

## Internal Revenue Service

## Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:

CC:DOM:P&SI:3 PLR-112644-99

Date:

November 19, 1999

Company:

Subsidiaries:

A:

B:

C:

D:

State:

Properties:

1.

2.

3.

4.

5.

6.

7.

8.

9.

Property types:

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Entity:

Business M:

Business N:

Business P:

a:

b:

c:

d:

e:

f:

g:

h:

i:

Dear

This letter responds to your letter dated July 19, 1999, as well as subsequent correspondence, submitted on behalf of Company, requesting a ruling that Company's income from the Properties and from Entity is not passive investment income under § 1362(d)(3)(C)(i) of the Internal Revenue Code. Company represents the following facts.

Company was incorporated under the laws of State in a and elected under § 1362(a) to be an S corporation effective b. It has accumulated earnings and profits.

Company owns, develops, leases, and manages commercial real estate (Property types). It conducts its real estate activities directly or through its Subsidiaries, which are qualified subchapter S subsidiaries under § 1361(b)(3).

In addition to its primary business of developing, leasing, and managing real

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estate, Company was engaged in Business M and is currently engaged, through a limited liability company, in Business N. Company sold Business M earlier this year and intends to sell or otherwise dispose of its interest in Business N as soon as commercially feasible. Company derives the rest of its income from marketable securities and other investments.

Through Company's c full-time employees, as well as through property managers and other contractors, Company provides various services in its real estate leasing and management business. These services include regular property inspection; common area maintenance; janitorial services; maintenance and repair of building structural components (e.g., roofs, exterior walls, and foundations), systems (e.g., heating, ventilation, and air conditioning), and surrounding areas (e.g., parking lots and sidewalks); testing and maintenance of fire alarms and sprinklers; security services and alarm monitoring; landscaping and grounds maintenance; trash and snow removal; pest control; construction and maintenance of outdoor signage; space planning services; construction of tenant improvements; and the handling of tenant concerns and complaints. (Not all of the listed services are provided to all of the Properties.) In addition to the services provided to tenants, Company handles the usual leasing and administrative functions involved in managing real estate.

Company received or accrued approximately d in rents and paid or incurred approximately e in relevant expenses on the Properties for f. The comparable figures for g (with the data for the final 2 months of the year projected) are h and i.

Company has invested in Entity, a publicly traded limited partnership (PTP). Company represents that Entity meets the qualifying income exception of § 7704(c)(2) and is taxed as a partnership for federal tax purposes. Company also represents that Entity is not an electing large partnership as defined by § 775 and, thus, the normal flowthrough provisions of Subchapter K apply to its partners.

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) 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 § 1362(d)(3)(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.

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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 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.

Section 702(a)(7) provides that, in determining income tax liability, each partner shall take into account separately his distributive share of the partnership's items of income, gain, loss, deduction, and credit to the extent provided by regulations.

Section 1.702-1(a)(8)(ii) provides that each partner must take into account separately his distributive share of any partnership item that would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately.

Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under § 702(a)(1) through (7) shall be determined as if the item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Except as provided in § 7704(c), § 7704(a) provides that a PTP shall be treated as a corporation for federal income tax purposes.

Section 7704(b) provides that the term PTP means any partnership if interests in that partnership are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof).

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Section 7704(c)(1) provides that § 7704(a) shall not apply to a PTP for any tax year if the partnership meets the gross income requirements of § 7704(c)(2) for that year and each preceding tax year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence. Section 7704(c)(2) provides that a partnership meets the gross income requirement for any tax year if at least 90 percent of the partnership's gross income for that year consists of qualifying income.

Section 7704(d)(1)(E) provides that income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber) is qualifying income. For purposes of this section, mineral or natural resource means any product of a character with respect to which a deduction for depletion is allowable under § 611, but is not a product described in § 613(b)(7)(A) or (B).

Rev. Rul. 71-455, 1971-2 C.B. 318, deals with an S corporation that operates a business in a joint venture with another corporation. In the tax year at issue, the total business expenses exceeded gross receipts. The revenue ruling holds that, in applying the passive investment income limitations, the S corporation should include its distributive share of the joint venture's gross receipts and not its share of the venture's loss. In accordance with § 702(b), the character of these gross receipts were not converted into passive investment income upon their allocation to the S corporation.

Company's distributive share of gross receipts from Entity, if separately taken into account, might affect its federal income tax liability. Under § 1362(d)(3), the status of Company as an S corporation could depend upon the character of its distributive share of gross receipts from Entity. Thus, pursuant to § 1.702-1(a)(8)(ii), Company must take into account separately its distributive share of the gross receipts from Entity. And because items of income maintain their character upon distribution to the partners under § 702(b), the character of these partnership receipts for Company will be the same as the character of the partnership receipts for Entity.

After applying the applicable law and regulations to the facts as presented in this ruling request, we conclude that the rental income Company receives from the Properties, as well as its distributive share of Entity's gross receipts attributable to Business P, is 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 income 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. Further, the passive investment income rules of § 1362 are completely independent of the passive activity rules of § 469; unless an

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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 the original of this letter to you and a copy to Company.

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,

WILLIAM P. O'SHEA  
Chief, Branch 3  
Office of Assistant Chief Counsel  
(Passthroughs and Special Industries)

enclosure: copy for § 6110 purposes