

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:2 - PLR-165000-02  
Date:  
April 2, 2003

X =

Properties =

D1 =

D2 =

\$x =

\$y =

Dear :

This letter responds to a letter dated November 26, 2002, and subsequent correspondence submitted by X's authorized representative on behalf of X, requesting a ruling that X's rental income from the Properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

The information submitted states that X is a corporation with accumulated earnings and profits that elected under § 1362(a) to be an S corporation effective D1. X owns, rents and manages the Properties, which are commercial, industrial and residential real estate.

Through X's eleven employees, as well as independent contractors, X provides various services to the tenants of the Properties as part of its real estate leasing and management business. These services include (not all services are applicable to all of the Properties): handling tenant requests and complaints; establishing rules and regulations for the safety, care, and cleanliness of common areas; performing regular safety and maintenance inspections; maintaining and repairing roofs, foundations, exterior and interior walls, sewers, service pipes, heating systems, air conditioning systems, and fixtures; painting; patching holes in, cleaning, and re-paving parking lots; maintaining security light fixtures and fences; landscaping and maintaining grounds; repairing casualty damage; and refurbishing (painting, reconfiguring, etc.) in connection with changes in tenants. X also has general responsibility for taxes and insurance on the Properties.

In the fiscal year ending D2, X received or accrued approximately \$x in rents and paid or incurred \$y in relevant expenses.

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 § 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).

Based solely on the facts and the representations submitted, we conclude that the rental income that X derives from Properties 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).

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. Further, we express no opinion on whether X is otherwise a valid S corporation.

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's authorized representative.

Sincerely yours,

J. THOMAS HINES  
Chief, Branch 2  
Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures: 2  
Copy of this letter  
Copy for § 6110 purposes