199952077

Internal Revenue Service

Index Number: 1362.02-03

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:3 PLR-121424-98
Date:
September 28, 1999

Company:

Shareholders:

Subsidiaries:

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Address:

Manager A:

474

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Manager B:

Corp A:

Partnerships/
-- Properties:

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a:

b:

c:

d:

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Dear .

This letter responds to a letter dated November 17, 1998, as well as subsequent correspondence, submitted on behalf of Company by your authorized representative, requesting a ruling that the rents Company receives from the leasing of the Properties (including the rents received through certain qualified subchapter S subsidiaries (QSubs)) will not constitute passive investment income under § 1362(d)(3)(C)(i) of the Internal Revenue Code. Company represents the following facts.

Company intends to elect under § 1362(a) to be an S corporation effective a and to elect under § 1361(b)(3)(B)(ii) to treat Subsidiaries as QSubs effective that same date. Company and Subsidiaries (the "Corporations") expect to have subchapter C earnings and profits at the time of the elections.

Subsidiaries are wholly owned by Company, which is owned by Shareholders. The Corporations acquire, develop, construct, lease, and manage real estate, primarily through general partner (GP) interests in Partnerships.

The Corporations provide services through Managers A and B. Manager A manages the multi-family properties, while Manager B manages the office properties and provides administrative services to Manager A.

Through Managers A and B, the Corporations provide various services in their real estate leasing and management business. These services include maintenance of building structural components, such as the roofs; regular building inspection; preparation of vacated spaces; leasehold improvement; general cleaning and painting; floor and ceiling repair; and preventative maintenance of property exteriors and common areas, including roofs, parking lots, hallways, plumbing, and mechanical systems. Office staff and maintenance crews respond to tenant calls regarding problems and take corrective action either directly or by means of subcontractors. The cost of these repairs or other actions might be borne by the Corporations or by the tenant, depending on the problem and the action taken. In addition to the services provided to tenants, the Corporations handle the usual marketing, leasing, and administrative functions involved in leasing and managing real estate.

As part of their distributive shares from Partnerships, the Corporations received or accrued approximately b in rents and paid or incurred approximately c in relevant expenses for d on the Properties. Company represents that these figures are representative of rental income and expenses for prior years and expects the figures for future years to be comparable.

Section 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(b)(3)(B) defines "qualified subchapter S subsidiary" as any domestic corporation that is not an ineligible corporation (as defined in § 1361(b)(2)), if (i) 100 percent of the stock of that corporation is held by the S corporation, and (ii) the S corporation elects to treat that corporation as a QSub. Notice 97-4, 1997-1 C.B. 351, provides guidance on making the QSub election.

Section 1361(b)(3)(A) provides that, except as provided in regulations, (i) a corporation that is a QSub shall not be treated as a separate corporation, and (ii) all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) to be an S corporation 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).

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Based solely on the facts as presented in this ruling request, and viewed in light of the applicable law and regulations, we conclude that Company's rental income from the leasing of Properties held through Partnerships, including the rent received through Company's QSubs, is not passive investment income under § 1362(d)(3)(C)(i).

Except for the specific rulings 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 whether Company qualifies as an S corporation or whether Subsidiaries qualify as QSubs. 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)

encl: copy for § 6110 purposes

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