LEGEND

Company 1   =

Company 2   =

State   =

Date 1   =

Date 2   =

Year   =

Shareholder A   =

Shareholder B   =

C   =

D   =

E   =

F   =

G   =

H   =

Dear   :

This letter responds to the letter dated October 20, 2006, as well as subsequent correspondence, submitted on behalf of Company 1, requesting a ruling that rental income received by Company 1 is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

<div align="center">FACTS</div>

Company 1 was incorporated under the laws of State on Date 1, and elected under § 1362(a) to be an S corporation effective Date 2. Company 1 has accumulated earnings and profits and is engaged in the business of owning and leasing residential and commercial real estate. Company 1 owns C parcels of real estate, collectively referred to as Properties.

Shareholder A owns D percent of the stock in Company 1 and E percent of the stock in Company 2. Shareholder B owns the balance of the stock in each company.

Company 2 manages the Properties owned by Company 1. Company 2 has F full-time employees. Company 2 provides various services to the Properties on behalf of Company 1. Through its employees, Company 2 obtains and negotiates leases; handles all aspects of tenant billings and collections; monitors tenant compliance with lease terms; collects rents from delinquent tenants; pays all expenses, including mortgage payments, property taxes, insurance, repairs and advertising; and supervises and coordinates the maintenance and repair of the Properties, including those relating to the heating and air conditioning, roof and other structural components. With respect to apartment buildings, Company 2 provides maintenance of the common areas. For example, Company 2 is responsible for cleaning the hallways and laundry rooms; changing light bulbs; cleaning the parking lot; and lawn maintenance, including mowing, trimming shrubbery, and cleaning up leaves. Company 2 remits to Company 1 the rental income it collects after deducting any expenses relating to the Properties and after deducting its management fee.

Company 1 makes monthly interest payments on unsecured promissory notes, pays legal and accounting fees, and pays expenses relating to the purchase and sale of properties. Company 1 also reimburses Company 2 for Company 2's payroll and payroll taxes which are incurred on behalf of Company 1.

In Year, Company 1 received $G in gross rental income and paid $H in operating expenses.

LAW AND ANALYSIS

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) shall be terminated whenever the corporation (1) has accumulated earnings and profits at the close of each of three consecutive taxable years, and (2) 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 that, except as otherwise provided in § 1362(d)(3)(C), 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 the 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 on the facts submitted and representations made, we conclude that the rental income Company 1 receives from the rental of the Properties is not passive investment income under § 1362(d)(3)(C)(i).

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 regarding Company 1's eligibility to be an S corporation. 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 requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

/s/

Tara P. Volungis
Senior Technician Reviewer, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)
    Copy of this letter
    Copy for § 6110 purposes