Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

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Number: **200002024**
Release Date: 1/14/2000

Date:
October 13, 1999

Company:

M:

Business:

Subsidiaries:

Affiliates:

Partnerships:

Shareholders:

Sources:

State:

a:

b:

c:

d:

e:

f:

g:

This letter responds to a letter from your authorized representative dated June 2, 1999, submitted on behalf of Company, requesting a ruling that the income received by Company from the Sources, including its distributive shares from the Partnerships, is not passive investment income within the meaning of § 1362(d)(3)(C)(i) of the Internal Revenue Code. Company represents the following facts.

Company was incorporated in State on a and elected to be an S corporation effective b. Since its inception, Company has been engaged in the Business and has been owned and controlled by the family of M the entire period.

Prior to b, Company formed Subsidiaries, wholly owned by Company. Effective c, Subsidiaries were merged into Company.

Company and its shareholders formed Affiliates over time. These companies are owned either by Company or by Shareholders or by both.

On c, Company had accumulated earnings and profits (E&P) of d. It made a timely election under § 1368(e)(3) to distribute E&P first, then made distributions in e sufficient to reduce E&P to zero.

On f, Company and the Service executed Form 872-R, agreeing to extend the statute of limitations for assessment for tax year g.

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 § 1362(d)(3)(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)(A)(1) of the Income Tax Regulations provides that “royalties” means all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, tradebrands, franchises, and other like property. The gross amount of royalties is not reduced by any part of the cost of the rights under which the royalties are received or by any amount allowable as a deduction in computing taxable income.

Section 1.1362-2(c)(5)(ii)(A)(2) provides that “royalties” does not include royalties derived in the ordinary course of a trade or business of franchising or licensing property. Royalties received by a corporation are derived in the ordinary course of a trade or business of franchising or licensing property only if, based on all the facts and circumstances, the corporation (i) created the property; or (ii) performed significant services or incurred substantial costs with respect to the development or marketing of the property.

Section 1.1362-2(c)(5)(ii)(B)(1) 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 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)(3) provides that "rents" does not include produced film rents as defined under § 543(a)(5). Section 543(a)(5)(B) defines “produced film rents” as payments received with respect to an interest in a film for the use of, or right to use, such film, but only to the extent that such interest was acquired before substantial completion of production of such film. In the case of a producer who actively participates in the production of the film, such term includes an interest in the proceeds or profits from the film, but only to the extent such interest is attributable to such active participation.

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 1.1362-7(b) provides that for tax years of an S corporation and all affected shareholders that are not closed, the S corporation and all affected shareholders may elect to apply the provisions of § 1.1362-2(c)(5). To make the election, the corporation and all affected shareholders must file a return or an amended return that is consistent with these rules for the tax year for which the election is made and each subsequent tax year. For purposes of this section, “affected shareholders” means all shareholders who received distributive shares of S corporation items in the tax year for which the election is made and all shareholders of the S corporation for all subsequent tax years.

To effectuate the application of § 1.1362-2(c)(5) to prior years, the Service will permit S corporations and their shareholders to revoke an election made under § 1368(e)(3). See preamble to T.D. 8449, 57 F.R. 55445, reprinted at 1992-2 C.B. 225, 227.

After applying the applicable law and regulations to the facts as presented in this ruling request, we conclude that the income that Company receives from the Sources, either directly or as part of its distributive share of Partnership income, is not passive investment income under § 1362(d)(3)(C)(i).

Except for the specific ruling above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provision of the Code. Specifically, no opinion is expressed regarding Company's eligibility 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 a copy 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,

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

encl: copy for § 6110 purposes