

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:1-PLR-102933-00
Date:
Feb 15, 2000

Legend:

X =

Y =

Z =

A =

B =

C =

State =

D1 =

D2 =

D3 =

b =

c =

This responds to your letter dated January 27, 2000, submitted on behalf of X, requesting a ruling that the rental income received by X from renting certain properties is not passive investment income within the meaning of section 1362(d)(3)(C)(i) of the Internal Revenue Code.

FACTS

X was incorporated in State on D1. X anticipates making an election to be

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treated as an S corporation for its taxable year beginning D2.

X owns Y, residential rental property in State. X is also a partner in three partnerships, A, B, and C, which own commercial rental properties in State. Each of X, A, B, and C employs Z to manage its respective rental properties. Through Z and through various independent contractors, each of X, A, B, and C provide services to its respective rental properties. Services provided in the last year include property inspection, grounds maintenance and general upkeep. Z also handles the usual leasing and administrative functions involved in overseeing the management of real estate.

Through its residential property, Y, and through its interests in A, B, and C, X received or accrued approximately b in rents and paid or incurred approximately c in relevant expenses in D3 for its residential property.

LAW AND ANALYSIS

Except as provided in section 1362(g), section 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of section 1362, to be an S corporation.

Section 1362(d)(3)(A)(i) provides that an election under section 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), section 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

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limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

CONCLUSION

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 X receives from the rental of its residential property, Y, and from its interest in the rental of commercial properties owned by A, B, and C, are not passive investment income under section 1362(d)(3)(C)(i).

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed concerning whether X otherwise satisfies the S corporation eligibility requirements under section 1361. Further, the passive investment income rules of section 1362 are completely independent of the passive activity rules of section 469; unless an exception under section 469 applies, the rental activity remains passive for purposes of section 469.

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.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

Sincerely,
David R. Haglund
Senior Technician Reviewer, Branch 1
Office of Assistant Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter
Copy for section 6110 purposes