Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Company A:

Company B:

Company C:

Shareholders:
(Company A)

Properties:
1:

2:

3:

4:

5:

6:

7:

8:

Area:

a:

b:

c:

d:

e:

f:

g:

h:

i:

j:

k:

Dear

This letter responds to a letter dated July 16, 1998, as well as subsequent correspondence, submitted on behalf of Companies A and B (the "Corporations") by your authorized representative, requesting a ruling under § 1362(d)(3)(C)(i) of the Internal Revenue Code regarding the rental income received by the Corporations from the Properties, as well as various rulings under § 368(a)(1)(D) and related provisions regarding a plan of reorganization between Companies A and B. The Corporations represent the following facts.

The Corporations acquire, develop, construct, lease, and manage real estate in the Area. Company A, formed in a, performs management and finance activities for the Corporations. Company B, which began operations in b, performs a majority of the operating activities of the Corporations. Company B owns Properties 1, 2, 3, 4, 7, & 8. Company B owns c percent of Property 5 as a member of Company C and owns d percent of Property 6 as a tenant-in-common. (Corporations have not requested a ruling, and there has been no consideration, as to whether the ownership of Property 6 actually results in a partnership with the other owners of the property.)

Company A is the common parent of an affiliated group of corporations, which includes Company B. Company B is a e percent-owned subsidiary of Company A. Whether the minority interest in Company B will be redeemed or otherwise eliminated before the transaction discussed below is unknown. Company B has outstanding a single class of common stock.

Company A has issued and outstanding two classes of stock: one class of common stock and one class of convertible preferred stock. Under the terms of Company A's Articles of Incorporation, each holder of convertible preferred stock has the right to convert all or any part of his convertible preferred stock into f shares of Company A common stock. In the event of a transfer of all or substantially all of the assets of Company A, however, the holder is entitled to convert these shares into the same kind and amount of stock as may be issuable or payable by the terms of the transfer with respect to the number of shares of common stock that he would have been entitled to receive had he exercised the conversion privilege immediately before the transfer. A convertible preferred stockholder has the right, also, to have the stock redeemed immediately before any such transfer of Company A's assets. Redemption, though, would not be in the best economic interests of the stockholder, and Company A's board of directors does not recommend redemption.

The Corporations are engaging in the transaction in order to enhance efficiencies and realize savings through the reduction of state tax liabilities, costs associated with adhering to consolidated return regulations, and costs incurred in completing multiple state and local tax returns. The transaction also will simplify, and thereby reduce costs associated with, the corporate and capital structures by eliminating unnecessary layers, simplify business records, combine certain overhead functions, and provide economies of scale with respect to overhead functions, accounting, auditing, legal, and directors fees. Finally, the transaction will facilitate a subchapter S election

under § 1362.

Pursuant to a plan of reorganization, Company A will transfer to Company B all of its assets, including its stock in Company B, in exchange for new Company B common stock and the assumption by Company B of all Company A's liabilities. After the initial exchange, and pursuant to the same plan of reorganization, Company A will distribute the Company B stock pro rata to its current shareholders in liquidation of all of its outstanding stock. Company A then will dissolve, with Company B as the surviving corporation. No fractional shares of Company B will be issued in the transaction.

After the merger of the Corporations, Company B will elect under § 1362(a) to be an S corporation effective g. Simultaneous with the S corporation election, the trustees of the nongrantor trusts holding stock in Company B (currently shareholders of Company A) will elect under § 1361(e) to treat the trusts as electing small business trusts.

Section 1362(d)(3)(C)(i)

Through Company B's approximately h employees, the Corporations provide various services in its real estate leasing and management business (which is only part of a vertically integrated real estate operation). Under all of the leases, the Corporations are responsible for maintaining the structural components of the buildings, including the roofs. Typically, the tenant is responsible for routine maintenance, but the Corporations often perform this function in the common areas to enhance the lessor-lessee relationship. The Corporations employ and supervise remodelling, maintenance, and landscape crews to inspect properties on a regular basis; to maintain and repair (or replace) property exteriors, including roofs, parking lots, facades, and sidewalks; to monitor and assist tenants in complying with environmental laws; to make leasehold improvements; and to perform various other functions. The Corporations' office staff and maintenance crews respond to tenant calls regarding problems and take corrective action either directly or by means of subcontractors. The cost of these repairs or other actions might be borne by the Corporations or by the tenant, depending on the problem and the action taken. In addition to the services provided to tenants, the Corporations handle the usual leasing and administrative functions involved in leasing and managing real estate.

The Corporations received or accrued $i in rents and paid or incurred $j in relevant expenses on the Properties for period k.

The Corporations represent that these figures are consistent with the income and expense figures for prior periods.

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 number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

Section 1.1362-2(c)(5)(ii)(B)(*4*) provides that "rents" does not include compensation, however designated, for the use of, or right to use, any real or tangible personal property developed, manufactured, or produced by the taxpayer, if during the tax year the taxpayer is engaged in substantial development, manufacturing, or production of real or tangible personal property of the same type.

Section 368(a)(1)(D)

Companies A and B make the following representations.

(a) The fair market value of the Company B stock and other consideration, if any, received by each Company A shareholder will be approximately equal to the fair market value of the Company A stock surrendered in the exchange.

(b) There is no plan or intention by the shareholders of Company A who own 1 percent or more of the Company A stock, and to the best of the knowledge of the management of Company A, there is no plan or intention on the part of the remaining shareholders of Company A to sell, exchange or otherwise dispose of a number of shares of Company B stock received in the transaction that would reduce the Company A shareholders' ownership of Company B stock to a number of shares having a value, as of the date of the transaction, of less than 50 percent of the value of all of the formerly outstanding stock of Company A as of the same date. For purposes of this representation, shares of Company A stock exchanged for cash or other property (if any), surrendered by dissenters (if any), or exchanged for cash in lieu of fractional shares (if any) will be treated as outstanding on the date of the transaction. Moreover, shares of Company A stock and shares of Company B stock held by Company A shareholders and otherwise sold, redeemed or disposed of prior or subsequent to the transaction have been considered in making this representation.

