

Internal Revenue Service

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Person to Contact:

Telephone Number:

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Date:

December 6, 2001

X =

State =

A =

Partnerships =

Management =

Properties =

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D1 =

D2 =

\$z =

\$y =

Dear :

This responds to a letter dated December 1, 2000, and subsequent correspondence submitted 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) and 1375(b)(3) of the Internal Revenue Code.

The information submitted states that X was incorporated under State law on D1, and plans to elect under § 1362(a) to be an S corporation. X has two shareholders, A and B. X has accumulated earnings and profits.

X is engaged in the business of owning and operating commercial rental real estate (office and industrial buildings). X owns interests in the properties either directly or through the Partnerships. X has a general partnership interest and limited partnership interest in the Partnerships.

Management, a corporation owned equally by A and B, manages the Properties, as well as other rental properties owned by corporations related to X. In addition, X retains various independent contractors to provide services with respect to the properties.

Through Management and contractors, the services provided by X include (not all services are provided to all properties): maintaining exterior areas, including policing of grounds, window washing, painting, roofing, landscaping, parking areas, and driveways areas; maintaining heating, cooling, lighting, and electrical systems; and providing janitorial and scavenger services.

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In addition to the services X provides to tenants, X, through Management, performs the usual leasing and administrative activities involved in managing real estate. These activities include: collecting rents, including taking legal action against delinquent tenants; collecting and analyzing rental market information; reviewing prospective tenants; drafting individual leases; reviewing and approving tenant improvements; and providing on call emergency services.

In the fiscal year ending D2, X, either directly or as part of its distributive share of the Partnerships' items, accrued approximately \$z in rents and incurred approximately \$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)(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.

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 1375(a) provides that if, at the close of a taxable year, an S corporation has subchapter C earnings and profits and gross receipts more than 25 percent of which are passive investment income, a tax is imposed on the excess net passive income of the corporation.

Section 1375(b)(3) provides that the terms "passive investment income" and "gross receipts" have the same respective meanings as when used in § 1362(d)(3).

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 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

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amounts of costs and expenses incurred (other than depreciation).

Based solely on the facts and the representations submitted, we conclude that the rental income that X derives from the 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) and 1375(a).

Except as specifically set forth above, we express no opinion as to the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express no opinion on whether X is a small business corporation eligible to make an S election. 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 purposes of § 469.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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
Associate Chief Counsel
(Passthroughs and Special Industries)

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