Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

199912036

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:3 PLR-111897-98
Date:
December 15, 1998

Company:

Properties:
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Corp A:

Corp B:

Corp C:

State:

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Dear

This letter responds to a letter dated June 1, 1998, as well as subsequent correspondence, submitted on behalf of Company by your authorized representative, requesting a ruling that Company's rental income from the Properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code. Company represents the following facts.

Company was incorporated in State on a and intends to elect under § 1362(a) to be an S corporation effective b. Company is on a fiscal year ending c. It has subchapter C earnings and profits.

Company acquires, develops, and leases both residential apartment and commercial office buildings in State. Some of the Properties are wholly owned by Company, some are partially owned by Company, and some are owned by a partnership or limited liability company in which Company owns an interest. Most of the Properties were developed and constructed by Company. Company's development activities are ongoing, consisting of the renovation of existing properties or the development of new ones.

Company characterizes 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 uses Corps A, B, and C (Management Companies) to manage the daily affairs of the Properties. Corp A, with d employees, provides full building operation and maintenance services for Properties 1, 2, 4, 6-10, and 12. Corp B (for Properties 5 and 11) and Corp C (for Property 3) have the same duties and perform the same tasks as does Corp A. Company closely monitors and reviews the management of the Properties by the Management Companies. Company monitors any necessary renovations (at times even supplying its own personnel for certain repairs) and approves all capital improvements; it attends regular meetings with senior management of the Management Companies; and it routinely inspects the Properties. Management Companies issue detailed monthly management reports to Company. Company and Corp A share an employee as well as office

facilities. Company's president serves as a director on Corp A's board, and a single shareholder owns approximately e of both Company and Corp A.

The services provided by the Management Companies include, but are not limited to, safety and maintenance inspections; cleaning, maintenance, and repair of common areas, including parking lots and garages; maintenance and repair of building structural components and systems; landscaping and grounds care; pest control inspection and treatment; utilities; trash and snow removal; security and patrol services; and space renovation and remodelling as required. Most of the residential properties provide various recreational amenities (swimming pools, tennis courts, exercise rooms, party rooms) as well as on-site stores and shops. Most of the commercial properties provide char services and the services of on-site engineers. In addition to the services provided to tenants, Company is responsible for the usual leasing and administrative functions involved in leasing and managing real estate. Company has f full-time and g part-time, or shared, employees.

Company received or accrued approximately h in rents and paid or incurred approximately i in relevant expenses on the Properties for j. The comparable figures for k, are m and n. Company expects its rental income and expenses for p to be approximately the same.

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), § 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, 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).

Section 1.1362-2(c)(5)(ii)(B)(4) provides that "rents" does not include compensation, however designated, for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the taxpayer, if during the tax year the taxpayer is engaged in substantial development, manufacturing, or production of real or tangible personal property of the same type.

Based solely on the facts presented in this ruling request, and viewed in light of the applicable law and regulations, 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 to be an S corporation or its ability to retain a fiscal year ending c. 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.

In accordance with the power of attorney on file with this office, we are sending copies of this letter to your authorized representatives.

This ruling is directed only to the taxpayer who requested it. According to § 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

Donna M. Young

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

enclosure: copy for § 6110 purposes