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December 21, 1999

LEGEND:

X =

D =

m =

n =

o =

a =

b =

c =

d =

e =

f =

Dear

This letter responds to a letter, dated October 11, 1999, written on behalf of X, requesting a ruling under § 1362(d)(3) of the Internal Revenue Code that X's rental income from residential real properties is not passive investment income.

FACTS

X is a former C corporation that elected S status effective D. X owns, rents and manages m residential real properties.

X employs n full-time employees (o in the summer) to maintain its residential rental properties. The services provided by these employees include inspection, general repair and maintenance, lawn mowing, plumbing and electrical work, and repair and replacement of doors, windows, water heaters, sinks, bath tubs and toilets. X also hires independent contractors to do interior and exterior painting, landscaping and snow removal, carpet cleaning, plastering, roofing, and driveway, step and stoop improvements.

X also employs a president, treasurer, property and lease administration manager (Manager) and an assistant to the Manager. The Manager's duties include ensuring rental payments are timely paid, overseeing lease terms, expirations and renewals, handling tenant problems, initiating and overseeing evictions, advertising, ordering credit checks, and filling vacancies.

X received or accrued approximately a in rents and paid or incurred approximately b in relevant expenses for period c. The comparable figures for period d are e and f. X represents that these figures are consistent with the income and expense figures for prior periods.

LAW AND ANALYSIS

Section 1362(d)(3)(A)(i) provides that an S corporation election shall be terminated whenever the corporation (I) has accumulated earnings 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.

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 the 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 the types and amounts of costs and expenses incurred (other than depreciation).

CONCLUSIONS

After applying the law to the facts submitted and the representations made, we conclude that the rents X receives from the residential rental properties will not be 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 described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is an S corporation for federal tax purposes. 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 who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Under the power of attorney on file with this office, a copy of this letter will be sent to your authorized representative.

Sincerely yours,

William P. O'Shea
Chief, Branch 3
Office of the Assistant Chief
Counsel
(Passthroughs and Special
Industries)

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