

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
February 20, 2002

Legend

Taxpayer =

Shareholder =

Amount 1 =

Amount 2 =

Amount 3 =

Amount 4 =

W =

X =

Y =

Z =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

States =

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Properties =

Dear :

We received your letter dated May 18, 2001, and subsequent correspondence, requesting a ruling on behalf of Taxpayer that rental income earned by Taxpayer at Properties will not be treated as passive investment income under § 1362(d)(3) of the Internal Revenue Code. This letter responds to your request.

Facts

Taxpayer was incorporated on Date 1 for the purpose of owning, developing, leasing, and managing residential real estate. Taxpayer has accumulated earnings and profits. Taxpayer has offices in States, and owns Properties, all of which are residential rental properties located in States. The Properties together contain a total of X units.

Taxpayer conducts its residential real estate activities directly through its Y full time employees, its Z part-time employees, and a variety of third-party subcontractors. Taxpayer's employees market its units to potential tenants, perform background investigations of potential tenants, and negotiate leases with potential tenants. Taxpayer's employees also collect monthly rents and pursue tenants through the eviction stage when necessary. Taxpayer's employees review property tax assessments on its Properties and either pay or challenge the property taxes owed. In addition, Taxpayer's employees maintain all financial and accounting records relating to the Properties. Additionally, the president of Taxpayer is involved in all material decisions regarding the leasing and management of its properties.

Taxpayer hires outside contractors to complete some of its maintenance obligations, such as roof repairs, glass, floor, and door installations and repairs, plumbing and heating repairs, and fire system maintenance and repairs. Taxpayer's employees complete most of the other repairs and maintenance, such as janitorial services, minor structural repairs, painting, landscaping, snow removal, and refurbishing of units when tenants vacate.

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In the Year 1 fiscal year, Taxpayer received or accrued Amount 1 in rents and paid or incurred Amount 2 in relevant expenses less depreciation. In the Year 2 fiscal year, Taxpayer received or accrued Amount 3 in rents and paid or incurred Amount 4 in relevant expenses less depreciation. Comparing gross rental receipts with expenses (without depreciation) for fiscal Year 1 and Year 2, Taxpayer expended about W percent of receipts on the management and maintenance of the Properties.

Taxpayer requests a ruling that income received from the Properties is income from an active trade or business and will not be considered rents under § 1.1362-2(c)(5)(ii)(B)(2). Thus, the income received from the Properties will not be passive investment income under § 1362(d)(3)(C)(i).

Section 1361(a)(1) provides that the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for the year.

Section 1362(d)(3)(A) provides that an election under § 1362(a) shall be terminated whenever the corporation (1) has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and (2) 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 in § 1362(d)(3)(C), the term “passive investment income” means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom).

Section 1.1362-2(c)(5)(ii)(B)(1) of the Income Tax Regulations provides that, for purposes of defining “passive investment income”, “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 the 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. Whether significant services are performed or substantial costs are incurred in the rental business is determined based on 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 on the facts submitted and representations made, we conclude that the income Taxpayer received from Properties is considered income from an active trade or business and is not to be treated as passive investment income under § 1362(d)(3)(C)(i).

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Except for the specific ruling above, we express or imply no opinion concerning the federal income tax consequences of the facts of this case under any other provision of the Internal Revenue Code. Specifically, we express or imply no opinion regarding Taxpayer's eligibility to be an S corporation under § 1361. Further, the passive investment income rules of § 1362 are entirely independent from the passive activity rules of § 469, and we express or imply no opinion herein with respect to the applicability of § 469 to Taxpayer.

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

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.

Sincerely yours,
Christine Ellison
Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter
Copy for § 6110 purposes