

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
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Legend

X =

PRS =

Property =

D1 =

D2 =

\$x =

\$y =

State =

m =

Dear :

This letter responds to a letter dated June 7, 2002, and subsequent correspondence written on behalf of X, requesting a ruling that X's rental income from Property is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

Facts

X is a corporation that elected to be treated as an S corporation effective D1. X has accumulated earnings and profits. X is a 50% general partner of PRS, a State general partnership. PRS owns and operates Property, a residential housing complex consisting of approximately m total units. PRS provides, through its four employees and independent contractors, various services to the tenants of Property. These services include: inspecting and maintaining all units; repairing plumbing; replacing and repairing appliances, locks and windows; maintaining heating and cooling equipment; cleaning and replacing carpeting; painting interior walls; removing garbage; landscaping; removing snow; maintaining the parking lot; and providing a 24 hour on-call service for emergencies and tenant problems.

For the taxable year ending on D2, X's distributive share of PRS's items, included approximately \$x in rents and approximately \$y in relevant expenses.

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 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 § 1362(d)(3)(A) 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 receives from Property through PRS is income from the active trade or business of renting property, and is not passive investment income as described in § 1362(d)(3)(C)(i) 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. Specifically, we express no opinion on whether X is a small business corporation eligible to be an S election. 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 requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to X.

Sincerely yours,

MATTHEW LAY
Senior Technician Reviewer,
Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2

Copy of this letter
Copy for § 6110 purposes