

**Internal Revenue Service**

Department of the Treasury

Index Number: 1362.02-03

Washington, DC 20224

Number: **200025042**  
Release Date: 6/23/2000

Person to Contact:

Telephone Number:

Refer Reply To:  
CC:DOM:P&SI:3 PLR-118658-99  
Date:  
March 27, 2000

**LEGEND:**

X =

Subsidiaries =

- a =
- b =
- c =
- d =
- e =
- f =
- g =
- h =
- i =
- j =

Dear

This letter responds to your letter, dated November 18, 1999, and subsequent correspondence, written on behalf of X, requesting a ruling under § 1362(d)(3) of the Internal Revenue Code that the rental income received by X from commercial and residential real properties (including rents received through certain qualified subchapter S subsidiaries (QSubs)) will not constitute passive investment income.

## **FACTS**

X is a C corporation with accumulated earnings and profits that intends to elect under § 1362(a) to be an S corporation and to elect under § 1362(b)(3)(B)(ii) to treat Subsidiaries as QSubs. X and its Subsidiaries acquire, develop and lease a commercial properties and b residential properties.

Through their c full-time and d part-time employees X and Subsidiaries provide various services with respect to the leasing of most of its properties. These services include repair and maintenance of elevators, roofs, and plumbing and HVAC systems; interior and exterior painting of apartment buildings and common areas; janitorial and cleaning services; pest control; trash removal; security, safety and fire protection services, including a 24 hour on-call security service, signs and emergency lights, and maintenance of emergency power generators, fire extinguishers, and alarm and sprinkler systems; groundskeeping services, including landscaping, snow removal, window washing, building exterior cleaning, parking lot restriping, and repairs to pot holes, fences and sidewalks; and miscellaneous maintenance services, including repairs to cabinets, counter tops, walls, ceilings, windows, screens, shelving, signage and building framework.

X and Subsidiaries received or accrued approximately e in rents and paid or incurred approximately f in relevant expenses for period g. The comparable figures for period h are i and j. X represents that these figures are consistent with the income and expense figures for prior periods and expects the figures for future years to be comparable.

## **LAW AND ANALYSIS**

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 1361(b)(3)(B) defines a “qualified subchapter S subsidiary” as any domestic corporation that is not an ineligible corporation (as defined in § 1361(b)(2)), if (i) 100 percent of the stock of that corporation is held by the S corporation, and (ii) the S corporation elects to treat that corporation as a QSub. Notice 97-4, 1997-1 C.B. 351, provides guidance on making the QSub election.

Section 1361(b)(3)(A) provides that, except as provided in regulations, (i) a corporation that 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 1362(d)(3)(A)(i) provides that an S corporation election shall be terminated whenever the corporation (I) has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and (II) has gross receipts for each of such

taxable years more than 25 percent of which are passive investment income.

Section 1375(a) imposes a tax on the income of an S corporation if the S corporation has (1) accumulated earnings and profits at the close of such taxable year, and (2) gross receipts more than 25 percent of which are passive investment income.

Section 1362(d)(3)(C)(i) 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) 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) provides that the term “rents” does not include rents derived in the active trade or business of renting property. Rents 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.

### **CONCLUSION**

After applying the law to the facts submitted and the representations made, we conclude that the rents X receives from its rental properties, including the rent received through its QSubs, will not be passive investment income under § 1362(d)(3)(C)(i).

Some of X's rental income is net lease income, which is generally passive investment income. However, X's net lease income is an incidental part of X's active rental business and will not be treated as passive investment income.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed concerning whether X qualifies as an S corporation or whether Subsidiaries qualify as QSubs. 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. §

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

Pursuant to a power of attorney on file with this office, we are sending a copy of this letter to X's authorized representative.

Sincerely yours,  
William P. O'Shea  
Chief, Branch 3  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)  
Copy of this letter  
Copy for § 6110 purposes