

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

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Telephone Number:

Refer Reply To:

CC:DOM:P&SI:2-PLR-102431-00

Date:

May 25, 2000

X =

Y =

A =

\$o =

Dear :

This letter responds to a January 20, 2000 ruling request and subsequent correspondence submitted on behalf of X by X's authorized representative requesting a ruling that X's rental income 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 incorporated on January 27, 1994, for the purpose of refurbishing, owning, operating, and managing residential real estate. X is currently a C corporation and proposes to elect to be an S corporation. X has C corporation accumulated earnings and profits.

X currently owns four apartment buildings (Properties) containing 27 residential apartment units. Each of these units is leased to independent third-party tenants by way of a written lease agreement. X has not rented any unit to any tenant on a net lease basis. X is responsible for substantially all of the responsibilities that derive from real estate ownership and management. For example, X is responsible for property insurance, all common area cleaning, janitorial, lawn care, landscaping and snow removal requirements, repair and maintenance

(including repair of roofs, sidewalks, parking lots and roadways) pest control, appliance replacement, rubbish collection, periodic property inspections, specialized tenant services and community relations.

X has contracted with Y, a related property management agent, for Y to provide the services for which X is responsible. A, the president of X, represents that the charges X pays to Y under the management contract are commercially reasonable and reasonably typical of the commercial charges of other providers of similar services. Y maintains a staff of five full-time employees, including one property manager, two maintenance employees, and two managerial personnel. Y performs services and activities directly through its employees or indirectly through independent contractors.

X's gross rental income for the 1999 taxable year totaled \$n and its related expenses (excluding depreciation) totaled \$o.

Section 1362(d)(3)(C)(i) of the Code 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 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) of the regulations provides that "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 information submitted and the representations made, we conclude that X's receipts from renting Properties are not passive investment income under § 1362(d)(3)(C)(i).

Except as specifically set forth above, we express no

opinion as to the federal tax consequences of the transaction described above under any other provision of the Code. Further, we express no opinion concerning the validity of X's election under § 1362(a) to be an S corporation, or X's qualification to be a small business corporation eligible to make an S election.

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 the power of attorney on file, a copy of this letter is being sent to X's authorized representative.

Sincerely yours,

H. GRACE KIM  
Assistant to the Chief  
Branch 2  
Office of the Assistant  
Chief Counsel  
(Passthroughs and Special  
Industries)

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