

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:1-PLR-112354-99

Date:

October 8, 1999

Legend

Company =

D1 =

D2 =

Year =

State =

Properties =

p =

\$q =

\$r =

This letter responds to your letter dated July 7, 1999, together with subsequent correspondence, submitted on behalf of Company, requesting a ruling that the rental income received by Company from certain properties is not passive investment income within the meaning of section 1362(d)(3)(C)(i) of the Internal Revenue Code.

Facts

Company was incorporated in State on D1. Company is engaged in the business of holding, leasing, and managing real estate. Company owns two parcels of commercial real estate (the Properties), consisting of land and buildings which it leases to third party tenants. Company anticipates making an election to be treated as an S corporation for its taxable year beginning D2.

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Company conducts regular inspections of the Properties, and is responsible for maintaining the roofs, exterior walls, heating and air conditioning systems, plumbing, foundations, and structures of the Properties. Company maintains fire and casualty insurance on the Properties. Company reviews and supervises all tenant alterations, additions, or improvements to the Properties. Company pays all property taxes, reviews property tax assessments, and pursues property tax appeals where appropriate. Company markets the Properties to potential tenants, evaluates potential tenants, and negotiates leases relating to the Properties and any amendments or extensions of such leases. Company maintains all financial and accounting records relating to the Properties.

The president of Company is involved in all material decisions regarding the leasing and management of the Properties. The president's services required approximately p hours per month in Year. Company hires outside contractors to fulfill some of its maintenance obligations, such as roof repairs, glass and door installation and repairs, flooring installation and repairs, plumbing and heating repairs, and fire system maintenance and repairs.

Company received or accrued approximately q in rents and paid or incurred approximately r in relevant expenses with respect to the Properties for Year.

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) 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 subparagraph (C), section 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.

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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).

Conclusion

Based solely on the facts as presented in this ruling request, and viewed in light of the applicable law and regulations, we conclude that the rents Company receives from the Properties is not passive investment income under section 1362(d)(3)(C)(i).

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding Company's eligibility under section 1361 to be an S corporation. 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.

In accordance with the 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 section 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,
Signed/Daniel J. Coburn
Daniel J. Coburn
Assistant Branch Chief, Branch 1
Office of the Assistant Chief Counsel
(Passthroughs and Special Industries)

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