

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Date:
December 15, 2017

LEGEND

X =

Trust =

A =

B =

Lease 1 =

Lease 2 =

Lease 3 =

Lease 4 =

State =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

a =
b =
c =
d =
e =
Year =

Dear _____ :

This letter responds to a letter dated July 14, 2017, and subsequent correspondence, submitted by X's authorized representative on behalf of X, requesting rulings that: (1) the rental income derived by X is not passive investment income within the meaning of § 1362(d)(3)(C) of the Internal Revenue Code (Code) and (2) that Trust will qualify as an electing small business trust (ESBT) under § 1361(e).

The information submitted states that X was incorporated under the law of State on Date 1. Trust, a shareholder of X, was created on Date 2 as a grantor trust. On Date 3, A, the grantor and owner of Trust, died. X represents that the beneficiaries of the Trust are two distributing trusts and two tax exempt organizations described in § 170(c)(2). The beneficiaries of the distributing trusts are U.S. individuals. None of the beneficiaries of Trust (or the distributing trusts) acquired their interest by purchase and the bases of their interests are determined by § 1014 and not § 1012. X made an election to be treated as an S corporation effective Date 4.

X's primary business activity consists of farming and managing real property. X has entered into Lease 1, Lease 2, Lease 3, and Lease 4 (collectively, the Leases). Lease 1, 2, and 3 provide that X is a full participant in the management of the farm, including that X will be responsible for determining the crop plan, which the tenant will not deviate from unless agreed to in a document signed by X. The tenant agrees to plant, cultivate, and harvest the farm in accordance with the crop plan and deliver X's share of crops to a location determined by X. The tenant also agrees to furnish X reports concerning the date of planting, seed variety, rate of planting, cultivation practices, and the use of fertilizer, insecticide, fungicides, and other chemicals. Furthermore, the farm will be operated in compliance with government programs unless X elections to opt out of the program.

Lease 1, 2, and 3 also provide that X participates in some of the associated costs of farming the property. The tenant will furnish all labor, equipment, and other expenses

for the operation of the farm, except that expenses for fertilizer, insecticide, fungicides, and grain drying shall be divided between X and the tenant in the same proportion as the crop share. The cost of lime is evenly divided between X and the tenant, provided, however, that a pro rata refund of the tenant's share will be made for each year of a four year period that the tenant does not have use of the land where the lime was applied. Further, in the event that government farm program payments relating to crop production are made, such payments shall be divided between X and the tenant in the same proportions that the crop is divided. X may engage in land improvement work when such work will not damage growing crops. No ditches, levees, or other earth moving work will be undertaken by the tenant directly or indirectly without the consent of X. Further, X will furnish materials and the tenant will provide labor for normal maintenance and repairs on buildings, fences, and other similar improvements on the farm. The tenant also agrees to seed, spray, and fertilizer all ditches at the request of X with X to furnish materials.

Lease 4 provides that the tenant will plow and farm all cleared land, plant and cultivate the crops, and deliver X's share of the crops for sale. The cultivating and handing of the land and all crops shall at all times be done under the supervision and control of X. The tenant will use commercial fertilizer or liquid fertilizer, the quality and quantity to be determined by X. The tenant pays for the same amount of the fertilizer as his shares in the crop. Ditching to be done will be shared by the tenant and X. X pays the cost of lime at the time of the application, but the tenant is responsible for one-half the cost which is to be paid to X in four annual payments.

Under Lease 1, X's share equals a of all corn, soybeans, milo and wheat crops, b of all rice, and c of all cotton crops produced. Lease 2 and 3 are the same as Lease 1, except X shares b in all cotton crops. Under Lease 4, X shares b in all grains, soybeans and rice, and c of all cotton grown.

During A's life, A performed the farm management services. Following her death, those services have been performed by B. X's Year return showed farm rental income of d and expenses of e, including officer compensation, salaries and wages, repairs and maintenance, fertilizer, insurance, and utilities.

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

Section 1361(b)(1) defines "small business corporation" as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361(c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1361(c)(2)(A)(v) provides that an ESBT may be a shareholder in an S corporation.

Section 1361(e)(1)(A) provides that an ESBT means any trust if (i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in § 170(c)(2), (3), (4), or (5), or (IV) an organization described in §170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary, (ii) no interest in such trust was acquired by purchase, and (iii) an election under §1361(e) applies to such trust.

Section 1361(e)(1)(B) provides that an ESBT does not include (i) any qualified subchapter S trust (QSST) (as defined by § 1361(d)(3)) if an election under § 1361(d)(2) applies to any corporation the stock of which is held by such trust, (ii) any trust exempt from tax under Subtitle A of the Code, and (iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in § 664(d)).

Section 1.1361-1(m)(1)(ii)(B) of the Income Tax Regulations provides that a distributee trust is a beneficiary of the ESBT only if the distributee trust is an organization described in § 170(c)(2) or (3). In all other situations, any person who has a beneficial interest in a distributee trust is a beneficiary of the ESBT. A distributee trust is a trust that receives or may receive a distribution from an ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.

Section 1.1361-1(m)(1)(iii) provides that a trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. Generally, if a person acquires an interest in the trust and thereby becomes a beneficiary of the trust as defined in § 1.1361-1(m)(1)(ii)(A), and any portion of the basis in the acquired interest in the trust is determined under § 1012, such interest has been acquired by purchase.

Section 1.1361-1(m)(4)(iv)(B) provides that if the distributee trust is not a trust described in § 1361(c)(2)(A), then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates. Section 1.1361-1(m)(4)(iv)(D) provides that a trust will be deemed to be described in § 1361(c)(2)(A) if such trust would qualify for a QSST election under § 1361(d) or an ESBT election under § 1361(e) if it owned S corporation stock.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(d)(3)(A) provides that an election under § 1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and has gross receipts for each of such taxable

years more than 25 percent of which are passive investment income. Any terminations under this paragraph shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to above.

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, and annuities.

Section 1.1362-2(c)(5)(ii)(B)(1) provides that “rents” means the 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 or persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation). See also Rev. Rul. 61-112, 1961-1 C.B. 399 (holding that amounts received by a corporation under share-farming agreements were not “rents” within the meaning of former § 1372(e)(5) where the corporation participated to a material degree in the production of farm commodities through physical work or management decisions, or a combination of both).

Based solely on the facts and representations submitted, we conclude that the rental income that X derives from the Leases will not be passive investment income as described in § 1362(d)(3)(C). In addition, we conclude that Trust qualifies as an ESBT because the beneficiaries of Trust are qualified beneficiaries and no interest in Trust was acquired by purchase.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion on whether X is a small business corporation under § 1361(b). Further, the passive investment income rules of § 1362 are independent of the passive activity rules of § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 469. X has represented that the proposed transaction concerning Trust's ownership of X stock is permissible under state law. We express or imply no opinion on the proposed transaction set forth in the private letter ruling request.

This ruling is directed only to the taxpayer requesting 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 on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

/s/

Bradford R. Poston
Special Counsel
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

Copy for § 6110 purposes