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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:
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Date:
September 23, 1999

LEGEND

Corporation =

Business 1 =

Business 2 =

Property =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

a =

b =

c =

d =

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Dear

This letter responds to your submission of September 15, 1998, requesting a ruling that Corporation's rental income from leasing Property is not passive investment income under section 1362(d)(3)(C)(i) of the Internal Revenue Code.

Facts

Prior to Year 1, Corporation was a C corporation that operated Business 1 and Business 2. In Year 1, Corporation sold Business 1. Corporation also owns certain real estate from which it receives rental income, including rents from the purchaser of Business 1 (an unrelated party). Subsequent to the sale of Business 1, Corporation made an S corporation election, and has filed its initial Form 1120S for the period Date 1 through Date 2. Corporation has C corporation accumulated earnings and profits.

Corporation provides significant services and incurs substantial costs in connection with its business of renting property, including providing maintenance service for common areas, signs, and parking facilities; handling emergency service calls on a 24-hour basis; maintaining arcade and arcade rest rooms; arranging garbage pickup and recycling services; periodically inspecting, repairing, and maintaining the plumbing, the electrical system, the heating and air conditioning, and HVAC systems; periodically inspecting and maintaining the fire alarm and sprinkler system; inspecting and maintaining the landscaping, cutting the grass and trimming the shrubs, and carrying out any other necessary ground and yard maintenance; making daily or weekly inspection of the exterior portions of the building looking for decay, dryrot, insect, termite, and other pest damages; resolving tenant complaints; and handling the usual leasing and administrative functions.

Also, Corporation's services include assisting in the remodeling process for new tenants; providing assistance to architects, builders, and other professionals on remodeling projects; recommending architects, contractors, and other vendors; providing sign criteria to tenants and working with sign vendors on design and installation; providing arcade area and sidewalk for special promotions and eating area; providing advertising through message board and special promotions; assisting tenants in financial difficulty with retail consulting; providing conference facilities for tenants; and providing monthly newsletters for tenants.

Although the tenants pay for a share of the real estate taxes, insurance, and some of the maintenance and repairs through a reimbursement program, Corporation is primarily responsible for these expenses. Corporation is solely responsible for payment of repair and/or replacement of the building foundations, exterior walls, and the roof.

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Corporation incurs various costs in its leasing businesses. For Year 2, Corporation received or accrued a total of approximately a in gross rent and paid or incurred approximately b in relevant operating expenses on Property. In addition, Corporation employs c people in the management and rental process, d of whom are on call 24 hours per day.

Analysis

Section 1362(a)(1) provides that, except as provided in § 1362(g), a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1362(d)(3)(A)(i) provides that an election under § 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) of the Code 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).

Conclusion

Based solely on the facts as represented, we rule that the rental income that Corporation receives from Property is not passive investment income under section 1362(d)(3)(C)(i).

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Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding Corporation's S corporation status under section 1362(a). Further, the passive investment income rules of section 1362 are completely independent of the passive activity rules of section 469; unless an exception under section 469 applies, the rental activity remains passive for purposes of section 469.

Pursuant to a power of attorney on file with this office, copies of this ruling are being sent to Corporation and to the other authorized representative.

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

Sincerely,

Donna M. Young
Senior Technician Reviewer,
Branch 3
Office of the Assistant
Chief Counsel
(Passthroughs and Special
Industries)

Enclosures:
Copy of this letter
Copy for § 6110 purposes