

**Internal Revenue Service**

**Department of the Treasury**

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:2 - PLR-114680-01  
Date:  
July 11, 2001

X =

Property =

D1 =

D2 =

D3 =

\$x =

\$y =

Dear :

This letter responds to your letter dated February 23, 2001, and subsequent correspondence submitted on behalf of X, requesting a ruling that X's rental income from the Property is not passive investment income within the meaning of § 1362(d)(3)(C)(i) and § 1375(a) of the Internal Revenue Code.

According to the information submitted, X was incorporated on D1 and is taxed as a C Corporation. X plans to elect under § 1362(a) to be an S corporation effective D2. X has accumulated earnings and profits.

X is in the business of owning and renting the Property. The Property is used as office buildings, and for light industrial use. Through its owner and an independent management company, X provides various services in operating the Property. These services include: maintaining the Property's facades, roof, down-spouts, and area fencing; maintaining the Property's plumbing, heating, air conditioning and electrical systems; making of ordinary repairs, necessary replacements, and required alterations; inspecting the Property; establishing emergency situation procedures; and maintaining a list of preferred vendors.

In addition to the services provides to tenants, X performs the usual activities involved in managing real estate. These activities include: seeking and screening prospective tenants; negotiating leases; ensuring that tenants understand and comply with lease terms; maintaining books, records, correspondence, contracts, and leases; and engaging accountants, attorneys and other professionals as necessary. In the fiscal year ending D3, X accrued approximately \$x in rents and 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 than 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 1375(a) provides that if, at the close of a taxable year, an S corporation has subchapter C earnings and profits and gross receipts more than 25 percent of which are passive investment income, a tax is imposed on the excess net passive income of the corporation.

Section 1375(b)(3) provides that the terms "passive investment income" and "gross receipts" have the same respective meanings as when used in § 1362(d)(3).

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, and the assumption that X makes a valid election to be an S corporation we conclude that under § 1.1362-2(c)(5)(ii)(B)(2) of the regulations, the rental income that X derives from Property 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) and § 1375(a) 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. Further, we express no opinion on whether X is a small business corporation eligible to make an S election.

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 X.

Sincerely yours,  
J. THOMAS HINES  
Chief, Branch 2  
Office of the Associate  
Chief Counsel  
(Passthroughs and  
Special Industries)

Enclosures: 2  
Copy of this letter  
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