

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:  
CC:PSI:3 PLR-100627-01  
Date:  
August 23, 2001

**Legend**

Corp A =

Corp B =

Corp C =

Manager =

A =

B =

C =

D =

E =

Properties A =

Properties B =

Properties C =

M =

N =

O =

P =

Y1 =

D1 =

D2 =

Dear

This letter responds to your letter dated December 22, 2000, and subsequent correspondence submitted on behalf of Corp A, Corp B, and Corp C, requesting a ruling that the rental income to be received by New Corporation from Properties after a proposed restructuring is not passive investment income as defined under section 1362(d)(3)(C)(i) of the Internal Revenue Code.

## **FACTS**

Manager is an S Corporation effective as of D1 and Corp A, Corp B, and Corp C elected under section 1362(a) to be S corporations effective D2.

A is the sole shareholder of Manager and Corp A. A, B, C, D, and E are the shareholders of Corp B. A and B are the shareholders of Corp C. Corp A, Corp B, and Corp C have accumulated earnings and profits.

Corp A, Corp B, Corp C, and Manager (collectively "Corporations") are in the process of implementing a corporate restructuring plan. Under the plan, Corp A, Corp B, Corp C, and Manager will each become a wholly-owned subsidiary of a new corporation to be formed ("New Corporation"). A, B, C, D, and E will contribute all of their stock in Corp A, Corp B, Corp C, and Manager, respectively, to New Corporation in exchange for shares of New Corporation's stock. New Corporation intends to elect to be an S corporation and to elect to treat Corporations as Qualified Subchapter S Subsidiaries (QSubs).

Corp A, Corp B, and Corp C are in the business of developing and leasing commercial real estate. Corp A owns Properties A, Corp B owns Properties B, and Corp C owns Properties C (collectively "Properties"). Manager does not own any real estate. Manager, however, provides services to the Properties.

Corp A, Corp B, and Corp C together with Manager provide various services to the Properties. These services include, but are not limited to: (1) negotiating and coordinating the services provided by the real estate brokers, architects, contractors, subcontractors, attorneys, and accountants; (2) supervising the services provided by the secretaries, maintenance handymen, and property management personnel; (3) screening prospective tenants and negotiating leases; (4) ensuring that the tenants understand and comply with the lease terms; (5) overseeing tenant improvements; (6) contracting for major repairs to building including roofs, structural components, facades, mechanical heating, plumbing and electrical systems; (7) maintaining and repairing the parking lots; (8) painting the exterior of the buildings; (9) landscaping; (10) providing and maintaining air conditioning, heating, plumbing, water and sewage systems; (11) establishing rules and regulations for the safety, care and cleanliness of common areas; (12) providing alarms, trash removal, and janitorial and cleaning services; (13) making regular inspections of the properties; (14) scheduling repair work and contracting for the repairs to be done; (15) designing and renovating property; (16) responding to and assisting tenants; (17) marketing, leasing, and administrative functions involved in leasing and managing properties; and (18) other services that the tenants may reasonably request.

Manager employs M or N maintenance handymen to provide the maintenance services to the Properties and hires independent contractors when appropriate. Corp A, Corp B, and Corp C compensate Manager for the services. In addition, Corp A, Corp

B, and Corp C pay the taxes, insurance, water, and costs of maintaining the common areas on the Properties.

Corp A, Corp B, and Corp C received approximately \$O in rents and paid approximately \$P in relevant expenses for the taxable year ending Y1.

### **LAW AND ANALYSIS**

Except as provided in section 1362(g), section 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of section 1362, to be an S corporation.

Section 1362(d)(3)(A)(i) provides that an election under section 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 section 1362(d)(3)(C), section 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).

### **CONCLUSIONS**

Based solely on the facts submitted, the representations made, and the assumption that New Corporation makes a valid election to be an S corporation and makes valid QSub elections for Corporations, we conclude as follows: the rents the New Corporation will receive from the Properties after the proposed restructuring will not be passive investment income as defined under section 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 concerning the proposed corporate restructuring plan and regarding Corporations' and New Corporation's eligibility to be S corporations or Corporations' eligibility to be QSubs. Further, the passive investment income rules of section 1362 are completely independent of the passive activity rules of section 469; unless an exception under section 469 applies, the rental activity remains passive for purposes of section 469.

Under a power of attorney on file with this office, we are sending a copy of this letter to the taxpayer and the second authorized representative listed on the power of attorney.

This ruling is directed only to the taxpayer who requested it. According to section 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,  
Mary Beth Collins  
Senior Technician Reviewer, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2):  
Copy of this letter  
Copy for § 6110 purposes