

**Internal Revenue Service**

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Department of the Treasury  
Washington, DC 20224

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:3 / PLR-166837-03

Date:

March 11, 2004

Company:

Shareholders:

Property:

A units:

B units:

C units:

State:

a:

b:

c:

d:

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e:f:g:h:i:k:m:

Dear ,

This letter responds to a letter from your authorized representative dated November 10, 2003, as well as subsequent correspondence, requesting a ruling that the rental income received by Company from the Property is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

Company was incorporated under the laws of State on a and elected under § 1362(a) to be an S corporation effective b. It owns, leases, and manages the Property.

Through its full-time officer-manager, as well as through independent contractors, Company provides various services to the Property in its real estate leasing and management activities. The A units, which are owned by the occupants, must be listed for sale through Company, which handles all advertising, showings, and closings. Company reviews and approves any renovations and handles the filing of permits. For the B units, also occupant-owned, Company prepares each lot for unit installation, including the digging and pouring of footers. Company hooks up plumbing and electricity for each unit; provides water and sewer; winterizes the water lines to nonoccupied units in the offseason; annually inspects units more than 20 years old; arranges for the removal of units upon their replacement or upon the withdrawal of the site lessees; and establishes and reviews design requirements for replacement units, which must be custom built. Company owns the C units, which it furnishes and fully maintains, and for which it supplies all utilities. For the entire Property, Company staffs its onsite office year-round, with the manager available 24 hours a day, 7 days a week to deal with problems and emergencies. The office facility, with copiers and fax machines, is accessible to Property occupants. Company maintains all common areas,

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including the beach, a wooden waterfront walkway, boat moorings, grounds and landscaping, roads, and streetlights. It provides trash cans and trash removal. Company constructed and maintains bicycle sheds for the use of occupants. It provides outdoor furniture and equipment for occupant use, such as lounge chairs, picnic tables, and gas grills. It coordinates summer holiday block parties and publishes and distributes newsletters and notices. In addition to the services provided to tenants, Company handles the usual leasing and administrative functions involved in managing rental real estate.

Company received or accrued approximately c in rents and paid or incurred approximately d in relevant expenses for e on the Property. The rental income and expense figures for f are g and h, respectively. The rental income and expense figures for i are k and m.

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) terminates whenever the corporation (I) has accumulated earnings and profits at the close of each of three consecutive tax years, and (II) has gross receipts for each of such tax 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)(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 costs and expenses incurred (other than depreciation).

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Based solely on the facts and representations submitted, we conclude that the rents Company receives from the Property are not passive investment income under § 1362(d)(3)(C)(i).

Except for the specific ruling above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding the validity of Company's election to be an S corporation. Further, the passive investment income rules of § 1362 are independent of the passive activity rules of § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 469.

Under a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

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

Sincerely,

/s/

JAMES A. QUINN  
Senior Counsel, Branch 3  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

enclosures: copy for § 6110 purposes

cc: