

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

December 13, 2000

X =

Properties=

A =

D1 =

D2 =

w =

Y =

z =

City =

Dear :

This letter responds to your letter dated July 27, 2000, and subsequent correspondence, submitted on behalf of X, requesting a ruling that rents received by X will not constitute "passive investment income" within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

The information submitted states that X is currently a C corporation and intends to make an election to be an S corporation effective D1. X has accumulated earnings and profits. Currently, X owns, manages, and leases Properties in City.

X has w employees, including its officers. A, as X's vice-president, represents that X provides the following services through its employees: seeking out qualified potential tenants; performing applicant background investigations; negotiating leases; collection and administration of security deposits; ensuring tenants understand and comply with the lease terms and rules and regulations; ongoing tenant relations and communication; collection of rents which are due on a weekly basis; bad debt collection efforts, including eviction of non-paying tenants; supplying utilities (by maintaining all individual apartment electric and gas accounts in X's name); performing all repairs necessary to resolve tenant complaints; performing regular property inspections of the inside of

apartments as well as the common grounds; providing and overseeing property improvements; providing maintenance and repair of parking areas, pavement, sidewalks, landscaping, and sprinkler systems, exterior lighting, grounds maintenance, windows, doors and locks, cabinetry, stoves and smoke detection devices; arranging for the pickup and removal of trash and tenants' abandoned personal property; providing for and maintaining water plumbing, sewage and propane gas systems; painting of exterior of buildings, as well as interior units when tenants vacate; making major repairs to buildings, as well as interior units when tenants vacate; making major repairs to buildings, including roofs, structural components, facades and electrical systems; and providing off-duty policemen to patrol the residential area for security purposes.

For its taxable year ending on D2, X accrued approximately \$y in rents and incurred approximately \$z in operating expenses for Properties.

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 income.

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 1.1362-2(c)(5)(ii)(B)(1) of the Income Tax Regulations defines "rents" 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).

Based solely on the facts and representations submitted, we conclude that X's receipts from leasing Properties are not passive investment income under § 1362(d)(3)(C)(i).

The ruling in this letter is based on information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for ruling, it is subject to verification on examination.

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

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X.

Sincerely yours,

JEANNE M. SULLIVAN  
Assistant to the Chief  
Branch 2  
Office of the Associate  
Chief Counsel  
(Passthroughs and  
Special Industries)

Enclosure: 2  
Copy of this letter  
Copy for § 6110 purposes