

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-112418-98

Date:

November 19, 1998

Company:

Shareholders:

Subsidiary 1:

Subsidiary 2:

Subsidiary 3:

Subsidiary 4:

Subsidiary 5:

Subsidiary 6:

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Subsidiary 7:

Subsidiary 8:

Subsidiary 9:

Subsidiary 10:

Property 1:

Property 2:

Property 3:

Manager:

Type A:

Type B:

a:

b:

c:

d:

e:

f:

g:

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h:

i:

Dear

This letter responds to a letter from your authorized representative dated June 2, 1998, as well as subsequent correspondence, submitted on behalf of Company, requesting a ruling that the rental income received by Company from Properties 1 and 2 is not passive investment income within the meaning of § 1362(d)(3)(C)(i). Company represents the following facts.

Company was incorporated on a and elected under § 1362(a) to be an S corporation effective b. It has C corporation earnings and profits. Company has elected under § 1361(b)(3)(B) to treat Subsidiaries 1 through 9 as qualified subchapter S subsidiaries.

In recent years Company and its subsidiaries have divested themselves of various businesses and assets. Subsidiaries 3 and 4 have sold off their commercial real estate. Subsidiaries 5, 6, 7, and 8 have sold their businesses to unrelated parties and are now engaged in winding up activities only. Subsidiaries 9 and 10 are inactive.

Company and its subsidiaries now are involved primarily in real estate operation and management, Type A management for related corporations, and various investment activities. Three principal properties remain.

Company owns Property 1, Subsidiary 1 owns Property 2, and Subsidiary 2 owns Property 3. Manager acts as Company's agent in all leasing and property management matters regarding Property 1. Manager consults with Company representatives frequently on major repairs, lease turnover, and other asset management issues. Company manages Property 2 with its own employees.

Through Company's c employees, as well as through Manager and a variety of independent contractors, Company provides various services to Properties 1 and 2 in its real estate leasing and management business (though the same services are not necessarily provided to both properties). These services include, but are not limited to, regular property inspection; common area cleaning and maintenance, including trash removal; maintenance and repair of building structural components and systems; maintenance and repair of Type B property; space planning services; landscaping; pest control; security;

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utilities; and a 24-hour contact for maintenance, repair, and security issues. In addition to the services provided to tenants, Company, along with Manager, handles the usual leasing and administrative functions involved in managing real estate.

Company received or accrued approximately d in rents and paid or incurred approximately e in relevant expenses on Properties 1 and 2 for f. The comparable figures for g are h and i.

Property 3, owned by Subsidiary 2, is leased on a net basis to a sister entity of Subsidiary 2. Subsidiary 2 has no obligation to maintain and repair the premises or related equipment. Subsidiary 2 incurs no expenses and performs no services for Property 3.

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

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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, we conclude that the rents Company receives from Properties 1 and 2 are not passive investment income under § 1362(d)(3)(C)(i).

Except for the specific ruling 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 S corporation election or its status as an S corporation. 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