Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
March 12, 1999

Number: **199924008**
Release Date: 6/18/1999

Company:

Shareholders:

Subsidiaries:

Entity:

Partnerships:

Properties:

a:

b:

c:

d:

e:

f:

g:

h:

i:

j:

Dear

This letter responds to your letter dated May 21, 1998, as well as subsequent correspondence, requesting a private letter ruling. Specifically, you ask the Internal Revenue Service to rule that (1) Company's elections to treat its wholly-owned first and second tier Subsidiaries as qualified subchapter S subsidiaries (QSSSs) will not cause any of the Subsidiaries to recognize income from built-in gains solely by reason of the elections, and (2) the rents received by Company from the leasing of the Properties do not constitute passive investment income under § 1362(d)(3)(C)(i). Company represents the following facts.

Company was incorporated on a and elected on b, under § 1362(a), to be an S corporation effective c. It has subchapter C earnings and profits. Company also elected on b, under § 1361(b)(3)(B)(ii), to treat Subsidiaries as QSSSs effective c.

Company manages the operations of the Properties. It owns interests in the Properties either directly or through Subsidiaries or Partnerships in which it owns a general partner interest. The Properties consist mainly of apartment and office buildings. A listing of partnership ownership percentages and property addresses is attached as Appendix A.

Company provides various services in its real estate leasing and management business. These services are provided by d persons, including property managers, onsite managers, onsite leasing agents, and onsite maintenance personnel, in addition to the Shareholders of Company and outside contractors when required. These services include, but are not limited to,

regular property inspection; comprehensive maintenance and repair (office tenants are responsible only for servicing the equipment and fixtures they install); janitorial services (mainly for the office buildings); landscaping; snow and rubbish removal; security; and a 24-hour on-call service for emergencies and tenant problems. In addition to the services provided to tenants, Company handles the usual marketing, leasing, and administrative functions involved in leasing and managing real estate.

None of the Properties is rented on a net lease basis. The owner pays for insurance, taxes, repairs, and all other operating expenses. The Properties generated a total of approximately e in rents and a total of approximately f in relevant expenses for g. The comparable figures for h, are i and j. Company's share of the income and expenses of the indirectly held Properties is determined by its ownership interests as reflected in App. A.

Section 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1361(b)(3)(B) defines "qualified subchapter S subsidiary" as any domestic corporation that is not an ineligible corporation (as defined in § 1361(b)(2)), if (i) 100 percent of the stock of that corporation is held by the S corporation, and (ii) the S corporation elects to treat that corporation as a QSSS. Notice 97-4, 1997-1 C.B. 351, provides guidance on making the QSSS election.

Section 1361(b)(3)(A) provides that, except as provided in regulations, (i) a corporation that is a QSSS shall not be treated as a separate corporation, 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.

The statutory provisions do not provide guidance on how the commingling of assets, liabilities, and other items occurs after the election is made. The legislative history, however, indicates that when the parent corporation makes the election, the subsidiary will be deemed to have liquidated under §§ 332 and 337 immediately before the election is effective. See S. Rep. No. 281, 104th Cong., 2d Sess. 53 (1996); H.R. Rep. No. 586, 104th Cong., 2d Sess. 89.

Section 1374 imposes a corporate level tax on the built-in gains recognized by a former C corporation during the 10-year

period beginning with the first day of the first tax year for which the corporation becomes an S corporation. For this purpose, "built-in gains" means any pre-S election appreciation of an asset. Under § 1374(d)(8), if an S corporation acquires an asset, and the S corporation's basis in the asset is determined by reference to the basis of the asset (or any other property) in the hands of a C corporation, the § 1374 tax is imposed on any net recognized built-in gain attributable to any such assets for any tax year beginning in the recognition period.

Section 1374(d)(3) defines "recognized built-in gain" as any gain recognized during the recognition period on the disposition of any asset, except to the extent that the S corporation establishes that (A) the asset was not held by the S corporation as of the beginning of the first tax year for which it was an S corporation, or (B) such gain exceeds the excess of the fair market value of the asset as of the beginning of the first tax year, over the adjusted basis of the asset at that time.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) to be an S corporation 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 as presented in this ruling request, and viewed in light of the applicable law and regulations, and provided that the deemed liquidations resulting from the QSSS elections qualify as complete liquidations under § 332(a), we conclude that neither Company nor any of the Subsidiaries will recognize income from built-in gains solely because of the deemed liquidations resulting from the QSSS elections filed with respect to Subsidiaries. Instead, the deemed liquidations will be treated as § 1374(d)(8) transactions, and § 1374 will apply accordingly. In addition, we conclude that the rents Company receives 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).

Temporary or final regulations pertaining to issues addressed in this ruling letter have not yet been adopted. Therefore, this ruling will be modified or revoked if the adopted temporary or final regulations are inconsistent with any conclusion in the ruling. See § 12.04 of Rev. Proc. 99-1, 1999-1 I.R.B. 6, 47. However, when the criteria of § 12.05 of Rev. Proc. 99-1 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

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 regarding Company's eligibility under § 1361 to be an S corporation, the validity of its election under § 1362(a) to be an S corporation, the effectiveness of its election to treat Subsidiaries as qualified subchapter S subsidiaries, the qualification of the deemed liquidations resulting from the QSSS elections as complete liquidations under § 332(a), or the effect the QSSS elections will have on Entity. 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
list of partnerships, including ownership percentages, assets, and property addresses (App. A)

Appendix A