Internal Revenue Service

Department of the Treasury

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Person to Contact:

Number: **200008027**
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November 29, 1999

LEGEND

Company =

d1 =

d2 =

d3 =

d4 =

V =

W =

X =

Y =

Z =

State =

Sub =

Partnership Interests =

Properties =

Dear

This letter responds to your letter dated May 27, 1999, and subsequent correspondence on behalf of Company, requesting a ruling that the rental income that Company receives from the Properties will not be passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

FACTS

According to the information submitted, Company, an S corporation with accumulated earnings and profits, was incorporated on d1 in State, and elected on d2 under § 1362 to be taxed as an S corporation.

Company is in the business of constructing, owning, managing, and developing the Properties, which are rental real estate. Company owns and operates these properties directly, through Sub (its wholly owned subsidiary) and through various partnerships (the Partnerships) in which it owns interests. Company's employees are involved in all aspects of Company's real estate leasing and management business. Through its V full-time employees, and through independent contractors, Company provides various services to the Properties. Among the services provided (though the same services are not necessarily provided to all properties) are building repair and renovation, landscaping, snow removal, parking lot maintenance, janitorial services, painting, security and 24-hour emergency assistance.

For the fiscal year ending d3, Company received or accrued W in rents and paid or incurred X in relevant expenses on the Properties. The comparable figures for the fiscal year ending d4 are Y and Z respectively.

LAW AND ANALYSIS

Section 1362(a) provides that except as provided in § 1362(g), a small business corporation may elect to be an S 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 702(a) provides, in part, that in determining his income tax, each partner

shall take into account separately his distributive share of the partnership's items of gain, loss, deduction, and credit to the extent provided by the regulations.

Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partnership's distributive share under paragraphs (1) through (7) of § 702(a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Section 1.702-1(a)(8)(ii) of the Income Tax Regulations provides that each partner must take into account separately his distributive share of any partnership item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately.

Revenue Ruling 71-455, 1971-2 C.B. 318, holds that for purposes of the passive investment income limitations, an electing small business corporation should include its distribute share of gross receipts from a joint venture rather than its distributive share of ordinary loss from the joint venture. The character of the income in the revenue ruling was gross receipts from the joint venture's operation of a motion picture theater. Because items of income maintain their character upon distribution to the partners under § 702(b), the gross receipts of the joint venture were not converted into passive income upon distribution to the small business company described in the ruling.

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 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).

After applying the applicable law to the facts presented and the representations made, we conclude that the income that Company receives from the Properties will not be considered rents under § 1.1362-2(c)(5)(ii)(B)(2) and therefore will not be passive investment income under § 1362(d)(3)(C)(i).

Except for the specific ruling above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed on whether Company is eligible 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 a power of attorney on file with this office, a copy of this letter will be sent to the taxpayer.

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

Sincerely yours,

Jeff Erickson
Assistant to the Branch Chief,
Branch 3
Office of the Assistant Chief
Counsel
(Passthroughs and Special
Industries)

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