

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:1-PLR-119734-02  
Date:  
January 6, 2003

Legend:

X =  
  
Locality =  
State =  
D1 =  
D2 =  
D3 =  
a =  
b =  
c =

Dear :

This responds to your letter dated April 3, 2002, submitted on behalf of X, requesting a ruling that the rental income received by X in the course of its operations from commercial properties is not passive investment income within the meaning of § 1362(d)(3) of the Internal Revenue Code.

Facts

X was incorporated in State on D1. X made an election to be treated as an S corporation under § 1362(a) on D2.

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X owns a commercial buildings in Locality, State. The services provided by X in operating its properties include, but are not limited to, identifying new tenants; negotiating all leases, renewals, and other agreements with tenants; collecting all rents and other amounts due under the leases; communicating with tenants on all issues relating to the management and operation of the properties including maintenance, repairs, hours of operation and similar matters that affect tenant occupancy; paying all water, gas, heat, light, power, sewer, janitorial, sprinkler charges and other utilities or services used on the premises; paying all taxes; maintaining the structural and exterior portions of the properties in good condition; providing trash removal service; maintaining insurance on the properties; and obtaining financing and refinancing for the properties.

For the tax year ending D3, X received \$b in rental income and paid or incurred \$c in relevant operating expenses.

### 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 election under § 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.

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 receipt 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 on all the facts and circumstances, the corporation provided 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

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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 X receives from the rental of its properties are not passive investment income under § 1362(d)(3)(C)(i).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed concerning whether X otherwise satisfies the S corporation eligibility requirements under § 1361. 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) of the Code 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 the taxpayer.

Sincerely,

**/s/ Dianna K. Miosi**

Dianna K. Miosi  
Chief, Branch 1  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

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