Internal Revenue Service

Index Number: 1362.02-03

199946033

Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:3 PLR-115970-98

Date:
August 18, 1999

Company:

Subsidiary 1:

Subsidiary 2:

D1:

D2:

D3:

D4:

Shareholder:

City:

State:

Property:

b:

c:

d:

e:

f:

182

Dear

This letter responds to a letter from your authorized representative dated July 31, 1998, and subsequent correspondence, requesting certain rulings on behalf of Company under § 1362(d)(3)(C)(i) of the Internal Revenue Code. Company represents the following facts.

Company was incorporated in State in D1 and elected S status effective D2. Company owns Property in City and has accumulated earnings and profits. Shareholder is the sole shareholder of Company.

On D3, Company formed Subsidiary 1 and elected to treat Subsidiary 1 as a qualified subchapter S subsidiary pursuant to § 1361(b)(3)(B) (QSSS 1). QSSS 1 was formed to conduct an aircraft leasing and sales business. It holds a dealer license and employs an outside consultant to provide assistance in evaluating potential aircraft purchases. As part of its aircraft leasing business, QSSS 1 is responsible for routine and extraordinary aircraft maintenance and all scheduling of aircraft usage. It negotiates contracts, handles the usual leasing and administrative functions, oversees the maintenance of flight records, assists lessees in obtaining ground transportation, provides catering to lessees as requested, works with the FAA and other state and federal agencies on licensing and other regulatory matters, and obtains necessary hangar space. QSSS 1 intends to provide a fully operational air charter service utilizing its own employee-pilots. When leasing aircraft, however, lessees can either utilize their own pilots, contract with third parties, or utilize employee-pilots of QSSS 1.

On D4, Company formed Subsidiary 2 and elected to treat Subsidiary 2 as a qualified subchapter S subsidiary pursuant to § 1361(b)(3)(B) (QSSS 2). QSSS 2 was formed to conduct a real estate management business and to manage various properties, including the Property owned by Company. QSSS 2 performs the following services as part of its business: advertising for tenants; negotiating leases; contracting for various services to be performed on the properties, including maintenance and upkeep of the properties, and the structural components, roofs, and plumbing; cleaning, and painting; settling tenant disputes; assisting tenants in the marketing and development of commercial real estate; and handling capital expenditures for commercial investment and development properties.

Company, either directly or through QSSS 2, provides various services in the leasing of Property, including maintenance of common areas, parking lots, sidewalks, structural components, plumbing, and roofs; periodic on-site inspections; negotiation and oversight of independent contractors who assist in the maintenance and upkeep of Property; general cleaning, painting, and repair; advertising assistance for tenants; and the usual marketing, leasing, and administrative functions involved in leasing and managing real estate.

Company anticipates receiving or accruing approximately $b in rents and incurring approximately $c in relevant expenses for d on Property.

Company anticipates receiving or accruing approximately $e in income and incurring approximately $f in relevant expenses for d in QSSS 1's aircraft leasing business.

Section 1361(a)(1) defines an "S corporation" as a small business corporation for which an election under § 1362(a) is in effect for the taxable year.

Section 1361(b)(3)(A) provides that a corporation that is a qualified subchapter S subsidiary (QSSS) shall not be treated as a separate corporation, and all assets, liabilities, and items of income, deduction, and credit of a QSSS 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 election under § 1362(a) to be an S corporation terminates whenever the corporation (I) has accumulated earnings and profits at the close of each of three 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 1362(d)(3)(C)(i) provides that except as otherwise provided in subparagraph (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)(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 1362(d)(3)(C)(ii) provides that passive investment income shall not include interest on any obligation acquired in the ordinary course of the corporation's trade or business from its sale of property described in § 1221(1). The property described in § 1221(1) is stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

Based solely on the facts as presented in this ruling request, and viewed in light of the applicable law and regulations, we conclude the following:

(1) Company meets the test of section 1.1362-2(c)(5)(ii)(B)(2) in its leasing of Property. Therefore, the rent Company receives from the leasing of Property is not passive investment income under § 1362(d)(3)(C)(i).

(2) Company meets the test of section 1.1362-2(c)(5)(ii)(B)(2) in its aircraft leasing business. Therefore, to the extent Company receives rent from QSSS 1's aircraft leasing business, the rent is not passive investment income under § 1362(d)(3)(C)(i).

(3) To the extent Company receives interest from an installment sale of inventory through QSSS 1's aircraft sales business, the exception in § 1362(d)(3)(C)(ii) applies, and the interest will not be passive investment income under § 1362(d)(3)(C)(i).

(4) The income Company receives from QSSS 2's rental management business is not passive investment income under

§ 1362(d)(3)(C)(i).

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 (1) the classification of any amount of income as "rent" in either the leasing of Property or the aircraft leasing business; (2) the qualification of any aircraft as inventory for purposes of QSSS 1's aircraft sales business; (3) whether Company is an S corporation; or (4) whether QSSS 1 or QSSS 2 are qualified subchapter S subsidiaries. Finally, 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 representative.

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,

Donna M. Young

DONNA M. YOUNG
Senior Technician Reviewer,
Branch 3
Office of the Assistant
Chief Counsel
(Passthroughs and
Special Industries)

encl: copy of this letter
copy for § 6110 purposes

188