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Person to Contact:

Telephone Number:

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X =

Y =

State =

d1 =

d2 =

d3 =

A =

b =

c =

d =

e =

f =

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Dear _____ :

This letter responds to a letter dated October 27, 2002, and supplemental correspondence, submitted on behalf of X by X's authorized representative, requesting a ruling under § 1362(d)(3)(C)(i) of the Internal Revenue Code.

Facts

X was incorporated under the laws of State on d1. X elected to be treated as an S corporation for federal income tax purposes effective d2. X has accumulated earnings and profits.

X is the sole general partner of Y. Y is engaged in the business of managing and operating a commercial office building located at A. X owns a b interest in Y. X's distributive share of Y's income and expenses is b.

In the taxable year beginning d2, and ending d3, Y, through c employees, spent approximately d managing and operating the commercial office building located at A. These services included: providing janitorial services, window washing, roof maintenance, parking lot maintenance, signage installation and maintenance, security, assisting with leasehold improvements, and common area maintenance. In addition, Y handled the usual administrative functions involved in the management, operation and leasing of commercial property.

In the taxable year beginning d2, and ending d3, X's allocable share of rental income received or accrued by Y was approximately e and X's allocable share of expenses paid or accrued by Y was approximately f.

Law and Analysis

Section 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.

Except as otherwise provided in § 1362(d)(3)(C), § 1362(d)(3)(C)(i) provides that 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)(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.

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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 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 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 submitted and representations made, we conclude that X's distributive share of Y's gross receipts attributable to the rental of the commercial office building located at A does not constitute passive investment income as defined by § 1362(d)(3)(C)(i).

Except for the specific ruling above, we express or imply no opinion concerning the federal 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 X's eligibility to elect to be treated as an 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.

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, copies of this letter are being sent to your authorized representatives.

Sincerely yours,

James A. Quinn
Senior Counsel, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure

Copy of this Letter
Copy for § 6110 purposes