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Department of the Treasury

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Date:

September 29, 2000

X =

D1 =

D2 =

Year 1 =

Year 2 =

Properties =

\$x1 =

\$y1 =

\$x2 =

\$y2 =

Dear :

This letter responds to a letter dated December 22, 1999, and subsequent correspondence written by X's authorized representative on behalf of X, requesting a ruling that X's rental income from Properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

The information submitted states that X was incorporated on D1 and elected under § 1362(a) to be an S corporation effective D2. X has accumulated earnings and profits.

X is in the business of owning, operating, and managing Properties, which are commercial rental real estate. X employs

two facilities managers and a maintenance staff of three. In addition, two corporate officers of X oversee the entire operation of the commercial real estate business.

Services that X provides with respect to Properties include janitorial services for common areas; stripe, sweep, and repair parking lots; repair roof leaks; HVAC cleaning and changing filters; landscaping and grounds maintenance; trash and snow removal; control and upkeep of signage. Not all services are provided for each property.

In Year 1 X accrued \$x1 in rents and incurred \$y1 in relevant expenses with respect to the Properties. In Year 2 X accrued \$x2 in rents and incurred \$y2 in relevant expenses with respect to the Properties.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under section 1362(a) is in effect for the taxable year.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time after the first day of the first taxable year for which corporation is an S corporation) such corporation ceases to be a small business corporation.

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 defines "rents" as 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).

Based solely on the facts and the representations submitted we conclude that under § 1.1362-2(c)(5)(ii)(B)(2) of the regulations, the rental income that X derives from Properties is income from the active trade or business of renting property and is not passive investment income as described in § 1362(d)(3)(C)(i).

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. Further, we express no opinion on whether X is a small business corporation eligible to make an S election under § 1361(b)(3).

This ruling is directed only to the taxpayer requesting 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, a copy of this letter is being sent to your first and second authorized representatives.

Sincerely yours,
J. THOMAS HINES
Acting Branch Chief, Branch 2
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2
Copy of this letter
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