Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:3 PLR-111799-03
Date:
July 8, 2003

Company:

State:

Trust:

Sub:

Services Sub:

Property Subs:

GP Subs:

Portfolio
Partnerships:

GP Partnerships:

Services LP:

Employees
Partnership:

a:

b:

Dear :

This letter responds to your letter dated February 12, 2003, as well as subsequent correspondence, requesting a ruling that a proposed change in Company's operating structure will not affect a previously issued private letter ruling that rental income received by Company from certain properties, both directly and through various partnerships, was not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code.

FACTS

Company, a closely held corporation, was formed under the laws of State in a and elected to be an S corporation effective b. That same date, Trust, Company's sole shareholder, elected to be treated as an electing small business trust (ESBT). Company made qualified subchapter S subsidiary (QSub) elections for Sub, Services Sub, Property Subs, and GP Subs (the QSubs), also effective b. Through its QSubs or their interests in partnerships, Company owns and leases commercial real estate properties. Company manages and maintains these properties through Services LP, of which Services Sub is the sole general partner.

In PLR 9844007 (July 30, 1998), the Internal Revenue Service ruled that Company's rental income from certain properties, received directly and through various partnerships, both before and after a proposed restructuring, was not passive investment income under § 1362(d)(3)(C)(i).

Company and Employees Partnership plan to convert Services LP from a limited partnership into a general partnership and to change the manner in which future Portfolio Partnerships are structured. Employees Partnership intends to become a limited liability company (Employees LLC).

As proposed, Services Sub and Employees Partnership will become co-equal general partners in Services GP (Services LP as converted), with Employees LLC acting as the managing partner. However, Services GP will be governed by a Board of Managers (Board), with Services Sub appointing two out of a total of five Board members and having veto power over certain actions relating to Services GP.

All other operations will remain unchanged. Services GP will continue to perform the property related services. The QSubs and Portfolio Partnerships will continue to own real estate generating rental income. Company, as the sole stockholder of the QSubs, will continue to receive rental income from the portfolio of properties. In addition, Company, through the QSubs and other interests in the GP Partnerships and Portfolio Partnerships, will continue to receive its distributive shares of the rental income earned by the Portfolio Partnerships.

Following the restructuring, Services GP plans to establish new partnerships (New Portfolio Partnerships) to acquire and develop a portfolio of real estate similar to the current Portfolio Partnerships. When Services GP establishes a New Portfolio Partnership, it will hold its interest in the New Portfolio Partnership through a general partnership (New GP Partnership) by way of an intervening wholly-owned limited liability company. Services GP will be the managing general partner in the New GP Partnership. An indirect subsidary of Company (New GP Sub), assuming that Sub invests in the New Portfolio Partnership as a limited partner, will be a co-general partner in the New GP Partnership. As with Services GP, the New GP Partnership will be governed by a board of managers. Services GP will be entitled to appoint three of the five members of this board, and the New GP Sub will be entitled to appoint the remaining two members. The New GP Sub will have no veto rights over decisions of this board, and none of the veto powers that Services Sub has with respect to Services GP will relate to actions relating to the New Portfolio Partnerships of the New GP Partnerships. Services GP will provide the property related services to the New Portfolio Partnerships.

LAW

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 § 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).

CONCLUSION

Based solely on the facts and representations submitted, we conclude that the proposed changes in Company's operating structure will not change the Service's conclusions in PLR 9844007, as long as Company continues to meet the standards of § 1.1362-2(c)(5)(ii)(B)(2). Except for this specific ruling, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code.

Under a 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 yours,

MARY BETH COLLINS
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosure: copy for § 6110 purposes

cc: