

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:2 - PLR-104671-01

Date:

August 28, 2001

X =

Properties =

D1 =

D2 =

Year 1 =

\$x =

\$y =

Dear :

This letter responds to a letter dated January 15, 2001, and subsequent correspondence written by X's authorized representative on behalf of X, requesting a ruling that X's rental income from the Properties 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 was incorporated in Year 1, and has been taxed as a C corporation. X intends to elect under § 1362(a) to be an S corporation effective D1. X has accumulated earnings and profits.

X is in the business of renting the Properties, which are commercial and residential real estate. Through its owner-employees and subcontractors, X provides various services in operating the Properties. These services include: maintain and

repair Properties' roofs, HVAC systems, plumbing systems, water systems, electrical systems, foundations, parking lots, and sidewalks; provide landscaping and pest control; maintain and repair signage; maintain fire and casualty insurance on Properties; and provides 24 hour, seven days a week on call property management.

In addition to the services provided to tenants, X performs the usual activities involved in managing real estate. These activities include: market Properties to potential tenants through local media; negotiate new, amended, or extended leases; collect rental payments, and initiate and oversee tenant evictions. In the fiscal year ending D2, X received or accrued approximately \$x in rents and paid or incurred \$y in relevant expenses.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(d)(3)(A) provides that an election under § 1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and has gross receipts for each of such taxable years more than 25 percent of which are passive investment income. Any termination under this paragraph shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to above.

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)(2) of the Income Tax Regulations 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 facts and the representations submitted, and the assumption that X makes a valid election to be an S corporation, we conclude that under § 1.1362-2(c)(5)(ii)(B)(2) of the regulations, the rental income that X derives from Properties is income from the active trade or business of renting property and is not passive investment income as described in § 1362(d)(3)(C)(i) of the Code.

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 election.

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.

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

Sincerely yours,
J. THOMAS HINES
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

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