

**Internal Revenue Service**

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Department of the Treasury

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Third Party Communication: None

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:3

PLR-161369-04

Date:

March 30, 2005

Company:

Shareholders:

Leases:

State:

a:

b:

Dear \_\_\_\_\_ :

This letter responds to a letter from your authorized representative dated November 4, 2004, as well as subsequent correspondence, submitted on behalf of Company, requesting a ruling that the rental income to be received by Company from Property under the Leases is not passive investment income within the meaning of ' 1362(d)(3)(C)(i) of the Internal Revenue Code.

**FACTS**

Company, a State corporation, elected under ' 1362(a) to be an S corporation effective a. It owns b acres of farmland in State (the Property). Having encountered

difficulty in hiring competent help in the past, Company intends to enter into Leases with multiple tenants to more efficiently work the Property.

Company anticipates a high level of involvement with the tenants and the farming operations. Under the Leases, Company will receive 50 percent of the income and pay 50 percent of most of the operating expenses associated with the Property. These expenses will include the cost of seeds, fertilizers, chemicals, irrigation fuel, and other supplies used by the tenants in farming the land; the cost of gas, electricity, and other public utilities furnished to the Property; the cost of any crop consultant; and all taxes on the Property. Company will furnish the irrigation equipment and well, maintain the groundwater within applicable limits, and make all repairs costing more than \$2,000. Under the leases, Company will participate in many of the critical decisions in the farming operations, such as those concerning crop pattern and rotation, fertilization levels and formula, plans for insect and weed control, soil and water usage, changes to tillage practices, variety of seeds, scheduling of repairs, marketing and delivery of crops, and government farm programs. Company's president/shareholder, a full-time employee, will be on the Property continuously for 6 months of each year and for 1 week per month for the other 6 months.

#### 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 will receive from the Property under the Leases 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 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), 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