

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:DOM:P&SI:3-PLR-118370-98  
Date:  
January 19, 1999

LEGEND

Corporation =

Tenant =

Properties =

Date =

a =

b =

c =

d =

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g =

Dear

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This letter responds to your letter dated September 18, 1998, submitted on behalf of Corporation, requesting a ruling on whether Corporation's gross revenue from leasing the Properties is passive investment income under § 1362(d)(3)(C)(i) of the Internal Revenue Code.

## **Facts**

Corporation, a C corporation, owns, develops, operates, and leases commercial warehouses, office space, and real estate. Corporation currently has subchapter C earnings and profits, and expects to have subchapter C earnings and profits when it makes its S corporation election.

Corporation owns and operates Properties, which provide both warehouse and office space. The warehouse facilities of Properties include extensive storage space, including areas for cooler, freezer, and bulk dry goods storage, truck and rail doors, and distribution and printing production facilities. The Properties also contain several office suites.

Corporation currently has a tenants. The terms of Corporation's leases with these tenants vary.

Under all of the leases, Corporation is responsible for maintaining the common areas, including hallways, corridors, lavatories, lunch rooms, driveways, most truck docks, parking lots, and landscaped areas.

Under the terms of the leases applicable to the majority of the leased space, Corporation is responsible for maintaining or repairing the structural portions of the building, as well as outside maintenance, including grounds and parking areas. Under the lease with Tenant, the largest tenant, Corporation is also responsible for maintaining, repairing, and replacing, if necessary, the heating and air conditioning, plumbing, and electrical systems.

Under the terms of approximately b leases, the tenants are responsible for the maintenance, repair, and replacement of heating and air conditioning fixtures, equipment, and systems, all lighting and plumbing fixtures and equipment, fixtures, motors and machinery, all interior walls, partitions, doors and docks, and the replacement of all broken glass. The tenants are responsible for keeping and maintaining all portions of the leased premises and the sidewalk and adjoining area in a clean and orderly condition, free of accumulation of dirt, rubbish, snow, and ice. Corporation is responsible for all property taxes and utility bills under all of these leases.

The leases with c smaller tenants obligate the tenants to pay certain operating expenses. Under these lease arrangements, Corporation is responsible for repairing and maintaining the structural portions of the property and for all outside maintenance,

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including grounds and parking areas. The tenants are responsible for keeping and maintaining the property in a clean, safe, and sanitary condition. The tenants are also responsible for the maintenance, repair, and replacement, if necessary, of heating and air conditioning fixtures, equipment, and systems, all lighting and plumbing fixtures and equipment, fixtures, motors and machinery, all interior walls, partitions, doors and windows, including the regular painting thereof, all exterior entrances, windows, doors, and docks, and the replacement of all broken glass. Corporation employees perform much of the maintenance and repair work. Base rent is determined on a per foot basis with an annual minimum. In addition to the base rent, the tenants pay as additional rent a proportionate share of real estate taxes, insurance, common area charges, management costs, and certain other operating costs. The tenants are responsible for all utility expenses metered to the leased space.

Under c leases, the tenant is required to pay utilities but is responsible for no other operating expenses, including property taxes. Under these leases, Corporation is obligated to keep the property in a structurally sound working condition, including all roofs, walls, floors, ceilings, foundations, wiring, plumbing, heating, elevators, and similar equipment, except for equipment and alterations owned or made by the tenant. Corporation is also responsible for maintaining all nonstructural portions of the property in good repair and condition at its expense.

The office space leases, unless included in a lease for warehouse space, provide for fixed rent on a per foot basis with no adjustment for property taxes, normal utilities, or other operating expenses. Under these leases, Corporation, at its expense, maintains, repairs, and replaces as necessary the roof, foundation, and exterior walls of the property and those portions of the heating, air conditioning, plumbing and electrical systems located within, but not serving exclusively, the leased property. The tenants are responsible for maintaining and repairing other parts of the property.

Corporation's employees perform a variety of other services in operating the Properties. Corporation investigates prospective tenants to ensure that they are financially able to fulfill the lease terms and are otherwise appropriate lessees. This includes checking credit reports of prospective tenants, conducting interviews, and checking references. Corporation markets the Properties through advertising and public relations activities. Corporation aggressively seeks new tenants through the sales activities of its employees, and actively negotiates lease terms with these prospective tenants.

On an ongoing basis, Corporation handles tenant complaints, responds to tenant requests, and resolves disputes between tenants. Corporation maintains security systems for the Properties. The security systems and gates are checked daily. Generally, Corporation will negotiate contracts for janitorial service, trash removal, lawn care, snow removal, security services, and extermination.

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Corporation assists tenants with space utilization, serving as an outsource facilities manager for many of its tenants. These tenants often have varying space requirements on a fluctuating basis, often on short notice and/or temporarily. Corporation strives to accommodate these tenants by helping them effectively utilize their space and, if necessary, temporarily reapportioning space between tenants.

Corporation's employees and owners also engage in other usual tasks related to a warehouse/office leasing operation, including inspecting the facilities every day, arranging for financing, negotiating leases, carrying insurance on the property, reviewing insurance policies, reviewing property tax assessments and challenging them if necessary, collecting rents, and preparing financial statements.

Corporation has and continues to seek new properties for development and explores options to expand its existing properties. For example, Corporation is currently negotiating with a prospective seller to purchase another substantial commercial property to meet a current tenant's need for increased space. If this property can be acquired, Corporation will modify the structure as necessary to meet the needs of the tenant.

Corporation incurs various costs in its leasing businesses. For the d months ended Date, Corporation received or accrued a total of approximately e in gross rent and paid or incurred approximately f in relevant operating expenses on the Properties. In addition, Corporation employs g people in the management and rental process, all of whom work for Corporation on a full-time basis.

## **Analysis**

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

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costs and expenses incurred (other than depreciation).

### **Conclusion**

After applying the relevant law to the facts as represented, we rule that the rental income that Corporation receives from Properties is not passive investment income under § 1362(d)(3)(C)(i).

Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding Corporation's S corporation status under § 1362(a). 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 under § 469.

Under a power of attorney on file with this office, a copy of this ruling is being sent to Corporation.

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

Sincerely,

Jeff Erickson  
Assistant to the Chief, Branch 3  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

Copy for section 6110 purposes