

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:2-PLR-100426-01

Date:

April 27, 2001

Legend

X:

Y:

Z:

a:

b:

Y1:

Dear _____ :

This letter responds to your letter dated December 18, 2000, and subsequent correspondence, on behalf of X, requesting a ruling that X's income from commercial real estate (Properties) is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

The information submitted states that X is a C corporation. X requests this ruling in anticipation of making an election to be treated as an S corporation.

X is a lessor of Properties located in Y. X, directly and through contractors, provides all of the repairs and maintenance on Properties. Services and repairs provided by X with respect to Properties include, but are not limited to, substantial outside repairs to parking lots, exterior doors, windows and siding, window cleaning, plumbing, heating and air conditioning, electrical and weekly cleaning of common areas. X also maintains insurance coverage on the buildings and liability insurance.

X has four employees. The president of X has responsibilities that include negotiating and renegotiating lease rates and reviewing potential additional property for leasing suitability. The second employee watches over the properties, finds new tenants and performs miscellaneous other tasks. The third employee is the office

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manager who primarily handles repair problems and tenant complaints, hires contractors to perform needed services, and reviews the invoicing of tenants. The office manager also spends a small amount of time supervising the employees of Z, X's subsidiary. The fourth employee is a bookkeeper who spends most of her time working for Z, but also performs some work for X, maintaining the accounting records, disbursing paychecks, preparing invoices to the tenants, preparing checks to pay bills, and similar duties.

In the Y1 fiscal year, X received approximately \$a in gross rental income and paid approximately \$b 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)(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.

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)(1) of the Income Tax Regulations defines "rents" as amounts received for the use of, or 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 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 income that X derives from Properties is income from the active trade or business of renting property and 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

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tax consequences of the transaction described above under any other provision of the Code. Further, we express no opinion on whether X is a small business corporation eligible to make an S election under § 1361(b)(3) of the Code.

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 a power of attorney on file with this office, a copy of this letter is being forwarded to X.

Sincerely yours,
J. Thomas Hines
Chief, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: 2

Copy of this letter

Copy for § 6110 purposes