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Nov 18, 1999

Legend

X =

Y =

Year1 =

Year2 =

State =

a =

b =

c =

Properties =

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\$d =\$e =\$f =\$g =

This letter responds to a letter dated May 14, 1999, written on behalf of X, requesting a ruling that the rental income received by X and its qualified subchapter S subsidiaries (QSUBS) from Properties is not passive investment income within the meaning of section 1362(d)(3)(C)(i) of the Code.

Facts

X has elected to be an S corporation and is engaged in the business of owning and managing real estate. X owns a residential apartments and b square feet of retail space. X performs management services through Y, a corporation for which a QSUB election is in effect. X proposes to form, under State law, a series of wholly-owned subsidiaries and elect for them to be treated as QSUBS. Each of Properties currently owned by X would be transferred to one of the newly formed QSUBS.

X conducts regular inspections of its real estate, and is responsible for maintaining the roofs, exterior walls, heating and air conditioning systems, plumbing, foundations, and structures of the real estate. X is responsible for providing on-premises superintendent or janitor, arranging social activities, painting of apartments, repairs within apartments, maintenance of common areas, pest control, snow removal, trash removal, seasonal decorations, provision of utilities, building security and patrol services, maintenance of alarm and sprinkler systems, handling tenant complaints, handling some eviction proceedings, general bidding for supplies and labor,

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maintenance and capital improvements, and ongoing capital improvement programs to existing properties. X also oversees the leasing of the real estate, advertising and marketing of the properties. These activities are performed for X through its QSUB, Y. Y has c employees who provide these services.

In Year1, X received or accrued approximately \$d in rents and paid or incurred approximately \$e in relevant expenses with respect to Properties. In Year2, X received or accrued approximately \$f in rents and paid or incurred approximately \$g in relevant expenses with respect to Properties.

Law and Analysis

Section 1361(b)(3) (A) provides that a corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary shall be treated as assets, liabilities, and such items of the S corporation.

Section 1361(b)(3)(B) provides that a qualified subchapter S subsidiary means any domestic corporation which is not an ineligible corporation if 100 percent of the stock of such corporation is held by the S corporation, and the S corporation elects to treat such corporation as a qualified subchapter S subsidiary.

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 subparagraph (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

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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).

Conclusion

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 X receives from Properties are not passive investment income under section 1362(d)(3)(C)(i). This ruling assumes that valid QSUB elections are in effect for each of the subsidiary corporations to which Properties are transferred and that Y has a valid QSUB election in effect.

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 eligibility under section 1361 to be an S corporation or the validity of the relevant QSUB elections. 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.

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 section 6110(k)(3), this ruling may not be used or cited as precedent.

Sincerely,

Signed/David R. Haglund

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Enclosures (2)

Copy of this letter

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