

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

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Date:

August 17, 2001

Legend

Company =

Subsidiaries =

A =

B =

C =

D =

P1 =

P2 =

Year 1 =

Date 1 =

Dear

This letter is in response to your letter dated December 13, 2000, and subsequent correspondence submitted on behalf of Company, requesting a ruling under §§ 1362(d)(3) and 1375(a) of the Internal Revenue Code.

FACTS

Company was incorporated in Year 1 and elected to be taxed as an S corporation effective Date 1. Company has Subchapter C earnings and profits. A, B, C and D are the shareholders of Company. Company has four wholly owned subsidiaries. Qualified Subchapter S Subsidiary elections were made for Subsidiaries.

To diversify, Company has or plans to invest in publicly traded limited partnerships (P1 and P2) that are taxed as partnerships for federal income tax purposes under § 7704(c)(2). Company has or will receive a distributive share of partnership income, gain, losses, deductions, credits and distributions from P1 and P2 in accordance with subchapter K.

P1's business consists of purchasing, gathering, transporting, trading, storage and resale of crude oil and refined petroleum products and related activities. P2's business consists of interstate and intrastate crude oil transportation, terminalling and storage, as well as crude oil gathering and marketing activities.

Company requests two rulings: 1.) For determining excess net passive income under §§ 1362(d)(3) and 1375(a), Company's distributive share of gross receipts attributable to the interests that it has or will acquire in P1 and P2, which are taxed as partnerships for federal income tax purposes pursuant to § 7704(c)(1), constitutes gross receipts and 2.) For purposes of determining excess net passive income under §§ 1362(d)(3) and 1375(a), Company's distributive share of gross receipts attributable to the interests it has or will acquire in P1 and P2, which are taxed as partnerships for federal income tax purposes pursuant to § 7704(c)(1), will not constitute passive investment income.

LAW AND ANALYSIS

Section 702(a)(7) requires each partner to take into account separately its distributive share of the partnership's items of income, gain, loss, deduction, and credit to the extent provided by regulations.

Section 1.702-1(a)(8)(ii) requires each partner to take into account separately any partnership item that would result in an income tax liability for any partner different from that which would result if that partner did not take the item into account separately.

Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under § 702(a)(1) through (7) shall be determined as if the item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Section 1362(a) allows a small business corporation, as defined in § 1361, to elect to be an S corporation. This election, however, is terminated under the provisions of § 1362(d)(3) if 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.

Section 1.1362-2(c)(4)(i) provides, in general, that gross receipts means the total amount received or accrued under the method of accounting used by the corporation in computing its taxable income and is not reduced by returns and allowances, cost of goods sold, or deductions.

Section 1362(d)(3)(C)(i) provides, in general, that the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales

or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom).

Section 1375 imposes a tax on the excess net passive income of an S corporation in any year in which the corporation has accumulated earnings and profits at the close of the taxable year, and has gross receipts more than 25 percent of which are passive investment income.

Section 7704(a) requires that, except as provided in § 7704(c), a publicly traded partnership shall be treated as a corporation for federal income tax purposes.

Section 7704(b) defines the term "publicly traded partnership" as any partnership if interests in such partnership are traded on an established securities market, or are readily tradeable on a secondary market (or the substantial equivalent thereof).

Section 7704(c) provides that § 7704(a) does not apply to any publicly traded partnership for any taxable year if the partnership met the gross income requirements of § 7704(c)(2) for the current taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence.

Section 7704(c)(2) provides that a partnership meets the gross income requirements if 90 percent or more of the gross income of such partnership for such taxable year consists of "qualifying income."

Section 7704(d)(1)(E) provides that income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber) is qualifying income, except as otherwise provided. For purposes of this section, mineral or natural resource means any product of a character with respect to which a deduction for depletion is allowable under § 611, but is not a product described in § 613(b)(7)(A) or (B).

Revenue Ruling 71-455, 1971-2 C.B. 318, holds that for purposes of the passive investment income limitations, an electing small business corporation should include its distributive share of gross receipts from a joint venture rather than its distributive share of ordinary loss from the joint venture. Because items of income maintain their character upon distribution to the partners under § 702(b), the character of the gross receipts of the joint venture were not converted into passive investment income upon distribution to the small business company described in the revenue ruling.

CONCLUSIONS

Company's distributive share of gross receipts from P1 and P2, if separately

taken into account, may affect Company's federal income tax liability. Under § 1362(d)(3), the status of Company as an S corporation could depend upon the character of Company's distributive share of gross receipts from P1 and P2. Thus, pursuant to § 1.702-1(a)(8)(ii), Company should separately take into account its distributive share of its gross receipts from P1 and P2. The character of Company's distributive share of gross receipts from P1 and P2 will be the same as the character of the partnership receipts for P1 and P2.

Based upon the information submitted and representations made, we conclude that: 1.) Company's distributive share of P1 and P2's gross receipts will be included in Company's gross receipts for the purpose of applying the passive investment limitation of §§ 1362(d)(3) and 1375(a) and 2.) Company's distributive share of gross receipts attributable to P1's purchasing, gathering, transporting, trading, storage and resale of crude oil and refined petroleum products and related activities, and P2's interstate and intrastate crude oil transportation, terminalling and storage, as well as crude oil gathering and marketing activities will not constitute passive investment income under §§ 1362(d)(3) and 1375(a).

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, we express or imply no opinion 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.

Under a power of attorney on file with this office, we are sending a copy of this letter to your authorized representatives.

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

Sincerely,
Christine Ellison
Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

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