Internal Revenue Service

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
March 12, 1999

Company 1 =

Company 2 =

Company 3 =

Company 5 =

Company 6 =

Company 7 =

Company 8 =

Company 9 =

Company 10 =

Company 11 =

Group =

Partnership 1 =

Partnership 2 =

Partnership 3 =

Partnership 4 =

Partnership 5 =

Partnership 6 =

State =

o =

Property 1 =

Property 2 =

Property 3 =

Property 4 =

Property 5 =

Property 6 =

Property 7 =

Property 8 =

Property 9 =

Property 10 =

Property 11 =

Property 12 =

Property 13 =

Property 14 =

Property 15 =

Property 16 =

Property 17 =

Property 18 =

Property 19 =

Property 20 =

Property 21 =

Property 22 =

Property 23 =

Property 24 =

Property 25 =

Property 26 =

Property 27 =

Property 28 =

Property 29 =

Property 30 =

Property 31 =

$x =

$z =

Taxable Year =

Dear :

This letter responds to your June 30, 1998 ruling request and subsequent correspondence submitted on behalf of Group concerning § 1362(d)(3) of the Internal Revenue Code.

Company 1 is the common parent of a group of corporations that are members of an affiliated group of corporations (Group). In addition to Group, there are related non-member entities that include partnerships. Group and a number of the related non-member entities own, rent, operate, manage, and develop commercial real estate. All of the corporations in Group are C corporations and all of the corporations except Company 3 have accumulated earnings and profits. Company 1 proposes to elect to be treated as an S corporation under § 1361 of the Code and to simultaneously elect qualified subchapter S subsidiary status under § 1361(b)(3) for Group members: Company 2, Company 3, Company 5, Company 6, Company 9, Company 10, and Company 11. Related non-member entities include Company 7, Company 8, Partnership 1, Partnership 2, Partnership 3, Partnership 4, Partnership 5, and Partnership 6.

Company 1 owns a 25 percent general partner interest, Company 5 owns a 50 percent general partner interest, and Company 6 owns a 25 percent general partner interest in Partnership 1. Company 1 owns a 50 percent general partner interest in Partnership 2. Company 6 owns a 6.25 percent limited partner interest in Partnership 3. Company 7 and Company 8 respectively own 0.2 percent and 50.8 percent in Partnership 4. Company 1, Company 5, Company 6, Company 9, and Company 10 collectively own a 66.84 percent general partner interest in Partnership 5. Partnership 5 owns a 50 percent general partner interest in Partnership 6.

Group members and the related non-member entities collectively own various interests in several properties. Company 6 owns Property 1, Company 9 owns Properties 2 and 3, Company 10 owns Property 4, Company 1 owns Properties 5 and 6, Partnership 6 owns Property 7, Partnership 1 owns Property 8, and Partnership 2 owns Property 9. Company 3 owns Property 10. Company 6 owns Properties 11 and 12. Company 1 owns Properties 13, 14, and 15. Company 6 owns Property 16, Company 9 owns Properties 17 through 19. Company 11 owns Property 20, and Company 1 owns Properties 21 through 25. Company 8 owns Property 26 and Company 6 owns Property 27. Company 6 and Company 1 own Property 28, Company 9 owns Property 29, and Company 1 owns Properties 30 and 31.

Company 2 performs management and administrative services and acts as agent for Group members. As agent, Company 2 performs management, accounting, executive, and transfer agent services for properties that members of Group collectively own. Company 2 charges and collects fees for these services on a monthly basis. Company 2 has o employees who perform some of the services and contracts with outside vendors for the remainder.

Company 2 also provides services and acts as agent for related non-member entities. Company 2 receives fees from the related non-member entities for accounting, executive, management, and transfer agent services performed directly by Company 2. The fees charged and collected from the related non-member entities are determined on an arm's length basis.

Company 3, a Group member, which owns Property 10 uses its own employees to operate Property 10 and also pays a management fee to Company 2 for managing the property.

Company 2 performs several services with respect to Properties 1 through 31. These services include, but are not limited to, soliciting prospective tenants, negotiating lease arrangements and renewals, and overseeing interior and exterior maintenance of buildings. Company 2 also pays property taxes, monitors property tax assessments, obtains insurance, and monitors tenants' compliance with lease provisions.

Group received gross rental/trade or business income of $x and paid or incurred $z in operating expenses for the Taxable Year.

Section 1362(d)(3)(C)(i) of the Code provides that, except as otherwise provided, 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 defines "rent" as 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) of the regulations provides that "rent" does not include rents derived in the 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).

Section 1375(a) of the Code provides that if, at the close of a taxable year, an S corporation has subchapter C earnings and profits and gross receipts more than 25 percent of which are

passive investment income, a tax is imposed on the excess net passive income of the corporation.

Section 1375(b)(3) of the Code provides that the terms "passive investment income" and "gross receipts" have the same respective meanings as when used in § 1362(d)(3).

In Rev. Rul. 71-455, 1971-2 C.B. 318, the taxpayer, a corporation, elected, pursuant to former § 1372(a) (the predecessor to § 1362), to be a subchapter S corporation. The taxpayer, which owned and operated motion picture theaters, entered into a joint venture as a partner, to own and operate a motion picture theater. For the 1968 tax year the joint venture realized total gross receipts of 40x dollars and had total ordinary and necessary business expenses of 50x dollars, resulting in a loss of 10x dollars. The joint venture had no other items of income, gain, loss, deduction, or credit for the tax year.

Rev. Rul. 71-455 holds that the taxpayer's distributive share of gross receipts from the joint venture rather than its distributive share of ordinary loss from such venture was to be used in applying the passive investment income test under former § 1372(e)(5) of the Code.

Based solely on the information submitted, the representations made, and the assumption that Company 1 makes a valid election to be an S corporation and makes valid qualified subchapter S subsidiary elections for eligible group members with rental income that is the subject of this ruling, we conclude as follows. Under § 1.1362-2(c)(5)(ii)(B)(2) of the regulations, the rental income that Group derives from Properties 1 through 31 is income from the active trade or business of renting property and is not passive investment income as described in §§ 1362(d)(3)(C)(i) or 1375(b)(3) of the Code.

The fees that Company 2 receives from related non-member entities for its services is not passive investment income as described in §§ 1362(d)(3)(C)(i) or 1375(b)(3) of the Code. Further, we conclude that the fees that Company 2 receives from related non-member entities is taken into account in determining Group’s gross receipts for purposes of § 1362(d)(3).

We further conclude that each member of Group that has an interest in Partnerships 1 through 6 will be required to include its distributive share of partnership gross receipts in Group’s gross receipts for purposes of § 1362(d)(3) of the Code to determine whether more than 25 percent of Group’s gross receipts are passive investment income. The character of Group’s distributive share of gross receipts from the partnerships will

be the same as the character of gross receipts to the partnerships.

Except as specifically set forth above, we express no opinion as to the federal tax consequences of the transaction described above under any other provision of the Code. Further, we express no opinion on whether Company 1 is a small business corporation eligible to make an S election nor whether the subsidiaries will be qualified subchapter S subsidiaries under § 1361(b)(3) of the Code.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the power of attorney submitted, we are sending a copy of this ruling to Company 1's authorized representative.

Sincerely yours,

J. THOMAS HINES
Senior Technician Reviewer
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs and Special
Industries)

Enclosures: 2
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