

## Internal Revenue Service

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CC:PSI:B01

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Date:

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### Legend:

X =

A =

State =

Properties =

a =

b =

c =

d =

e =

f =

D1 =

D2 =

D3 =

D4 =

Dear

This responds to your letter dated April 26, 2005, submitted on behalf of X, requesting a ruling that the rental income received by X from renting Properties is not passive investment income within the meaning of § 1362(d)(3) of the Internal Revenue Code.

#### Facts

The information submitted states that X was incorporated in State on D1. X made an election to be treated as an S corporation under § 1362(a) effective D2. X has accumulated earnings and profits. X is engaged in the business of owning and operating rental real estate.

A, X's president, represents that X provides various services to Properties. The services provided by X in operating Properties include, but are not limited to the following. Identifying new tenants; negotiating all leases, renewals, and other agreements with tenants; collecting all rents and other amounts due under the leases; communicating with tenants on all issues relating to the management and operation of Properties including maintenance and repairs; paying for water and sewage services; removing garbage, rubbish and snow from the common areas; providing and maintaining the interior and exterior of Properties, including but not limited to, maintenance and repairs on the roofs, canopies, external walls, concrete floors, structural foundation, gutters, downspouts, plumbing, parking lots, light fixtures in the parking lots, sidewalks, curbs, and air conditioning and heating; landscaping and maintenance of grounds; providing storage; repairing and maintaining tenant plumbing; providing heating and air conditioning at the apartment complexes; supervision of all development and construction on Properties; handling suggestions, service needs and complaints of the tenants; providing janitorial services; providing security; monitoring and inspection of Properties; paying taxes; and maintaining insurance on Properties. In addition to the independent contractors retained by X, X has a full-time and b part-time employees.

For the tax year ending D3, X received \$c in rental income and paid or incurred \$d in relevant operating expenses. For the tax year ending D4, X received \$e in rental income and paid or incurred \$f in relevant operating expenses.

### Law and Analysis

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.

Section 1375(a) imposes a tax on the income of an S corporation if the S corporation has (1) accumulated earnings and profits at the close of such taxable year, and (2) gross receipts 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 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 facts and circumstances, the corporation provided 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).

### Conclusion

Based solely on the facts and representations submitted, we conclude that the rental income X receives from Properties is income from the active trade or business of renting property, and is not passive investment income under § 1362(d)(3)(C)(i).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts of this case under any other provisions of the Code. Specifically, no opinion is expressed concerning whether X otherwise satisfies the S corporation eligibility requirements under § 1361. 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.

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 X's authorized representative.

Sincerely,

Audrey Ellis

Audrey Ellis  
Senior Counsel, Branch 1  
Office of Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter;

Copy for § 6110 purposes