

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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December 29, 1999

X =

Sub1 =

Sub2 =

D1 =

Year 1 =

Property 1 =

Property 2 =

Property 3 =

\$x =

\$y =

Dear :

This letter responds to your letter, dated August 25, 1999, and subsequent correspondence, requesting a ruling that X's rental income from certain real property is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

The information submitted states that X is a closely held property holding company. X is the sole shareholder of Sub1 and Sub2. X will elect under § 1362(a) to be an S corporation

effective beginning with its Year 1 taxable year. X will elect to treat Sub1 and Sub2 as qualified subchapter S subsidiaries, also effective beginning with the Year 1 taxable year. X, Sub1, and Sub2 have accumulated earnings and profits.

X owns and operates Property 1, an industrial property. Sub2 owns and operates Property 2 and Property 3, both parking lots located across the street from Property 1. Sub1 is the administrative management entity for X and does not own any property. X leases Property 1 to tenants and Sub2 leases parking area to tenants of Property 1 as well as to a transportation corporation located adjacent to the parking lots.

X, Sub1, and Sub2, directly and through contractors, provide various services in operating Property 1, Property 2, and Property 3. These include maintaining and repairing Property 1's roof, structural foundation, sewers, service pipes, plumbing, and electrical services and fixtures; patching holes in the parking lot pavement of Property 2 and Property 3; maintaining the light fixtures and the fencing around Property 2 and Property 3; employing a licenced real estate agent to assist in determining rents and finding tenants; negotiating leases with new and current tenants; removing hazardous materials for tenants; and performing safety and maintenance inspections.

For the taxable year ending D1, the consolidated income statement of X, Sub1, and Sub2 shows \$x in rents derived from Property 1, Property 2, and Property 3 and \$y in relevant expenses not including depreciation. X employs a full time president, and part-time chief financial officer, and secretary.

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) of the Income Tax Regulations defines "rents" 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 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).

Based solely on the information submitted and the representations made, we conclude that the gross receipts that X derives from X's and Sub2's business of renting Property 1, Property 2, and Property 3 are income from the active trade or business of renting property and 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 on whether X is a small business corporation eligible to make an S corporation election or on whether Sub1 and Sub2 are eligible to be treated as qualified subchapter S subsidiaries under § 1361(b)(3) of the Code.

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.

Sincerely yours,

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

Enclosures: 2
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