

Dear _____ :

This letter responds to a letter dated December 23, 2004, submitted on behalf of X by X's authorized representative, requesting a ruling that X's rental income from Buildings in Business Park is not passive investment income within the meaning of § 1362(d)(3)(C)(i).

The information submitted states that X was incorporated in State on Date 1. Effective Date 2, X elected to be treated as an S corporation. Beginning Date 3, X's principal business has been to develop, manage, and operate Business Park. As of Date 4, Buildings have been completed and they are primarily rented to tenants as office space. A, the president of X, represents that X, through its independent contractors, provides various services to its tenants. Services provided by X include but are not limited to, the following: the provision and maintenance of electricity and water for the common areas; the provision and maintenance of fire alarm systems; maintenance and repair of roofs, foundations, and exterior walls; maintenance and repair of the plumbing, electrical, heating and air conditioning systems; ground maintenance, landscaping and tree trimming; maintenance of Business Park lighting; maintenance of parking lots; maintenance of a private road through Business Park; maintenance of Business Park water and sewer system; maintenance of underground cables; maintenance of sidewalks and fencing; window washing; janitorial services; security services; regular property inspection; 24 hour call service and a newsletter. In addition to services provided to tenants, X, through independent contractors, handles the leasing and administrative functions involved with managing the business park, including billing tenants and collecting rents, finding new tenants and negotiating leases.

In the taxable year ending Date 4, X received or accrued \$x in rents, which includes reimbursements by some tenants for insurance, property taxes and property maintenance expenses paid by X. X paid or incurred \$y in relevant expenses other than depreciation. X represents that it anticipates future amounts of income and expense with respect to Buildings to be consistent with the income and expense amounts from previous periods.

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 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).

Based solely on the facts and the representations submitted we conclude that the rental income that X derives from Buildings is not passive investment income as 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 transaction described above under any other provision of the Code. Specifically, we express no opinion on whether X is a small business corporation eligible to make an S election. Further, the passive investment income rules of § 1362 are completely independent of the passive activity rules of section § 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) of the Code provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

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

Enclosures: 2

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