Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Date:
April 11, 2000

Company:

State:

a:

Dear

This letter responds to a letter from your authorized representative dated December 14, 1999, submitted on behalf of Company, requesting rulings under §§ 1362(d)(3) and 1375(a) of the Internal Revenue Code. Company represents the following facts.

Company, incorporated under the laws of State, is contemplating an election under § 1362(a) to be an S corporation effective a. It has accumulated earnings and profits.

Company develops and leases commercial real estate. To diversify its business holdings, Company wants to invest in entities that operate in industries different from its own. To that end, Company has identified several publicly traded limited partnerships (PTPs) engaged in the business of purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other chemical products.

Company represents that the PTPs in which it is seeking to invest meet either the qualifying income exception of § 7704(c) or the electing 1987 partnership exception of § 7704(g) and, thus, are taxed as partnerships for federal tax purposes. Company also represents that these PTPs are not electing large partnerships as defined by § 775 and, thus, the normal flowthrough provisions of subchapter K apply to their partners.

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 1375(a) provides that a tax is imposed on the income of an S corporation for any tax year in which the corporation has accumulated earnings and profits at the close of that year and gross receipts more than 25 percent of which are passive investment income.

Section 702(a)(7) provides that, in determining income tax liability, each partner shall take into account separately his 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) provides that each partner must take into account separately his distributive share of any partnership item that would result in an income tax liability for that 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.

Except as provided in § 7704(c), § 7704(a) provides that a PTP shall be treated as a corporation for federal income tax purposes.

Section 7704(b) provides that the term PTP means any partnership if interests in that partnership are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 7704(c)(1) provides that § 7704(a) shall not apply to a PTP for any tax year if the partnership meets the gross income requirements of § 7704(c)(2) for that year and each preceding tax 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 requirement for any tax year if at least 90 percent of the partnership's gross income for that 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 marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber) is qualifying income. 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).

Section 7704(g)(1) provides that § 7704(a) shall not apply to an electing 1987 partnership. Section 7704(g)(2) provides that, for purposes of this subsection, the term "electing 1987 partnership" means any publicly traded partnership if (A) the partnership is an existing partnership (as defined in § 10211(c)(2) of the Revenue Reconciliation Act of 1987), (B) § 7704(a) has not applied (and without regard to § 7704(c)(1) would not have applied) to the partnership for all prior tax years beginning after December 31, 1987, and before January 1, 1998, and (C) the partnership elects the application of § 7704(g), and consents to the application of the tax imposed by § 7704(g)(3), for its first tax year beginning after December 31, 1997. A partnership that, but for this sentence, would be treated as an electing 1987 partnership shall cease to be so treated (and the election under § 7704(g)(2)(C) shall cease to be in effect) as of the 1st day after December 31, 1997, on which there has been an addition of a substantial new line of business with respect to the partnership.

Rev. Rul. 71-455, 1971-2 C.B. 318, deals with an S corporation that operates a business in a joint venture with another corporation. In the tax year at issue, the total business expenses exceeded gross receipts. The revenue ruling holds that, in applying the passive investment income limitations, the S corporation should include its distributive share of the joint venture's gross receipts and not its share of the venture's loss. In accordance with § 702(b), the character of these gross receipts were not converted into passive investment income upon their allocation to the S corporation.

Company's distributive shares of gross receipts from the PTPs, if separately taken into account, might affect its federal income tax liability. Under § 1362(d)(3), the status of Company as an S corporation could depend upon the character of its distributive shares of gross receipts from the PTPs. Thus, pursuant to § 1.702-1(a)(8)(ii), Company must take into account separately its distributive shares of the gross receipts from the PTPs. The character of these partnership receipts for Company will be the same as the character of the partnership receipts for the PTPs, in accordance with § 702(b).

Based solely on the facts as represented, we rule that–

(1) Company's distributive shares of the gross receipts of the PTPs in which it

intends to invest will be included in its gross receipts for purposes of §§ 1362(d)(3) and 1375(a).

(2) Company's distributive shares of the PTPs' gross receipts attributable to the purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other chemical products will not constitute passive investment income as defined by § 1362(d)(3)(C).

Except for the specific rulings above, no opinion is expressed or implied concerning the federal income tax consequences of the facts of this case under any other provisions 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,
JONI LARSON
Acting Assistant to the Chief, Branch 3
Office of Assistant Chief Counsel
(Passthroughs and Special Industries)

enclosure: copy for § 6110 purposes