

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

September 18, 2000

LEGEND

X =

Y =

Z =

Properties =

State =

Entity =

d1 =

d2 =

d3 =

SH1 =

SH2 =

Dear

This letter responds to your letter dated February 25, 2000, and subsequent correspondence on behalf of X, requesting a ruling that the income X receives from the

Properties will not be passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

FACTS

According to the information submitted, X is a State Entity organized on d1, and elected to be treated as an S corporation under § 1362(a) on d2. The owners of X are SH1 and SH2. X, which has accumulated earnings and profits, is engaged in the business of owning, leasing, operating, and maintaining commercial and residential rental real estate.

Through its employees, as well as through independent contractors, X provides various services in its rental real estate business. For residential properties, X is responsible for all maintenance, repairs, and real estate taxes. X provides many of the same services for the commercial properties. Some of the tenants pay a fee to reimburse X for these services. X treats these fees as additional rental income. In addition to the services provided to tenants, X handles the usual marketing, leasing, and administrative functions involved in leasing and managing the Properties. For the fiscal year ending d3, X received or accrued Y in rents and paid or incurred Z in relevant expenses on the Properties. X represents that it anticipates future figures to be consistent with the income and expense figures for prior periods.

LAW AND ANALYSIS

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)(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. Any termination under this paragraph shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to above.

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)(2) of the Income Tax Regulations 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).

After applying the relevant law to the facts submitted and the representations made, we conclude that the rents X receives from the Properties are not passive investment income under § 1362(d)(3)(C)(i).

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding X's eligibility under § 1361 to be an S corporation. 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.

The rulings contained in this letter are 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 request for rulings, it is subject to verification on examination. Pursuant to a power of attorney on file with this office, we are sending a copy of this letter to the taxpayer.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3) of the Code, this ruling may not be used or cited as precedent.

Sincerely yours,
Robert Honigman
Acting Assistant to the Chief, Branch 3
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

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