

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

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February 28, 2001

Legend

- X =
- D1 =
- Year =
- Property 1 =
- Property 2 =
- Property 3 =
- Property 4 =
- a =
- b =

This responds to a letter dated November 20, 2000, together with subsequent correspondence, submitted on behalf of X, requesting a ruling that the rental income received in the course of its operations does not constitute passive investment income within the meaning of section 1362(d)(3)(C)(i) of the Internal Revenue Code.

Facts

X is a C corporation. X anticipates making an election to be treated as an S corporation for its taxable year beginning DI.

X owns Property 1, Property 2, and Property 3, which are commercial properties, as well as Property 4 (the "Properties").

X provides various services to the Properties. Services provided in the last year include leasing, managing, maintaining and repairing the property, providing pest

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control, janitorial service, window cleaning, trash collection, and landscaping. X handles the usual leasing and administrative functions involved in overseeing the management of real estate. In addition, X is responsible for major remodeling projects.

In Year, X received or accrued a in rents and paid or incurred b in relevant expenses on the Properties.

### 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 a subchapter 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 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 section 1362(d)(3)(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 the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

### Conclusion

After applying the law to the facts submitted and representations made, we conclude that the rental income X receives from Properties 1, 2, 3, and 4 is not passive investment income under section 1362(d)(3)(C)(i).

Except as expressly provided herein, no opinion is expressed or implied

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concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed regarding 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 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 your authorized representative.

Sincerely,  
Matthew Lay  
Assistant to the Branch Chief, Branch 1  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

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