

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-113426-98

Date:

January 28, 1999

Company:

Subsidiaries:

Partnerships:

Properties:

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Affiliate:

Manager A:

Manager B:

State:

a:

b:

c:

d:

e:

f:

Dear:

This letter responds to a letter from your authorized representative dated June 26, 1998, and subsequent correspondence, submitted on behalf of Company, requesting a ruling that the rental income received by Company from the Properties will not be passive investment income within the meaning of § 1362(d)(3)(C)(i). Company represents the following facts.

Company was incorporated in State on a and intends to elect under § 1362(a) to be an S corporation. Company also intends to elect under § 1361(b)(3)(B)(ii) to treat Subsidiaries as

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qualified subchapter S subsidiaries (QSSSs) (see § 1361(b)(3)(A) for the effect of a QSSS election).

Company acquires, manages, leases, operates, and sells commercial real estate (the Properties) and creates and invests in other entities (the Partnerships) which engage in these same activities. Company or its Subsidiaries serve as the managing general partner of the Partnerships. (A diagram of partnership investments in affiliated partnerships is attached as Appendix A.)

Under the partnership agreements, the general partner is vested with the exclusive right and power to manage, operate, and control all business and partnership affairs. Company receives management fees from the Partnerships. Company's duties are carried out by selected officers and directors of Company.

Company contracts with Manager A, a division of Affiliate, to perform the organizational and management functions. Manager A employs b persons in managing the Properties and the affiliated Partnerships. Its chief executive officer and its president also are officers of Company. Manager A receives management fees from Company. (A list of the common shareholders of Company and Affiliate is attached as Appendix B.)

Manager A contracts with Manager B, another division of Affiliate, to provide most of the physical maintenance of the Properties. Manager B employs c persons in performing these functions, for which it receives fees from Manager A.

Through Managers A and B, as well as through various third-party contractors, Company provides various services in the real estate leasing and management business. These services include, but are not limited to, building common area maintenance; parking lot and sidewalk maintenance and repair; roof and other building structural component repair; retaining wall maintenance; lighting studies and upgrades; landscaping; snow removal; and painting. In addition to the services provided to tenants, Company is responsible for the usual marketing, leasing, and administrative functions involved in leasing and managing real estate.

Company received or accrued approximately d in rents and paid or incurred approximately e in relevant expenses for f.

Except as provided in regulations, § 1361(b)(3)(A) provides that (i) a corporation that is a QSSS [as defined by § 1361(b)(3)(B)] shall not be treated as a separate corporation,

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and (ii) all assets, liabilities, and items of income, deduction, and credit of a QSSS shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

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 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).

Based solely on the facts presented in this ruling request and the applicable law and regulations, and assuming Company is a valid S corporation and its Subsidiaries are valid QSSSs, we concluded that the rents Company receives from the Properties, either directly or as part of its distributive share of partnership income, will not be passive investment income under § 1362(d)(3)(C)(i).

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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 under § 1361 regarding Company's eligibility to be an S corporation or Subsidiaries' eligibility to be qualified subchapter S subsidiaries. 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 a copy of this letter to your authorized representative.

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
Senior Technician Reviewer,
Branch 3
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

encl: copy for § 6110 purposes

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Appendix A

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Appendix B