**Internal Revenue Service**

Department of the Treasury

Washington, DC 20224

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Company 1 =

Company 2 =

Company 3 =

Group =

Partnership 1 =

Partnership 2 =

p =

m =

n =

State =

o =

Property 1 =

Property 2 =

$x =

$z =

Taxable Year =

Dear :

This letter responds to your June 30, 1998 ruling request and subsequent correspondence submitted on behalf of Company 1 concerning § 1362(d)(3) of the Internal Revenue Code.

Company 1 is a member of a controlled group with Company 2 and subsidiaries (Group). Company 1 and Company 2 have 100 percent common brother-sister ownership. Company 1 is a C corporation incorporated in State with accumulated earnings and profits. It proposes to elect to be treated as an S corporation under § 1361 of the Code.

Company 1 represents that before making its S election, it will own a p percent general partner interest and a m percent limited partner interest in Partnership 1 which owns a n percent general partner interest in Partnership 2.

Company 1's income is derived primarily from its leasing business activities in real estate. Company 1's officers are primarily responsible for the management of Company 1's property and make decisions regarding the property's operation, including lease negotiations, screening of prospective tenants, and major repairs and renovations.

Company 3, a Group member, acts as an agent for Company 1, Partnership 1, and Partnership 2. Company 3 has o employees. As agent, Company 3 performs management, accounting, executive, and transfer agent services. It charges and collects fees for these services on a monthly basis. Fees collected from Company 1, Partnership 1, and Partnership 2 are charged on an arm's-length basis.

Company 1's officers are employees of Company 3. Company 1 also has an 8-member board of directors that oversees strategic management of Company 1's property.

Company 1 owns and operates Property 1. Partnership 2, of which Partnership 1 is a n percent partner, owns and operates Property 2.

Company 3 performs several services with respect to Property 1. These services include, but are not limited to, soliciting prospective tenants, negotiating leases, and arranging for tenant reimbursement. In addition, Company 3 monitors property tax assessments, pays property taxes, arranges and pays for building and liability insurance, collects rents, and monitors compliance with lease provisions.

Company 3 also performs several services with respect to Property 2 for Partnership 2. These services include, but are not limited to, constructing building improvements as needed, preparing reports and monitoring performance against annual operating budgets, and maintaining lease files. In addition, Company 3 oversees interior and exterior building maintenance, pays property taxes, obtains insurance, and negotiates lease arrangements and renewals.

Company 1 received gross rental income of $x and paid or incurred $z in operating expenses for Property 1 and Property 2 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 "rents" 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 "rents" 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 accumulated 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 1968.

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 and the representations made, we conclude that Company 1's gross receipts from rents from Property 1 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. In addition, we conclude that Company 1's gross receipts allocated to it from Property 2 with respect to Company 1's interest in Partnership 1 and Partnership 1's interest in Partnership 2 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.

Further, we conclude that Company 1's gross receipts include its distributive share of Partnership 1's gross receipts (which includes Partnership 1's n percent ownership in Partnership 2) for purposes of § 1362(d)(3) of the Code to determine whether more than 25 percent of Company 1's gross receipts are passive investment income. In addition, the character of Company 1's distributive share of gross receipts (rental income) from Partnership 1 will be the same as the character of the gross receipts to Partnership 1.

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.

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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