

**Internal Revenue Service**

Department of the Treasury

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Washington, DC 20224

Number: **200008017**  
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Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:Br.1 PLR-114652-99

Date:

November 19, 1999

Legend:

X =

Y =

Shareholder 1 =

Shareholder 2 =

D1 =

D2 =

p =

This letter responds to your letter dated August 16, 1999, together with subsequent correspondence, submitted on behalf of X, requesting a ruling that X's rental income is not passive investment income within the meaning of section 1362(d)(3)(C)(i) of the Internal Revenue Code and S corporation election relief under section 1362(b)(5).

**FACTS**

X was incorporated on D1. X intended to be treated as an S corporation for federal income tax purposes effective on D2, but the S election was not timely filed.

X acquires, leases, and manages commercial and residential real estate. X's shareholder officers devote all their time to the rental activities of X, other related corporations and other real estate held individually. X's rental income generating property (the Properties) consists of commercial property and residential property.

The commercial property is managed by Y, which is owned 100% by Shareholder 1, a shareholder in X. Y performs all management functions of the commercial property for X, including, but not limited to, negotiating leases, repairs and maintenance of the structure and grounds, marketing, lease negotiations and administrative functions involved in managing real estate, as well as overseeing the collection of rent. X also owns equipment used for maintaining for the commercial properties.

X has a bookkeeper that works three days per week writing checks and maintaining a general ledger. Shareholder 2, a shareholder in X, serves as consultant to lease negotiations, and negotiates all third party mortgage financing. Shareholder 2 is also involved in negotiating property insurance for X.

Manager, an entity unrelated to X or Y, manages the residential properties. Manager collects the rents and pays the operating and general maintenance expenses. However, X approves, arranges and supervises all capital improvements; reviews, appeals and pays all property tax assessments; and negotiates all property insurance contracts and pays the insurance premiums relating to the residential properties.

Financial information relating to X's most recent tax year indicates that X's relevant costs from renting the Properties constituted p% of its gross receipts.

## 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 an 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 tax 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 subparagraph (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, 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).

Section 1362(b)(5) provides that if - - (A) an election under 1362(a) is made for any taxable year after the date prescribed by section 1362(b) for making such election for such taxable year or no such election is made for any taxable year, and (B) the Secretary determines that there was reasonable cause for the failure to timely make such election, the Secretary may treat such an election as timely made for such taxable year.

X did not file a timely election to be treated as an S corporation under § 1362(a) effective on D1. X has, however, established reasonable cause for not making a timely election and is entitled to relief under § 1362(b)(5).

### CONCLUSIONS

Based solely on the facts submitted and representations made, and provided that X otherwise qualifies as a subchapter S corporation, we conclude that X will be recognized as an S corporation effective D2. Within 60 days from the date of this letter, X should submit a properly completed Form 2553, with a copy of this letter attached, to the relevant service center.

Based solely on the facts as presented in this ruling request, and viewed in light of the applicable law and regulations, we conclude that the rents X receives from the Properties are not passive investment income under section 1362(d)(3)(c)(i).

Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the transaction described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X is, in fact, an S corporation for federal tax purposes.

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, the original of this letter is being sent to the taxpayer and a copy is being sent to the taxpayer's authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

Signed/Daniel J. Coburn  
Daniel J. Coburn  
Assistant to the Branch Chief, Branch 1  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter  
Copy for § 6110 purposes