

**Internal Revenue Service**

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Person To Contact:

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Telephone Number:

Refer Reply To:

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Date:

February 06, 2004

X =

Sub1 =

Sub2 =

Sub3 =

Sub4 =

Sub5 =

Sub6 =

Sub7 =

Sub8 =

Sub9 =

Properties =

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D1 =

D2 =

D3 =

\$X =

\$y =

Dear :

This responds to your letter dated September 29, 2003, and subsequent correspondence submitted on behalf of X and the Subs (the Company), requesting a ruling that the Company's rental income from the 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 was incorporated in D1. X is the sole owner of Sub1 through Sub7. Sub3 owns 100 percent of the capital and is the sole managing member of Sub8. Sub9 is solely owned by Sub8 and is a disregarded entity for federal tax purposes. Sub1 through Sub9 are hereafter referred to as the Subs. X and the Subs together are collectively referred to as the Company. X intends to elect to be treated as an S corporation and to treat Sub1 through Sub7 as qualified subchapter S subsidiaries (QSubs) effective D2. X has accumulated earnings and profits.

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The Company is engaged in the business of owning and operating the Properties, which are commercial rental real estate. Through its seven employees and independent contractors, the Company provides services to the tenants of the Properties. The services provided by the Company include (not all services are provided to all properties): maintaining and repairing the Properties' structural integrity, roofs, HVAC, plumbing, security, fire systems, and elevators; providing pest control, window washing, janitorial, and trash removal services; and maintaining exterior landscaping and parking areas.

In addition to the services that the Company provides to tenants, the Company performs the usual leasing and administrative activities involved in managing real estate. These activities include: dealing with real estate brokers and agents; profiling and qualifying prospective tenants; and negotiating and signing individual leases.

In the year ending D3, the Company accrued approximately \$x in rents and incurred \$y in relevant expenses.

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 § 1362(d)(3)(A) 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,

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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 the Company derives from the Properties is income from the active trade or business of renting property, and is not passive investment income 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 facts of this case under any other provision of the Code. Specifically, we express no opinion on whether X is otherwise eligible to be an S corporation nor whether Sub1 through Sub7 are eligible to be QSubs under § 1361(b)(3). 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.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) 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 X.

Sincerely,

J. Thomas Hines  
Chief, Branch 2  
Office of Associate Chief Counsel  
(Passthroughs & Special Industries)

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