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Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:2-PLR-114884-98

Date:
JUN 24 1999

Parent =

Sub 1 =

Bank =

Sub 2 =

Sub 3 =

Partnership =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

State =

Dear :

This letter responds to a letter dated July 21, 1998 and subsequent correspondence submitted by your authorized representative concerning § 1362(d)(3)(C) of the Internal Revenue Code.

The information submitted states that Parent incorporated on Date 1 under the laws of State and is a savings and loan holding company as defined in 12 U.S.C. § 1467a(a) and 12 C.F.R. § 583.20. On or about Date 2, Parent filed a Form 2553, Election by a Small Business Corporation, to elect to be an S corporation effective for its taxable year beginning Date 3. Parent represents that it is not an "ineligible corporation" as defined in § 1361(b)(2). Parent also represents that Parent had subchapter C earnings and profits at the time that it elected to be an S corporation.

Parent owns 100 percent of the stock of Sub 1. Sub 1 owns 100 percent of the stock of Bank. Bank represents that it is a "bank" within the meaning of § 581. Bank owns 100 percent of the stock of Sub 2 and Sub 3. Sub 1, Bank, Sub 2, and Sub 3 represent, respectively, that Sub 1, Bank, Sub 2, and Sub 3 are not "ineligible corporations" as defined in § 1361(b)(2). Parent elected to treat Sub 1, Bank, and Sub 2 as qualified subchapter S subsidiaries (QSubs) within the meaning of § 1361(b)(3)(B) as of Date 3. Parent elected to treat Sub 3 as a QSub as of Date 4, Sub 3's date of incorporation.

Effective Date 5, the following transactions took place. Pursuant to a Participation Agreement, Bank transferred to Sub 3 an undivided 99 percent interest in certain commercial loans owned by Bank. The commercial loans subject to the Participation Agreement consist of construction loans, nonresidential loans, building loans, land loans, and other loans that Bank acquired in secondary markets in the ordinary course of its banking business. The Participation Agreement requires Bank, as lead lender, to continue to remain responsible for servicing the loans. Bank also transferred cash to Sub 2. Sub 2 and Sub 3 formed Partnership. Sub 3 contributed to Partnership its interests in the loans, received from Bank under the Participation Agreement, in exchange for a 99 percent limited partner interest in Partnership and Sub 2 contributed to Partnership the cash received from Bank in exchange for a one percent general partner interest in Partnership. Sub 3 also assigned its rights under the Participation Agreement to Partnership.

Partnership represents that it is an "eligible entity" as defined in § 301.7701-3(a) of the Procedure and Administration Regulations and that it has not elected to be classified as an association taxable as a corporation pursuant to § 301.7701-3(a) and (b).

Bank proposes to contribute, through Sub 2 and Sub 3, to Partnership other interests in loans that Bank acquires in the

ordinary course of its banking business. Bank represents that such loan interests transferred in the future will be subject to the Participation Agreement described above or a substantially similar agreement.

Sections 1308(a) and 1315 of the Small Business Job Protection Act of 1996 (the Act), Pub. L. 104-188, 110 Stat. 1755, amended § 1361(b)(2) of the Code to allow financial institutions that do not use the reserve method of accounting for bad debts to be eligible to be small business corporations. Section 1308(b) of the Act added new § 1361(b)(3) to allow an S corporation to own a qualified subchapter S subsidiary (QSub).

Section 1362(d)(3)(C)(i) provides that, for purposes of § 1361(d)(3), except as otherwise provided in § 1362(d)(3)(C), 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)(iii)(B)(1) provides that passive investment income does not include gross receipts directly derived in the ordinary course of a trade or business of (i) lending or financing; (ii) dealing in property; (iii) purchasing or discounting accounts receivable, notes, or installment obligations; or (iv) servicing mortgages. Under § 1.1362-2(c)(5)(iii)(B)(2), gross receipts directly derived in the ordinary course of business include gain (as well as interest income) with respect to loans originated in a lending business; however, interest earned from investment of idle funds in short-term securities does not constitute gross receipts directly derived in the ordinary course of business.

Based on the facts and representations submitted, we conclude that interest income derived from interests in loans held by Partnership, pursuant to the transactions described above, will be gross receipts directly derived in the ordinary course of a trade or business described in § 1.1362-2(c)(5)(iii)(B)(1) and will not be considered "passive investment income" under § 1362(d)(3)(C) to Parent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling letter have not yet been adopted. Therefore, this letter will be modified or revoked to the extent the adopted temporary or final regulations are inconsistent with any conclusion in the letter. See section 12.04 of Rev. Proc. 99-1, 1999-1 I.R.B. 6, 47. However, when the criteria in § 12.05 of Rev. Proc. 99-1 are satisfied, a ruling is

not revoked or modified retroactively except in rare or unusual circumstances.

Except as specifically set forth above, no opinion is expressed or implied as to the federal income tax consequences of the transaction described above under any other provision of the Code. This ruling letter applies only to the extent that the specific ownership structure described in the facts above is not altered.

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.

Pursuant to a power of attorney on file in this office a copy of this letter will be sent to the authorized representative of the parties involved.

Sincerely yours,

(signed) H. GRACE KIM

H. GRACE KIM
Assistant to the Chief,
Branch 2
Office of the Assistant
Chief Counsel
(Passthroughs & Special
Industries)

Enclosures: (2)
Copy of this letter
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