

**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-101790-00  
Date:  
May 5, 2000

Company:

Sub A:

Sub B:

Sub C:

Corp X:

Corp Z:

Trust M:

Trust N:

State:

Properties:

Types:

Statute 1:

Statute 2:

a:

b:

c:

d:

e:

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f:g:h:i:j:k:

Dear

This letter responds to a letter from your authorized representative dated January 13, 2000, as well as subsequent correspondence, requesting rulings on 1) the proper treatment under § 1362(d)(3)(C) of the Internal Revenue Code of rental income from the Properties, 2) the proper owner under § 1361(b)(1)(B) of Company stock held in usufruct, and 3) the effect of the early termination provision in Trust M's governing instrument (the "Provision") on the ability of Trust M to qualify under § 1361(d) as a qualified subchapter S trust (QSST). Company represents the following facts.

Company, an S corporation, is engaged in the real estate rental business through 2 of its wholly-owned subsidiaries (Sub A and Sub B). It receives from this business several types of rental income (Types). It intends to elect under § 1361(b)(3)(B) to treat Sub A and Sub B as qualified subchapter S subsidiaries (QSubs).

Company owns and manages substantial interests in approximately a acres of land in State. It owns Properties 1-9 equally with Corp X, an unrelated corporation. Sub B owns Property 10 equally with Corp Z, an unrelated corporation. It manages daily the land use agreements and associates activities of approximately b surface tenants and manages routinely the leases and associated surface activities of an ever-changing number of oil and gas leases.

There are c persons engaged in a wide variety of land management activities necessary to generate Company's rental income: d are employed by Company and e by Sub A. One of these persons performs significant services for Company but is employed by Sub C, for which a QSub election will not be made.

The Company received or accrued approximately f in rents and paid or incurred

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approximately g in relevant expenses on the Properties for h. The comparable figures for i are j and k.

Company expects that the services and costs detailed in its ruling request will, in the aggregate, approximate the operations of Company's integrated real estate rental business in future years.

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).

Trust M owns, among other assets, a usufructuary interest in Company stock. Trust N, the principal beneficiary of Trust M, holds the naked ownership interest in the Company stock subject to the usufruct. The usufructuary interest terminates at the death of the income beneficiary of Trust M.

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any tax year, a small business corporation for which an election under § 1362(a) is in

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effect for the year.

Section 1361(b)(1) provides that the term "small business corporation" means a domestic corporation that is not an ineligible corporation and that does not, among other things, have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual.

A usufruct under State law is defined as a real right of limited duration on the property of another. Statute 1. The usufructuary has the right to possess the property subject to the usufruct and to derive the utility, profits, and advantages that the property produces. Statute 2. The usufructuary is bound to deliver the property subject to the usufruct to the naked owner at the termination of the usufruct. Statute 2.

In Rev. Rul. 64-249, 1964-2 C.B. 332, the taxpayer and her husband owned, as community property, all of the stock of a small business corporation. Upon his death, the husband bequeathed his shares of stock in the corporation to his children, with a usufruct for life to the taxpayer. The taxpayer was considered neither a guardian nor a trustee for the benefit of her children, but rather held her interest as usufructuary for her own benefit. Rev. Rul. 64-249 provided that the relationship between the children and the taxpayer was roughly comparable to the relationship between remainderman and life tenant in a common law state. As a result, the usufructuary (the taxpayer) had the income interest and was required to include in her gross income the dividends paid with respect to the stock. Rev. Rul. 64-249 held that a usufructuary under Louisiana law is considered to be a shareholder of a small business corporation. Because the taxpayer in Rev. Rul. 64-249 acquired one-half of the community property at the death of her spouse and one-half as usufructuary, she was regarded as the only shareholder of the small business corporation.

Trust M will terminate at the later of the expiration of 20 years from the settlor's death or the death of the income beneficiary. In addition, Trust M will terminate at any time its existence jeopardizes Company's current status under the Bank Holding Company Act of 1956 as amended in 1970 (the early termination provision). The income interest will terminate at the earlier of the termination of Trust M or the income beneficiary's death.

At the time Trust M was formed, Company was a significant shareholder in a national bank. Company has since divested itself of this bank stock. Trust M currently owns no interest in a bank or a bank holding company. Company represents that neither it nor Trust M will ever be subject to the Bank Holding Company Act, and that it is now impossible for Trust M's existence to jeopardize Company's status under the Act, making the early termination provision of the trust instrument effectively inoperable.

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According to § 1361(b)(1)(B), an S corporation can have as a shareholder no trust other than one described in § 1361(c)(2). Section 1361(d)(1) provides that a QSST with respect to which a beneficiary makes an election under paragraph § 1361(d)(2) shall be treated as a trust described in § 1361(c)(2)(A)(i).

Section 1361(d)(3) provides that, for purposes of § 1361(d), the term “qualified subchapter S trust” means a trust—

(A) the terms of which require that—

- (i) during the life of the current income beneficiary there shall be only 1 income beneficiary of the trust,
- (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary,
- (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary’s death or the termination of the trust, and
- (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary, and

(B) all of the income (within the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

Regarding § 1361(d)(3)(A)(iv), the trust instrument of Trust M provides for early termination in the event that the existence of the trust threatens the status of Company under the Bank Holding Company Act. However, Company represents that this trust provision will never be operative.

Based solely on the facts as represented by Company in this ruling request, we conclude that—

- 1) the rents Company receives from the Properties are not passive investment income under § 1362(d)(3)(C)(i);
- 2) Trust M, as usufructuary, is treated as the owner of the Company stock subject to usufruct for purposes of § 1361; and

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3) the early termination provision in the trust agreement for Trust M will not preclude Trust M from qualifying as a QSST under § 1361(d).

Except for the specific rulings above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provisions of the Code. Specifically, no opinion is expressed on whether Company is eligible to be an S corporation, on whether Subs A and B are eligible to be QSubs, or on whether Trust M is eligible to be a QSST. 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,  
JONI LARSON  
Acting Assistant to the Chief, Branch 3  
Office of Assistant Chief Counsel  
(Passthroughs and Special Industries)

enclosure: copy for § 6110 purposes