

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
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Legend

X =

D1 =

D2 =

Y1 =

Y2 =

Property 1 =

Property 2 =

Property 3 =

\$a =

\$b =

\$c =

\$d =

Dear :

This responds to your letter dated, October 2, 2001, together with subsequent correspondence, in which you requested a ruling that X's rental income from certain properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

Facts

X, a C corporation, was incorporated on D1 and anticipates making an election to be treated as an S corporation for its taxable year beginning D2. X has C corporation earnings and profits.

X owns Property 1, Property 2, and Property 3 (the properties), which are all commercial facilities, and receives income from the rental of the properties. X's duties with respect to the properties includes: securing tenants; preparing and administering lease agreements; maintaining common spaces; maintaining the structural portions of the property; landscaping and grounds maintenance; and repairing casualty damage. Tenants pay certain amounts as "additional rent" to reimburse X for expenses incurred in performing some of its duties. X employs a full-time vice-president/treasurer, a full-time contract manager, a part-time accountant, and two part-time property coordinators for the properties.

X's income from the properties during Y1 totaled \$a and its nonreimbursed expenses related to the properties totaled \$b. X's income from the properties during Y2 totaled \$c and its nonreimbursed expenses related to the properties totaled \$d. X expects to have similar income and expenses during subsequent years.

Law and Analysis

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

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated 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.

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 sale 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 a corporation. Section 1.1362-2(c)(5)(ii)(B)(2) provides that the term "rents" does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in 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 personnel employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Section 1375(a) of the Internal Revenue Code provides that if for the taxable year an S corporation has (1) accumulated earnings and profits at the close of the taxable year, and (2) gross receipts more than 25 percent of which are passive investment income, then a tax is imposed on the income of the corporation for such

taxable year. Such tax shall be computed by multiplying the excess net passive income by the highest rate of tax specified in section 11(b).

Conclusion

Based solely on the representations made and the information submitted we conclude that X's rental income from the properties, received during Y1 and Y2, is not passive income under § 1362(d)(3)(C)(i).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed regarding X's eligibility under § 1361 to be an S corporation or regarding whether X's rental income is passive income under § 469.

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

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