

Internal Revenue Service

Department of the Treasury

Number: **200106030**

Washington, DC 20224

Release Date: 2/9/2001

Index Number: 1362.02-03

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:3 PLR-113795-00

Date:

November 13, 2000

Company:

Corp A:

Corp B:

Corp C:

Corp D:

Corp E:

Partnership W:

Partnership X:

Partnership Y:

Partnership Z:

Partner M:

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Partner N:

Manager:

Contractor:

Property 1:

Property 2:

State:

a:

b:

c:

d:

e:

f:

g:

h:

Dear

This letter responds to your letter dated July 12, 2000, as well as subsequent correspondence, requesting a ruling that the rental income received by Company from Properties will not be passive investment income under § 1362(d)(3)(C)(i) of the Internal Revenue Code. Company represents the following facts.

FACTS

Company, a State corporation, intends to elect under § 1362(a) to be an S corporation effective a. Effective that same date, Company intends to elect under

§ 1361(b)(3)(B) to treat certain of its subsidiaries (Corps A, B, C, D, and E) as qualified subchapter S subsidiaries (QSubs).

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Company is the common parent of an affiliated group of corporations. Company owns Corp A, which in turn owns Corps B and C. Corp B owns Corp D, and Corp C owns Corp E.

Corps D and E have ownership interests in Properties 1 and 2 (Properties) through their interests in Partnerships W, X, Y, and Z. Partnership W is owned by Corp D as general partner and by Corp E and Partnership X as limited partners. Partnership X is owned by Corp E as general partner and by employees of Company as limited partners. See the legend for ownership percentages.

Property 1 is owned by Partnership Y, which in turn is owned by Partnership W and Partner M as general partners. Property 2 is owned by Partnership Z, which in turn is owned by Partnership W and Partner N as general partners. Partners M and N serve as the managing partners for Partnerships Y and Z, respectively. See the legend for ownership percentages.

Partnerships Y and Z use an unrelated management company (Manager) to perform certain management, leasing, and construction supervision services for Properties, and they use an unrelated service contractor (Contractor) to provide building maintenance services for Properties. On behalf of Partnership W, b employees of Company work with Manager and Partners M and N to oversee the operation and management of Properties.

The parties above, along with independent contractors, provide various services to Properties. These services include regular property inspection; cleaning of common areas; janitorial services; window washing; maintenance and repair of building structural components, including foundations, roofs, and exterior walls and windows; maintenance and repair of building systems, including plumbing, electrical, heating and air conditioning, and elevators; testing and maintenance of fire alarms and sprinklers; landscaping and grounds maintenance; utilities; trash and snow removal; pest control; security; assistance with, and supervision of, tenant improvements; and handling of tenant problems and requests for service.

Properties generated a total of approximately c in rents and a total of approximately d in relevant expenses for e. The comparable figures for f are g and h. The distributive shares for Corps D and E of the income and expenses of Properties are determined by their ownership interests as reflected in the legend.

LAW AND ANALYSIS

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.

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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.

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.

After the QSub elections, Company will hold direct general partnership interests in Partnerships W and X.

Based solely on the facts as represented by Company in this ruling request, we conclude that, after the QSub elections, the rents Company receives from Properties as part of its distributive share of partnership income will not constitute passive investment income under § 1362(d)(3)(C)(i).

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The ruling in this letter is based on information and representations submitted by the Company 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.

Under a power of attorney on file with this office, we are sending a copy of this letter to Company.

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,

MARY BETH COLLINS
Assistant to the Chief, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

enclosure: copy for § 6110 purposes