

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:3 PLR-110295-00
Date:
September 8, 2000

Company:

Corp A:

Corp B:

Corp C:

Manager:

Properties:

Partnerships:

Shareholders:

Manager:

State:

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City:

a:

b:

c:

d:

e:

f:

Dear

This letter responds to a letter from your authorized representative dated May 4, 2000, and received by the Internal Revenue Service on May 16, 2000, as well as subsequent correspondence, requesting a ruling that the rental income received by Company from the Properties is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code. Company represents the following facts.

Company, a State corporation, elected under § 1362(a) to be an S corporation effective a. Effective that same date, Company elected under § 1361(b)(3)(B) to treat its wholly-owned subsidiaries (Corps A, B, and C) as qualified subchapter S subsidiaries (QSubs). Company has C corporation earnings and profits. The shareholders of Company are listed in the legend of this letter.

Corp A develops, leases, and operates commercial and residential real estate (the Properties) in City. It owns interests in the Properties either directly or through Partnerships in which it owns an interest as a general partner.

Corp B has discontinued all business operations. Corp C is inactive. Neither of these corporations is covered by this ruling.

Corp A, either as owner or in its capacity as general partner, is responsible for Properties. Corp A uses Company to manage and monitor all aspects of its rental real estate operations. Company, with b full-time employees, provides executive management, administrative, accounting, and tax reporting services to Corp A and other affiliates. Company uses Manager, a related corporation, to handle the day-to-day operations of the Properties. Manager has an on-site staff equivalent to c full-time employees to manage and maintain the Properties.

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Through its own employees, as well as through third-party contractors, Manager provides various services to the Properties. These services include maintenance and repair of building systems and structural components (e.g., electrical systems, heating and air conditioning, plumbing, elevators, roofs, and masonry); cleaning; janitorial services; painting; alterations; landscaping and grounds maintenance; trash and snow removal; pest control; and building security. Manager serves as the owner's representative in dealings with tenants and responds to all tenant service requests.

Company, either directly or as part of its distributive share of Partnership items, received or accrued approximately d in rents and paid or incurred approximately e in relevant expenses for f on the Properties.

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.

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 1361(b)(3)(A) provides that, except as provided in regulations, (i) a corporation which 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.

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Section 1.1361-4(a) states that the separate existence of a QSub is ignored for Federal tax purposes. Thus, a corporation which is a QSub shall not be treated as a separate corporation and all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and items of income, deduction, and credit of the S corporation.

Based solely on the facts as represented by Company in this ruling request, we conclude that the rents Company received from the Properties, either directly or as part of its distributive share of Partnership income, are not passive investment income under § 1362(d)(3)(C)(i).

The ruling in this letter is based on 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 ruling, it is subject to verification on examination.

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 S corporation and QSub elections. 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,
ROBERT HONIGMAN
Acting Assistant to the Chief, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

enclosure: copy for § 6110 purposes