

Internal Revenue Service

Department of the Treasury

Index Number: 1362.02-03

Washington, DC 20224

Number: **199924011**

Person to Contact:

Release Date: 6/18/1999

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:3 PLR-120778-98

Date:

March 16, 1999

Company:

Properties

State:

City:

a:

b:

c:

d:

e:

f:

g:

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h:

i:

Dear

This letter responds to your letter dated November 6, 1998, as well as subsequent correspondence, submitted on behalf of Company, requesting a ruling that the rental income received by Company from the Properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code. Company represents the following facts.

Company was incorporated in State on a to acquire, develop, lease, and manage commercial real estate (the Properties), all located in City. Company intends to elect under § 1362(a) to be an S corporation effective b.

Through Company's c part-time employees and a family member associate who is paid a fee, as well as through independent contractors, Company provides various services in its real estate leasing and management business. Regarding Properties 1-10, Company performs such services as regularly monitoring and inspecting the premises, analyzing specific property needs, and completing all necessary repairs; maintaining and repairing the parking lots; handling emergency trouble and repair calls during nonbusiness hours, weekends, and holidays; closely supervising and inspecting all work by independent contractors; inspecting and maintaining the roofing and structural components of the buildings, as well as the building heating, ventilation, air conditioning systems; constantly monitoring overall facility security and taking necessary actions; and monitoring the success of its tenant business and intervening if a tenant experiences business difficulties.

Regarding Property 11, which is part of a condominium project, Company performs such services as regularly monitoring and inspecting the premises; as well as handling emergency trouble and repair calls during nonbusiness hours, weekends, and holidays. A property owners' association, funded by monthly dues paid by each owner (including Company), provides such services as parking lot upkeep, water and sewer service, trash removal, exterior building maintenance and renovation, security services, landscaping, and pest control.

In addition to the services provided to tenants, Company handles the usual marketing, leasing, and administrative

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functions involved in leasing and managing the Properties.

For d, Company received or accrued approximately e in rents and paid or incurred approximately f in relevant expenses on the Properties. The comparable figures for g are h and i.

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 investment income.

Except as otherwise provided in subparagraph (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 provides that "rents" means 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 "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 as presented in this ruling request, and viewed in light of the applicable law and regulations, we conclude that the rents Company receives from the Properties will not be passive investment income under § 1362(d)(3)(C)(i).

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Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding Company's eligibility under § 1361 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 purposes of § 469.

In accordance with the power of attorney on file with this office, we are sending you the original of this letter and a copy to Company.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

DONNA M. YOUNG
Senior Technician Reviewer,
Branch 3
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

encl: copy for § 6110 purposes