

**Internal Revenue Service**

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:3-PLR-163800-02  
Date:  
March 11, 2003

Legend

Taxpayer =

Shareholders =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

Amount 5 =

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Amount 6 =

X =

Y =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

Year 3 =

State =

Commercial Real Estate =

Residential Real Estate =

Undeveloped Lots =

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Dear \_\_\_\_\_ :

This letter responds to your letter dated November 4, 2002, and subsequent correspondence, requesting a ruling on behalf of Taxpayer that rental income earned by Taxpayer at its Commercial Real Estate, Residential Real Estate, and Undeveloped Lots (collectively referred to as Properties) will not be treated as passive investment income under § 1362(d)(3) of the Internal Revenue Code. This letter responds to your request.

### Facts

Taxpayer was incorporated in State on Date 1 for the purpose of owning and operating commercial and residential real estate. Taxpayer is owned by Shareholders. Taxpayer has accumulated earnings and profits and intends to make an election under § 1362(a) to be an S corporation effective Date 2. Properties owned by Taxpayer are all located in State.

Taxpayer conducts its activities related to Properties directly through its X full time office employees and its Y full time residential apartment managers. Taxpayer, through its employees, negotiates and signs leases, approves all purchases, schedules, oversees, and inspects all repairs and capital improvements, negotiates financing, settles tenant disputes, makes personnel decisions, markets its units to potential tenants, performs all bookkeeping tasks, and maintains the properties.

In the Year 1 fiscal year, Taxpayer received or accrued Amount 1 in rents and paid or incurred Amount 2 in relevant expenses less depreciation. In the Year 2 fiscal year, Taxpayer received or accrued Amount 3 in rents and paid or incurred Amount 4 in relevant expenses less depreciation. In the Year 3 fiscal year, Taxpayer received or accrued Amount 5 in rents and paid or incurred Amount 6 in relevant expenses less depreciation.

Taxpayer requests a ruling that income received from the Properties is income from an active trade or business and will not be considered rents under § 1.1362-2(c)(5)(ii)(B)(2). Thus, the income received from the Properties will not be passive investment income under § 1362(d)(3)(C)(i).

### Law

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation (1) has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and (2) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income.

Section 1362(d)(3)(C)(i) provides that, except as otherwise provided in § 1362(d)(3)(C), the term "passive investment income" means gross receipts derived

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from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom).

Section 1.1362-2(c)(5)(ii)(B)(1) of the Income Tax Regulations provides that, for purposes of defining “passive investment income”, “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 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. Whether significant services are performed or substantial costs are incurred in the rental business is determined based on 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 on the facts submitted and representations made, we conclude that the income Taxpayer received from Properties is considered income from an active trade or business and is not to be treated as passive investment income under § 1362(d)(3)(C)(i).

Except for the specific ruling above, we express or imply no opinion concerning the federal income tax consequences of the facts of this case under any other provision of the Internal Revenue Code. Specifically, we express or imply no opinion regarding Taxpayer’s eligibility to be an S corporation under § 1361. Further, the passive investment income rules of § 1362 are entirely independent from the passive activity rules of § 469, and we express or imply no opinion herein with respect to the applicability of § 469 to Taxpayer or Shareholders.

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, we are sending a copy of this letter to Taxpayer and its authorized representative.

Sincerely yours,

Jeanne M. Sullivan  
Senior Technician Reviewer  
Branch 3  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter  
Copy for § 6110 purposes