



a ruling that X's rental income from LLC is not passive investment income within the meaning of § 1362(d)(3)(C)(i).

The information submitted states that X was incorporated in State on Date 1. X elected to be treated as an S corporation effective Date 1.

X owns an interest in LLC, which is treated as a partnership for federal tax purposes and is in the business of renting real property to tenants. X represents that as a managing member of LLC, it is responsible for managing the properties owned by LLC. As of Date 3, X represents LLC owns a.

X has approximately b employees, of which c provide services on behalf of LLC. X represents that it provides various services. Services provided by X include but are not limited to, the following: renovating and remodeling spaces to suit new tenants; cleaning and making spaces ready for new tenants; inspecting spaces for safety and proper maintenance; maintaining physical security; cleaning and repairing common areas; landscaping and maintaining the grounds; maintaining the heating, air conditioning, ventilation, plumbing, wastewater, and electrical systems; hiring, supervising and compensating outside vendors and service providers; supplying tenant amenities; supplying and making available discounts and special offers from area merchants; providing marketing services to merchant tenants.

In taxable year ending Date 3, LLC received or accrued approximately \$y in rents, which includes any reimbursements by tenants for insurance, property taxes, expenses for maintaining common areas and promotional fees paid by LLC. LLC paid or incurred approximately \$z in relevant expenses other than depreciation.

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)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

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. Any termination under this paragraph shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to above.

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 1.1362-2(c)(5)(ii)(B)(2) of the Income Tax Regulations 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 and the representations submitted we conclude that the rental income that X derives from the LLC is not passive investment income as described in § 1362(d)(3)(C)(i).

Except as specifically set forth above, we express no opinion as to the federal tax consequences of the transaction described above 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 section § 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) of the Code provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Audrey W. Ellis  
Senior Counsel, Branch 1  
(Passthroughs & Special Industries)

Enclosures (2)

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