

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:2 - PLR-110759-01
Date:
February 5, 2002

X =

LLC =

Property 1 =

Property 2 =

Property 3 =

Property 4 =

Property 5 =

Property 6 =

Property 7 =

Property 8 =

Property 9 =

D1 =

Year 1 =

\$x =

\$y =

Dear :

This letter responds to a letter dated February 14, 2001, and subsequent correspondence submitted on behalf of X, requesting a ruling that X's rental income from Property 1 through Property 9 (the Properties) is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

According to the information submitted, X was organized in Year 1 as a C corporation, and intends to elect under § 1362(a) to be an S corporation. X has accumulated earnings and profits.

X is in the business of owning, operating, and managing commercial real estate. X is a 50% owner of LLC, which is a limited liability company that is treated as a partnership for federal tax purposes. X owns Property 1 through Property 6 directly, and LLC owns Property 7 through Property 9. Under the operating agreement for LLC, the business and affairs of LLC are managed by its members. X participates in the direction, management and control of the business of LLC. Through its six full time employees and contractors, X provides various services in operating the Properties. These services include: general repairs; central heating and air maintenance; snow removal; window washing; pest control; night security; painting; and garbage removal. In addition to the services provides to tenants, X is continually searching for new tenants and negotiating new leases.

In the fiscal year ending D1, X accrued, either directly or as part of its distributive share of LLC items, 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)(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.

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)(1) of the Income Tax Regulations provides that "rents" means amounts received for the use of, or 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, 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).

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).

Based solely on the facts and the representations submitted, we conclude that the rental income that X derives from the Properties, either directly or as part of its distributive share of LLC income, is not passive investment income under § 1362(d)(3)(C)(i) or §1375(b)(3).

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. In particular, we express no opinion on whether X is a small business corporation eligible to make an S election. 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, a copy of this letter is being sent to X.

Sincerely yours,
MATTHEW LAY
Senior Technician Reviewer,
Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
Copy for § 6110 purposes