

Internal Revenue Service

Department of the Treasury

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Date:
August 16, 2002

Legend

Company =

State =

Date =

D1 =

D2 =

N1 =

N2 =

Dear :

This letter responds to a letter dated December 15, 2001, submitted on behalf of Company, requesting a ruling that the rental income received by Company from its operations is not passive investment income within the meaning of Internal Revenue Code §1362(d)(3)(C)(i).

STATEMENT OF FACTS

Company, a State corporation, filed an election to be treated as an S corporation, effective for the tax year beginning Date. Company has subchapter C accumulated earnings and profits.

Company engages in the business of owning and renting real and personal property. The real property Company owns and rents is used for commercial and industrial purposes. The equipment Company rents is used for commercial and industrial purposes in connection with the real property. Company employs N1 individuals, N2 of whom are seasonal employees who provide services to the parties renting the real property. Company does not employ a management agency.

Company's employees perform the following services: lease negotiation, collection of rent, maintenance of the properties, pest control, and management of the operations of the seasonal employees. Company's seasonal employees engage in loading, unloading, stacking, packing, and organization of tenants' products, cleaning and maintenance of the premises leased to tenants, and identification and location of samples of product for tenant inspection. The seasonal employees also perform semi-monthly physical inventories of tenants' products and equipment.

The majority of the real property leases are for multi-year terms and none of the tenancies are on a net lease basis. Company's gross rental revenues for its most recently completed tax year were D1 and its expenses related to the rental activities, net of depreciation, were D2.

LAW

Except as provided in §1362(g), §1362(a)(1) provides that 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 §1362(d)(3)(C), §1362(d)(3)(C)(i) 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 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 by Company, we conclude that the rents Company receives are not passive investment income under §1362(d)(3)(C)(i).

Except for the specific ruling above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding Company's eligibility to elect to be treated as 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.

Under 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(s) requesting it. Section §6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

/s/

Christine E. Ellison
Branch Chief
Office of Associate Chief Counsel
(Passthroughs and Special Industries)