Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Date:
May 10, 2007

Company:

Entity 1:

Entity 2:

Entity 3:

Entity 4:

Entity 5:

Entity 6:

Entity 7:

Entity 8:

Entity 9:

Entity 10:

Entity 11:

Entity 12:

Entity 13:

Entity 14:

Entity 15:

Entity 16:

Entity 17:

Entity 18:

Entity 19:

Entity 20:

Entity 21:

Entity 22:

Entity 23:

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Entity 28:

Entity 29:

Entity 30:

Entity 31:

Entity 32:

Entity 33:

Entity 34:

Entity 35:

Entity 36:

Entity 37:

Entity 38:

Property 1:

Property 2:

Property 3:

Property 4:

Property 5:

Property 6:

Property 7:

Property 8:

Property 9:

Property 10:

Property 11:

Property 12:

Property 13:

Property 14:

Property 15:

Property 16:

Property 17:

Property 18:

Property 19:

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Property 31:

Property 32:

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Property 35:

Property 36:

Property 37:

Property 38:

Property 39:

Property 40:

Property 41:

Property 42:

Property 43:

Property 44:

Property 45:

Property 46:

Property 47:

Property 48:

Property 49:

State A:

State B:

Country A:

Country B:

Foreign Entity:

a:

b:

c:

d:

e:

Dear :

This letter responds to your letter dated August 14, 2006, as well as subsequent correspondence, submitted on behalf of Company, requesting a ruling that certain income received by Company is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

FACTS

The information submitted states that Company was incorporated under the laws of State A on a, and it intends to elect under § 1362(a) to be an S corporation. Company has accumulated earnings and profits.

On b, Company acquired all the shares of Entities 1 and 2. It will either elect under § 1361(b)(3)(B)(ii) to treat these entities as qualified subchapter S subsidiaries or merge each of them into a limited liability company wholly owned by Company. Thus, Entities 1 and 2 effectively will be disregarded for federal tax purposes. On the same date, Company acquired most of the shares of Entities 3 and 4. Entity 3 will be merged into a limited liability company (LLC), which will be treated as a partnership for federal tax purposes. Company will be the managing member of Entity 3. Company owns 80% of Entity 4, by vote and value, from which it anticipates receiving dividends. Entity 4 owns an interest in Entity 5. Entity 4, together with Company and Entities 1-3, will constitute a member group which will act as a managing member of Entity 5. In addition

to its acquisition on b of Entities 1-4, Company acquired on the same date interests in an LLC and various partnerships: Entities 8, 10, and 28-38.

As part of its expansion and restructuring, Company will cause Entity 7, a corporation, to merge into a Foreign Entity. Entity 7 owns Property 15. Subsequent to the merger, Entity 7 will be treated as a partnership for U.S. tax purposes.

Company is involved in all phases of real estate rental, development, and management. It owns direct and indirect interests in 49 rental properties (the Properties), which are located in Countries A and B and include shopping centers, office buildings, and other commercial real estate. Company owns 100% of Properties 1-8, either directly or through Entities 1 or 2. Company owns less then 100% of Properties 9-49 through tenancies-in-common (Entities 6 and 12), partnerships (Entities 3, 7-30, and 32-38), LLCs (Entities 5 and 31), and a corporate subsidiary (Entity 4). Entity 5, an LLC, is to be managed by a board of managers composed of 5 individuals, each one to be appointed by one of five managing members or member groups (see the second paragraph under FACTS). Entity 11 is a limited partnership in which Company holds a general partnership interest. Entity 31 is an LLC from which Company receives an insubstantial amount of rental income each year. The remaining entities that are less than wholly-owned by Company are entities which, as represented by Company, are treated under the laws of State B as giving all of their members direct rights of control over day-to-day operations as well as over major property management decisions. Company anticipates that the real estate ventures will be converted to limited liability companies that will be treated as partnerships for federal tax purposes. Company (or the entity through which it owns its interest in the venture) or Entity 1 will be the manager or co-manager of each of the limited liability companies.

Through its wholly-owned property management company (Entity 1) and the employees of the real estate ventures in which it owns interests, as well as through independent contractors, Company provides various services in leasing and managing the Properties. The type and level of services vary according to the particular lease for a property, 26 of which leases are net leases (covering Properties 2-8, 10-12, 15, 20, 23-25, 31, 33-36, 38-40, 44, 45, and 48). The services Company provides with respect to the non-net lease properties (Properties 1, 9, 13, 14, 16-19, 21, 22, 26-30, 32, 37, 41-43, 46, 47, and 49) include periodic inspection; cleaning and maintenance of common areas; maintenance and repair of building structure and systems, including roofs, exterior walls, foundations, heating and air conditioning, plumbing, and electrical systems; maintenance of interior walls, including painting; testing and maintenance of fire alarms, sprinklers, and security systems; parking lot and pavement maintenance, including cleaning and upkeep; landscape and grounds maintenance; janitorial services; security; pest control; rubbish and snow removal; and assisting tenants with move-in and the construction of tenant improvements. In addition to the services provided to

tenants, Company handles the usual leasing and administrative functions involved in managing rental real estate.

Based on a pro forma income and expense statement for c, Company expects to receive or accrue approximately d in rents (including its allocable or proportionate share of rental income) and to pay or incur approximately e in relevant expenses (including its allocable or proportionate share of rental expenses) on the Properties.

LAW & REGULATIONS

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 1.1362-8(a) provides that, for purposes of § 1362(d)(3), if an S corporation holds stock in a C corporation meeting the requirements of § 1504(a)(2) [the affiliated group 80% voting and value test], the term “passive investment income” shall not include dividends from such C corporation to the extent such dividends are

attributable to the earnings and profits of such C corporation derived from the active conduct of a trade or business (active earnings and profits). For purposes of applying § 1362(d)(3), earnings and profits of a C corporation are active earnings and profits to the extent that the earnings and profits are derived from activities that would not produce passive investment income (as defined in § 1362(d)(3)) if the C corporation were an S corporation.

CONCLUSIONS

Based solely on the facts and representations submitted, we conclude that–

1) the rents Company receives from Properties 1, 9, 13, 14, 16-19, 21, 22, 26-30, 32, 37, 41-43, 46, 47 and 49, including its share of such rents earned by the Entities of which it is a member, are not passive investment income under § 1362(d)(3)(C)(i);

2) the rents Entity 5 receives from Property 13, and Entity 4's share of those rents, are not passive investment income under § 1362(d)(3)(C)(i); thus, the dividends Company receives from Entity 4, to the extent such dividends are attributable to rental income realized by Entity 5 from Property 13, are not passive investment income under § 1362(d)(3)(C)(i); and

3) the leasing and management fees Company receives for services rendered by Entity 1 with regard to the Properties are not passive investment income under § 1362(d)(3)(C)(i).

Except for the specific rulings above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding Company'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.

Company represents that, given its level of activity, Entity 12 should be treated as a partnership and that a Form 1065, U.S. Return of Partnership Income, will be filed as soon as possible.

Under a power of attorney on file with this office, we are sending copies of this letter to Company's 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,

/s/

JAMES A. QUINN
Senior Technician Reviewer (Acting), Branch 2
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

enclosures: copy for § 6110 purposes

cc :