

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

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Date:

December 11, 2003

Company:

Shareholders:

Properties - A:

B:

C:

State:

a:

b:

c:

d:

e:

f:

g:

h:

i:

k:

Dear _____ :

This letter responds to your letter dated July 7, 2003, as well as subsequent correspondence, submitted on behalf of Company, requesting a ruling that the rental income received by Company from the Properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

FACTS

Company, a C corporation in State, intends to elect under § 1362(a) to be an S corporation effective a. Company has accumulated earnings and profits.

Company operates a warehousing business as well as owning, leasing, and managing commercial office and warehouse properties.

Through its b full-time and c part-time employees, as well as independent contractors, Company provides various services to the Properties in its real estate leasing and management activities. Regarding Property A, these services include regular property inspection, common area maintenance, maintenance of the structural portion of the property, maintenance of the heating and air conditioning facilities and equipment, landscaping and grounds maintenance, repair of any casualty damage, and review and supervision of tenant improvements. Regarding Properties B and C, the services provided by Company include regular property inspection; maintenance and repair of roofs, foundations, load-bearing walls, and all other structural components; maintenance of paved areas and fences; and review and supervision of any tenant improvements (there are no heating or air conditioning systems, no significant landscaping, no common areas, no office facilities, and no significant nonstructural improvements). In addition to the services provided to tenants, Company handles the usual leasing and administrative functions involved in managing rental real estate.

Company received or accrued approximately d in rents and paid or incurred approximately e in relevant expenses for f on Properties A and B. Company expects to have similar income and expenses on these properties for subsequent years. The lease on Property C commenced on g. The projected rental income and expense figures on Property C for h are i and k, respectively.

LAW AND ANALYSIS

Except as provided in § 1362(g), § 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.

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 and representations submitted, we conclude that the rents Company receives from the Properties are not passive investment income under § 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 Code. Specifically, we express or imply no opinion regarding Company's eligibility to be an S corporation. Further, the passive investment income rules of § 1362 are independent of the passive activity rules of § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 469.

Under a power of attorney on file with this office, we are sending the original of this letter to you and a copy to Company and to Company's other authorized representative.

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

Sincerely,

MARY BETH COLLINS
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

enclosures: copy for § 6110 purposes