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Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
PLR-120477-98 CC:DOM:P&SI:3
Date:
February 19, 1999

LEGEND

Company =

X =

Y =

Date =

a =

b =

c =

d =

e =

f =

Properties

Dear

This letter responds to a letter from your authorized representative dated November 4, 1998, and subsequent correspondence, requesting a ruling that the rental income received by Company from its ownership of various real estate properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

FACTS

According to the information submitted, Company, a closely held C corporation with accumulated earnings and profits, plans on electing S corporation status effective Date. Company has two shareholders, X and Y, and is engaged in the business of owning and managing the Properties, which are rental real estate. Company is requesting a ruling on its various degrees of interest in a properties. Some of the Properties are wholly owned by Company, some are partially owned by Company, and some are owned by partnerships in which Company owns interests.

Company characterizes some of its partial interests in the Properties as cotenancies. On the basis of the facts presented, however, it appears that one or more of these ventures might be a partnership for federal income tax purposes. Company is not requesting a ruling on the classification of these ventures, and we are not ruling on this issue.

Company's rental Properties consist of retail, office, and apartment buildings. Company, through a management company that is owned by Company's two shareholders, provides general management services to the Properties. Company's b employees provide on-site services for the direct or indirect benefit of tenants of the Properties. Additionally, Company shares c employees who provide administrative services to the properties, with the sister management company and two other corporations also owned by X and Y.

Company's on-site employees provide services for the Properties including maintenance, custodial work, landscaping, snow removal, security, and other services. Company also hires independent contractors to perform services that include roof work, paving, elevator repair and maintenance, HVAC maintenance and electrical work. Additionally, Company also provides different services to each property, based on the specific needs of individual tenants. For example, many of the apartment buildings have full time employees who reside in the buildings and are available to provide on-site maintenance to tenants on a 24-hour basis.

In d, Company received or accrued approximately e, in rents and paid or incurred approximately f, in relevant expenses in all of its properties.

LAW

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 than an election under § 1362(a) shall be terminated whenever (at any time after the first day of the first taxable year for which 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).

After applying the relevant law to the facts submitted and the representations made, we conclude that the rents Company receives from the Properties are not passive investment income under § 1362(d)(3)(C)(i).

Except for the specific ruling above, no opinion is expressed or implied concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding Company's eligibility under § 1361 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.

Pursuant to a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

This ruling is directed only to 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,

(signed) William P. O'Shea

William P. O'Shea
Chief, Branch 3
Office of the Assistant Chief
Counsel
(Passthroughs and Special
Industries)

Enclosures (2):

Copy of this letter
Copy for § 6110 purposes