Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
July 25, 2001

X =

Sub =

Y =

Venture 1 =

Venture 2 =

Venture 3 =

Venture 4 =

Venture 5 =

Venture 6 =

Property 1 =

Property 2 =

Property 3 =

Property 4 =

Property 5 =

Property 6 =

$x1 =

$x2 =

$x3 =

$x4 =

$x5 =

$x6 =

$y1 =

$y2 =

$y3 =

$y4 =

$y5 =

$y6 =

x% =

D1 =

D2 =

D3 =

Dear :

This letter responds to a letter dated August 21, 2000, and subsequent correspondence written by your authorized representative on behalf of X, requesting a ruling concerning § 1362(d)(3)(C)(i) of the Internal Revenue Code.

According to the information submitted, X was incorporated on D1. Sub is a wholly owned subsidiary of X that was incorporated on D2. X, and Sub and are C corporations that file a consolidated income tax return. X has accumulated earnings and profits. X proposes to elect to be treated as an S corporation and to treat Sub as a qualified subchapter S subsidiary (QSub).

Sub and Y, an unrelated entity, are partners in limited partnerships, Ventures 1 through 6. Sub is a limited partner in each Venture and, through wholly-owned LLCs, Sub owns an x% general partnership interest in each Venture. Because no election will be made for any of the wholly-owned LLCs, each LLC will be disregarded as an entity separate from its owner under § 301.7701-3(b)(1)(ii). Each Venture owns and operates a single commercial real estate property, Properties 1 through 6.

In the fiscal year ending D3, Venture 1 accrued approximately $x1 in rents and incurred approximately $y1 in relevant expenses with respect to Property 1, Venture 2 accrued approximately $x2 in rents and incurred approximately $y2 in relevant expenses with respect to Property 2, Venture 3 accrued approximately $x3 in rents and incurred approximately $y3 in relevant expenses with respect to Property 3, Venture 4 accrued

approximately $x4 in rents and incurred approximately $y4 in relevant expenses with respect to Property 4, Venture 5 accrued approximately $x5 in rents and incurred approximately $y5 in relevant expenses with respect to Property 5, Venture 6 accrued approximately $x6 in rents and incurred approximately $y6 in relevant expenses with respect to Property 6.

The Ventures provide various services to its tenants. Services provided by Ventures 1, 3, 4, and 6 to its various tenants include, but are not limited to: maintenance and repair of parking lots, parking structures, and easements; repair, maintenance, and decoration of common areas; snow removal from common areas; provision of all electric light bulbs, tubes and ballasts for building standard fixtures, janitorial services, window washing, repair service for any building equipment or machinery; installation of tenant improvements.

Services provided by Venture 2 to its various tenants include, but are not limited to: providing managers, engineers, porters, and matrons; providing repairs and general nightly maintenance of offices, elevators, public corridors, lobbies, restrooms, and stairwells; dusting, vacuuming, and trash removal.

Venture 5 contracts with an independent hotel management company which provides extensive services to Property 5 on behalf of Venture 5.

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).

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.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an eligible entity) can elect its classification for federal tax purposes as provided in this section.

Section 301.7701-3(b)(1)(ii) provides that, unless the entity elects otherwise, a domestic eligible entity is disregarded as an entity separate from its owner if it has a single owner.

LLC will be a disregarded entity of Sub, which in turn will be ignored for federal tax purposes after X makes the QSub election for Sub. Thus, X will hold, for federal tax purposes, direct general partnership interests in Ventures 1 through 6.

Based solely on the information submitted, and the representations made, if X makes a valid election to be an S corporation and a valid QSub election for Sub, the rents that X receives through Ventures 1 through 6 will not be passive investment income as described in § 1362(d)(3)(C)(i).

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 X is a small business

corporation eligible to be an S corporation nor whether Sub is eligible to be a qualified subchapter S subsidiary under § 1361(b)(3).

This ruling is directed only to the taxpayer requesting 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 on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely yours,
JEANNE M. SULLIVAN
Acting Senior Technician
Reviewer, Branch 2
Office of the Associate
Chief Counsel
(Passthroughs and
Special Industries)

Enclosures: 2
Copy of this letter
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