(c) Company B will acquire at least 90 percent of the fair market value of the net assets and at least 70 percent of the gross assets held by Company A immediately prior to the transaction. For purposes of this representation, amounts paid by Company A to dissenters, amounts paid by Company A to shareholders who receive cash and or other property, amounts used by Company A to pay its reorganization expenses and all redemptions and distributions (except for regular, normal dividends) made by Company A immediately before the transfer are included as assets of Company A held immediately before the transaction.

(d) After the transaction, the shareholders of Company A will be in control of Company B within the meaning of § 368(a)(2)(H).

(e) Company B has no plan or intention to reacquire any of its stock issued in the transaction.

(f) Company B has no plan or intention to sell or otherwise dispose of any of the assets of Company A acquired in the transaction, except for dispositions made in the ordinary course of business.

(g) The liabilities of Company A assumed by Company B plus the liabilities, if any, to which the transferred assets were subject were incurred by Company A in the ordinary course of its business and were associated with the assets transferred.

(h) Following the transaction, Company B will continue the historic business of Company A or use a significant portion of Company A's historic business assets in a business.

(i) At the time of the transaction, Company B will not have outstanding any warrants, options, convertible securities, or any other type of right pursuant to which any person could acquire stock in Company B that, if exercised or converted, would affect the Company A shareholders' acquisition or retention of control of Company B, as defined in § 368(a)(2)(H).

(j) Company B, Company A, and the shareholders of Company A will pay their respective expenses, if any, incurred in connection with the transaction.

(k) There is no intercorporate indebtedness existing between Company A and Company B that was issued, acquired, or will be settled at a discount.

(l) No two parties to the transaction are "investment companies" as defined in § 368(a)(2)(F)(iii) and (iv).

(m) The fair market value of the assets of Company A transferred to Company B will equal or exceed the sum of the liabilities assumed by Company B, plus the amount of liabilities, if any, to which the transferred assets are subject.

(n) The total adjusted basis of the assets of Company A transferred to Company B will equal or exceed the sum of the liabilities assumed by Company B, plus the amount of liabilities, if any, to which the transferred assets are subject.

(o) Company A is not under the jurisdiction of a court in a Title 11 or similar case within the meaning of § 368(a)(3)(A).

(p) None of the compensation received by any shareholder-employees of Company A will be separate consideration for, or allocable to, any of their shares of Company A stock; none of the shares of Company B stock received by any shareholder-employees will be separate consideration for, or allocable to, any employment agreement; and the compensation paid to any shareholder-employees will be for services actually rendered and will be commensurate with amounts paid to third parties bargaining at arm's-length for similar services.

Based solely on the facts as presented in this ruling request, and viewed in light of the applicable law and regulations, we rule as follows.

(1) The rents the Corporations receive from the Properties are not passive investment income under § 1362(d)(3)(C)(i).

(2) The transfer by Company A of substantially all of its assets to Company B in exchange for Company B stock and the assumption by Company B of the liabilities of Company A, followed by the distribution by Company A of the Company B stock to the shareholders of Company A, will be a "reorganization" within the meaning of § 368(a)(1)(D). For purposes of this ruling, "substantially all" means at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets of Company A. Companies A and B each will be a "party to a reorganization" within the meaning of § 368(b).

(3) No gain or loss will be recognized by Company A on the transfer of substantially all of its assets to Company B in exchange for Company B stock and the assumption of its liabilities, or on the distribution of the Company B stock received pursuant to the plan of reorganization to its shareholders (§§ 361(a), 357(a), and 361(c)).

(4) No gain or loss will be recognized by Company B on the receipt of Company A's assets in exchange for shares of Company B stock and assumption of Company A's liabilities (§ 1032(a)).

(5) The basis of the assets of Company A in the hands of Company B will be the same as the basis of those assets in the hands of Company A immediately prior to the transaction (§ 362(b)).

(6) The holding period for the assets of Company A in the hands of Company B will include the period during which those assets were held by Company A (§ 1223(2)).

(7) No gain or loss will be recognized by the shareholders of Company A on the exchange of their stock in Company A for shares of Company B stock (§ 354(a)(1)).

(8) The basis of the Company B stock to be received by shareholders of Company A will be the same as the basis of the Company A stock surrendered in exchange therefor (§ 358(a)(1)).

(9) The holding period of the Company B stock to be received by shareholders of Company A will include the holding period of the Company A stock surrendered in exchange therefor, provided the Company A stock was held as a capital asset on the date of the exchange (§ 1223(1)).

(10) The tax year of Company A will end on the effective date of the transaction (§ 1.381(b)-1(a) of the Income Tax Regulations), and as provided in § 381(a) and § 1.381(a)-(1), Company B will succeed to and take into account those attributes of Company A described in § 381(c), subject to the provisions and limitations specified in §§ 381, 382, 383, and 384, if applicable, and the regulations thereunder.

(11) Pursuant to § 381(c)(2) and § 1.381(c)(2)-1, Company B will succeed to and take into account the earnings and profits, or deficit in earnings and profits, of Company A as of the date of transfer. Any deficit in earnings and profits of either Company A or Company B will be used only to offset the earnings and profits accumulated after the date of the transfer.

Except for the specific rulings 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 B's eligibility under § 1361 to be 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 copies of this letter to your authorized

representatives.

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,

WILLIAM P. O'SHEA
Chief, Branch 3
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

enclosure: copy for § 6110 purposes