year ending D2, X received or accrued approximately \$x in rents and paid or incurred \$y in relevant expenses. X represents that it anticipates future figures to be consistent with the income and expense figures for prior periods.

### Law and Analysis

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 1.1362-2(c)(5)(ii)(B)(2) of the Income Tax Regulations 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).

### Conclusion

Based solely on the facts and the representations submitted we conclude that the rental income that X derives from the properties is not passive investment income as described in §1362(d)(3)(C)(i).

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. Specifically, we express no opinion on whether X is a small business corporation eligible to make an S election. Further, the passive investment income rules of §1362 are completely independent of the passive activity rules of section §469; unless an exception under §469 applies, the rental activity remains passive for 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's authorized representative.

Sincerely yours,  
Matthew Lay  
Senior Technician Reviewer, Branch 2  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures: 2

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