

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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June 23, 1999

LEGEND

Company =

State =

d1 =

d2 =

d3 =

Shareholders =

business =

a =

b =

x =

y =

z =

address =

Dear

This letter responds to a letter dated February 26, 1999, and subsequent correspondence written by your authorized representative on behalf of Company, requesting a ruling that Company's rental income from certain rental properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

FACTS

According to the information submitted, Company was incorporated on d1 under the laws of State, and elected to be treated as an S corporation as defined by § 1361 on d2. Company, which is owned by the Shareholders, has accumulated earnings and profits. Company was formed to operate a business, but currently, Company is primarily engaged in owning and operating rental real estate. Company owns x acres of developed land with y commercial buildings (the Properties), and z acres of undeveloped land. All of Company's property is contiguous and is located at address.

Through its owners, employees and independent contractors, Company provides a variety of services to its properties. The services for which Company is responsible include but are not limited to: buildings and grounds maintenance, pest control, landscaping, contracting with architects to design rental space for tenants, and fire and hazard insurance negotiations on behalf of tenants. In the taxable year ending d3, Company received or accrued approximately \$a in rents and paid or incurred approximately \$b in non-reimbursed relevant expenses on the Properties. Company represents that it anticipates future figures to be consistent with the income and expense figures for prior periods.

LAW

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 on or 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 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 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).

After applying the relevant law to the facts submitted and the representations made, we conclude that the rent Company receives from the Properties is not passive investment income under § 1362(d)(3)(C)(i).

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding whether Company is a valid S corporation. 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.

Pursuant to a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3) of the Code, this ruling may not be used or cited as precedent.

Sincerely yours,

William P. O'Shea
Chief, Branch 3
Office of the Assistant Chief
Counsel
(Passthroughs and Special
Industries)

Enclosures (2):

Copy of this letter
Copy for § 6110 purposes