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LEGEND:

- X =
- T-1 =
- T-2 =
- Year A =
- Year B =
- Year C =
- M =
- N =

Dear _____ :

This responds to a letter dated December 4, 2001, and subsequent correspondence, submitted on behalf of X, requesting a ruling that certain rental income of X is not passive investment income as defined under section 1362(d)(3) of the Internal Revenue Code.

FACTS

The information submitted states that X was incorporated in Year A. X is a manager, developer and licensed broker of real estate. It had been a C corporation since its inception. T-1 and T-2 were incorporated in Year B, and have also been C corporations at all times since their inception. T-1 and T-2 own developed real properties which they lease to unrelated parties. T-2 also owns unimproved real estate held for future development. X plans to acquire T-1 and T-2 by merger, and then elect to be an S corporation.

A majority of the services performed by X in its business are done on behalf of T-1 or T-2. X provides the following services, via its own employees, for T-1 and T-2 in connection with the rental properties: negotiate leases; settle tenant disputes; evaluate proposed tenants; inspect the property; oversee rent collection. X provides additional services for properties of T-1 and T-2: secure insurance; arrange pest control when necessary; inspect for needed repair; inspect and maintain HVAC; perform building and repairs, specifically roof, wall, floor tile, plumbing and electrical maintenance; paint walls and roofs; perform parking lot repairs.

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X, T-1 and T-2 incur various costs in the leasing businesses. In Year C, T-1 and T-2 collected approximately M in gross rents and incurred approximately N in relevant operating expenses.

X has requested a ruling that its rental income from the leasing of its properties is passive investment income under sections 1362 (d)(3).

ANALYSIS

Section 1362(a) allows a small business corporation, as defined in section 1361, to elect to be an S corporation. This election, however, terminates under the provisions of section 1362(d)(3) if the corporation has accumulated earnings and profits at the close of each of three consecutive taxable years and 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, in general, that the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales and 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) 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 submitted, the representations made, we conclude that the rents that X will receive from T-1 and T-2 after the proposed merger will not be passive investment income as defined under section 1362(d)(3)(C)(i).

Except as specifically set forth above, no opinion is expressed as to the federal income tax consequences of the above- described facts. Specifically, we express no opinion regarding A's status as an S corporation under section 1362(a). Further, the passive investment income rules of section 1362 are completely independent of the

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passive activity rules of section 469; unless an exception under section 469 applies, the rental activity is passive for purposes of section 469.

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

Pursuant to a power of attorney on file with this office, a copy of this ruling is being sent to X.

Sincerely,

/s/ David R. Haglund

David R. Haglund
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Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

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