

Internal Revenue Service

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Person To Contact:

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Telephone Number:

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Date:
March 20, 2008

Legend:

X =

Year 1 =

Year 2 =

State =

Date 1 =

Property 1 =

Property 2 =

Property 3 =

\$M =

\$N =

Dear _____ :

This letter is in response to your letter, on behalf of X, dated October 5, 2007, requesting a ruling that X's rental income from Property 1, Property 2, and Property 3 is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

Facts

The information submitted states that X was incorporated in Year 1 in accordance with the laws of State. X intends to elect to be an S corporation effective Date 1. On Date 1, X expects to have accumulated earnings and profits from prior years.

X owns Property 1, Property 2 and Property 3 (collectively, "the Properties"). Property 1 and Property 2 are commercial real estate properties that are leased to tenants. Property 3 is a residential real estate property, also leased to tenants. X, through its employees or independent contractors, provides certain services with respect to the leasing of the Properties. These services involve maintaining and repairing the buildings, appurtenances, and grounds of the Properties, including cleaning, painting, electrical, plumbing, roof and structural maintenance, HVAC, trash and snow removal, landscaping services, and extermination services.

In Year 2, X collected approximately \$M in gross rents and incurred approximately \$N in relevant operating expenses.

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)(3)(A)(i) provides that an S corporation election shall be terminated whenever the corporation (I) has accumulated earning and profits at the close of each of 3 consecutive taxable years, and (II) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income. The termination is effective on and after the first date of the first taxable year beginning after the third consecutive taxable year referred to in § 1362(d)(3)(A)(i). Section 1362(d)(3)(A)(ii).

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 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) defines “rent” 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 the term “rents” does not include rents derived in the active trade or business of renting property. Rents 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 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 that X derives from the Properties is not passive investment income as described in §1362(d)(3)(C)(i).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether X is a small business corporation eligible to make an S corporation election. 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.

Pursuant to the power of attorney on file with this office, a copy of this letter will be sent to the taxpayer's representative.

Sincerely,

/s/

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

Enclosures (2)

Copy of this letter

Copy of this letter for § 6110 purposes

cc: