

Internal Revenue Service

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Person To Contact: _____, ID No.

Telephone Number:

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Legend

X =

M =

State =

City =

Year1 =

Year2 =

Year3 =

N1 =

N2 =

N3 =

N4 =

N5 =

N6 =

N7 =

Dear _____ :

This responds to a letter dated November 4, 2016, submitted on behalf of X by X's authorized representative, requesting a ruling that the rental income received by X from certain rental real estate is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code (the Code).

The information submitted states that X was incorporated under the laws of State in Year1. X has been taxed as a C corporation since its formation. X currently has accumulated earnings and profits of \$N1. X represents that it intends to elect to be an S corporation effective for Year2. According to the submission, X is active in the business of acquiring, developing, leasing and managing commercial real estate, concentrating in medical office suites and clinics. X's primary asset is M, located in City.

M is composed of a parcel of land situated on two contiguous lots. X acquired this parcel of land in Year1. At the time of acquisition, M was partially developed as a plaza containing N2 single-story buildings in a cottage complex along with a single two-story building, with a combined commercial office space of approximately N3 square feet. X later constructed another building to the cottage complex and a separate two-story building in M. With the addition of these two buildings, M had a combined commercial office space of approximately N4 square feet. In Year3, X finished construction of a new N5 square foot, tri-level building within M. All of the suite space comprising M is currently leased for use as medical offices and/or related services.

X contracts with an independent leasing agent to assist in soliciting prospective tenants for M, negotiating leases and renewals, and overseeing post-leasing activities such as build-outs and renovations of suite space. X, with the assistance of the independent leasing agent, drafts, proposes, presents, and negotiates letters of intent to lease available suite spaces. Negotiation for leasing regularly requires the use of an independent space planner to design and tailor the spaces for prospective tenants. Once letters of intent are accepted, X, with the assistance of the independent leasing agent, prepares, finalizes, and executes the lease agreements with prospective tenants. Renewals of leases are similarly handled by X, which are often complicated by requests for concessions and renegotiation of the leasing rate. Renewals often require significant time and attention by X.

X, through its employees, its agents, and the agents' employees, provides certain services in maintaining and repairing of the buildings, common areas, and grounds of M. X utilizes a standard lease agreement for its tenants, and under the lease agreements X has the obligation to provide certain services with respect to the leasing of space within M and to maintain or repair the following items: the heat and air

conditioning systems, plumbing, hot water heaters, exterior lighting, signs, lawn care and gardening, roofs and exterior walls, exterior walkways, courtyards, parking areas, electricity, water and sewer, drainage, and garbage pickup.

In addition, the following specific services are provided to M and its tenants by an employee or independent contractor/worker of X: daily walk-through inspections of M to report on water breaks, lighting outage, vandalism, damage to building exteriors and certain interior spaces; sweeping, cleaning and maintaining the common areas of M such as sideways, walkways, and parking lot; routine periodic inspection of building exteriors and interiors, including foundations, roofs, exterior lighting, grounds, and parking lot and engaging in maintenance and repairs as needed; treating the roofs of the buildings for moss growth yearly; recoating and resurfacing the parking lot; routine and periodic maintenance of the numerous heating and air conditioning units; renovating vacant suites for leasing; routine and periodic maintenance of the plumbing and sewer lines, and their repair and replacement as needed; maintenance, repair and replacement of exterior lighting and selected interior lighting; janitorial services for selected units and common areas; exterior window washing; regular maintenance of grounds and lawn care, and landscaping services when necessary; seasonal snow removal and ice control; weekly trash removal; periodic pest and vermin control; and emergency response and property access for public safety.

In Year3, X collected approximately \$N6 in gross rents and incurred approximately \$N7 in relevant operating expenses for the Properties.

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) shall be terminated whenever the corporation (1) has accumulated earnings and profits at the close of each of three consecutive taxable years, and (2) has gross receipts for each of such taxable 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)(iii)B(i) 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 the active trade or business of renting property only if, based

on all of 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 of 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).

Based solely on the facts submitted and the representations made, we conclude that the rental income X receives from its operations described above is not passive investment income under § 1362(d)(3)(C)(i).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code, including whether X was or is a small business corporation under § 1361(b). Further, the passive investment income rules of § 1362 are independent of the passive activity loss rules of § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 469.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code 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 X's authorized representatives.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 3
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

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