

Internal Revenue Service

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Legend

X =

A =

State =

Date 1 =

Date 2 =

Year 1=

Year 2=

N1=

N2=

N3

N4

Dear _____ :

This letter responds to a letter dated November 21, 2011, and subsequent correspondence, submitted by X's authorized representatives on behalf of X, requesting a ruling that rental income that X received from certain real estate is not passive

investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

The information submitted states that X was incorporated under the laws of State and subsequently made an election to be treated as an S corporation effective Date 1. X owns, leases and manages a certain commercial real estate property (the “Property”). X has accumulated earnings and profits.

X, through its shareholder and officers, has provided and continues to provide certain services with respect to the leasing of the Property. These services include inspecting, maintaining, and repairing the building, including the roofs, canopies, external walls, windows, floors, foundations, guttering and downspouts, plumbing, painting and internal light fixtures. These services also include inspecting, maintaining and repairing all common areas, including the parking lots, sidewalks, curbs and external light fixtures, and maintenance of Property grounds, including landscaping, garbage removal and snow and ice removal. X negotiates leases, renewals and other agreements with tenants, collects rents, monitors compliance with lease terms, addresses tenant complaints and requests and advertises available commercial space and solicits new tenants as applicable.

For the Year 1 and Year 2 taxable years, X collected approximately \$N1 and \$N2, respectively, in gross rents and paid or incurred approximately \$N3 and \$N4, respectively, in relevant operating expenses excluding depreciation.

In Year 2, X's former accountant attached a statement X's Year 1 Form 1120S, U.S. Income Return for an S Corporation, indicating that X's S corporation election had terminated effective Year 1 because of excess passive investment income. This statement did not satisfy the requirements for an effective S corporation election revocation set forth in §§ 1.1362-2(a)(1) and 1.1362-6(a)(3) of the Income Tax Regulations.

Section 1361(a)(1) of the Code defines an “S corporation” as a small business corporation for which an election under § 1362(a) is in effect for such 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) 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(a)(1) provides that an election made under § 1362(a) is terminated if the corporation revokes the election for any taxable year of the corporation for which the election is effective. Section 1.1362-2(a)(1) further provides that a revocation may only be made with the consent of shareholders who, at the time the revocation is made, hold more than one-half of the number of issued and outstanding shares of stock (including non-voting stock) of the corporation.

Section 1.1362-6(a)(3)(i) provides that an S corporation revokes its S election by filing a statement with the service center where its election was properly filed. The revocation statement must include the number of shares of stock (including non-voting stock) issued and outstanding at the time the revocation is made. Section 1.1362-6(a)(3)(i) further provides that a revocation is not valid unless all shareholders of the corporation at the time of the election consent to the election in the manner required under § 1.1362-6(b).

Based solely on the information submitted and the representations made, we conclude that the rental income that X receives from its operations described above is not passive investment income under § 1362(d)(3)(C)(i). We further conclude that the statement attached to X's Year 1 Form 1120S was not an effective revocation of X's S corporation election.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion on whether X is a small business corporation under § 1361(b). Further, the passive investment income rules of

§ 1362 are independent of the passive activity rules of § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 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 the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representatives.

Sincerely,

Bradford R. Poston
Senior Counsel, Branch 2
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: (2)

Copy of this letter

Copy for § 6110 purposes

cc: