

Internal Revenue Service

Department of the Treasury

Index Number: 1362.02-03

Washington, DC 20224

Number: **199933016**
Release Date: 8/20/1999

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:3-PLR-102781-99
Date:
May 12, 1999

Legend

A =

Year 1 =

Year 2 =

Date 1 =

Date 2 =

a =

b =

Dear

This letter responds to your letter dated January 21, 1999, submitted on behalf of A, requesting rulings under 1362(d)(3) and 1375(a) of the Internal Revenue Code.

Facts

A was incorporated in Year 1 to own and operate the real estate properties being used by its parent corporation in its business operations. The parent corporation was wholly owned by a sole shareholder from its inception until the death of the shareholder in Year 2. Subsequent to the death of the shareholder, the parent corporation's business was terminated. The parent corporation was merged into A, which is now

wholly owned by the estate of the shareholder. A has made an election to be taxed as

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an S corporation under Section 1362 effective for its taxable year beginning Date 1.

A is an owner-operator of commercial real estate properties. While some of the properties historically had been utilized in the parent corporation's business, additional properties were acquired and leased to third parties. In addition, subsequent to the termination of the parent corporation's business, virtually all other properties were leased to third party tenants.

A provides the following services, via its own employees and employees of affiliated entities, in connection with its properties: negotiating all leases and lease renewals; rent invoicing and collection; monitoring of tenant obligations under the leases, such as proper insurance coverage; negotiation and payment for services required by the properties; cleaning and janitorial services; construction of tenant improvements; and repairs and maintenance with respect to the properties. Under the terms of various leases, A also is responsible for maintenance and repair of the following: exterior repairs; roofs; sidewalks; plumbing systems; HVAC systems; and building systems.

A maintains an office during normal business hours to allow its tenants and outside vendors to contact A. All lease negotiations, including modifications and renewals, are handled by A's employees. A performs all lease administrative services in-house, including all billings and follow-up collection activity. In the case of delinquencies, initial collection efforts are made through A's employees, with outside counsel handling any legal actions required. All payments for property operating expenses and all accounting and bookkeeping services are performed in-house by A's employees. In addition, all required tax and administrative filings are prepared and/or coordinated by A's employees.

A incurs various costs in its leasing businesses. For the taxable year ending Date 2, A collected approximately \$a in gross rents and incurred approximately \$b in relevant operating expenses.

A has requested a ruling that its rental income from the leasing of its properties will not constitute passive investment income under sections 1362(d)(3) and 1375(a).

Analysis

Section 1362(a) allows a small business corporation, as defined in section 1361, to elect to be an S corporation. This election, however, terminates under the provisions of section 1362(d)(3) if the corporation has accumulated earnings and profits at the close of each of three 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, in general, that the term "passive investment

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income” means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales and exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom).

Section 1.1362-2(c)(5)((ii)(B)(1) 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, 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 imposes a tax on the excess net passive income of an S corporation in any year in which the corporation has accumulated earnings and profits at the close of the taxable year, and has gross receipts more than 25 percent of which are passive investment income.

Based solely on the facts as represented, we rule that A's rental income from the leasing of its properties is not passive investment income under sections 1362(d)(3) and 1375(a).

Except as specifically set forth above, no opinion is expressed as to the federal income tax consequences of the above-described facts. Specifically, we express no opinion regarding A's status as an S corporation under section 1362(a). Further, the passive investment income rules of section 1362 are completely independent of the passive activity rules of section 469; unless an exception under section 469 applies, the rental activity is passive for purposes of section 469.

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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.

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

Sincerely,

William P. O'Shea
Chief, Branch 3
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for Section 6110 purposes