

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

January 8, 2001

Legend:

X =

State =

D1 =

D2 =

D3 =

D4 =

Property A =

Property B =

Property C =

Property D =

Property E =

\$a =

\$b =

:

This responds to your representative's letter dated August 14, 2000, together with subsequent correspondence, submitted on behalf of X, requesting a ruling that the rental income received by X from renting certain properties will not constitute passive investment income within the meaning of section 1362(d)(3) of the Internal Revenue Code.

FACTS

X was incorporated in State on D1. X anticipates making an election to be treated as an S corporation for its taxable year beginning D2.

X owns Property A, Property B, Property C, Property D, and Property E (the "Properties"), all of which are commercial facilities. The duties of X's officers, employees, and associates include the following with respect to the leasing of most of the Properties: negotiate and sign leases; settle tenant disputes; evaluate backgrounds of prospective tenants; conduct regular inspections of property; negotiate and contract for insurance coverages; oversee rental collections; monitor overall security;

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communicate to prospective tenants; arrange for pest control; inspect roofs, drainage systems, and exterior walls for repair; perform plumbing, electrical and carpentry maintenance; maintain common areas; and hire and monitor subcontractors as needed for repairs. Not all services are provided to all of the tenants in the Properties. In particular, X does not provide significant services for Property E.

From D3 to D4, X received or accrued \$a in rental income and paid or incurred \$b in relevant expenses with respect to the Properties. X represents that these figures are consistent with the income and expense figures for prior periods and expects the figures for future years to be comparable.

LAW AND ANALYSIS

Except as provided in section 1362(g), section 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of section 1362, to be an S corporation.

Section 1362(d)(3)(A)(i) provides that an election under section 1362(a) shall be terminated 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 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).

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Section 1.1362-2(c)(5)(ii)(B)(4) provides that rents do not include compensation, however designated, for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the taxpayer, if during the taxable year the taxpayer is engaged in substantial development, manufacturing, or production of real or tangible personal property of the same type.

CONCLUSION

Some of X's rental income is net lease income, which is generally passive investment income. However, X's net lease income is an incidental part of X's active rental business and will not be treated as passive investment income. Accordingly, after applying the law to the facts submitted and the representations made, we conclude that the rental income X receives from Properties A, B, C, D and E is not passive investment income under section 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 provision of the Code. Specifically, no opinion is expressed concerning whether X otherwise satisfies the S corporation eligibility requirements under section 1361. 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 remains passive for purposes of section 469.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,
/s/Matthew Lay
Assistant to the Branch Chief, Branch 1
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

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