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Legend

Taxpayer =

This letter responds to a letter dated August 20, 1999, submitted on behalf of Taxpayer, requesting a rulings that, for purposes of §§ 1362(d)(3) and 1375(a) of the Internal Revenue Code, Taxpayer's distributive shares of gross receipts from the publicly traded limited partnerships described below (the "PTPs") (i) will be included in the corporation's gross receipts for purposes of applying the passive investment income limitations and (ii) will not be passive investment income.

FACTS

The following facts have been submitted. Taxpayer is a subchapter C corporation that proposes to elect under § 1362 to be taxed as an S corporation for federal income tax purposes. Taxpayer will have subchapter C earnings and profits remaining after it makes the election.

Taxpayer plans to invest in PTPs engaged in the purchasing, gathering, transporting, storage and resale of the following products: crude oil, refined petroleum products, and natural gas liquids. The PTPs also engage in some related activities. Taxpayer's purpose for this investment is to provide for liquidity and also to diversify investment risk. Taxpayer represents that the PTPs meet the qualifying income exception under § 7704(c)(2) and are taxed as partnerships for federal tax purposes. Additionally, Taxpayer represents that the PTPs are not "electing large partnerships" under § 771, and that the normal flow-through provisions of Subchapter K apply to its partners.

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) of the Income Tax Regulations provides circumstances under which each partner must take into account separately their distributive share of a partnership item. Specifically, § 1.702-1(a)(8)(ii) provides that each partner must do so if the amount of any partner's income tax liability would depend on whether, when that partner took into account that partnership item, that partner took that item into account separately.

Under § 702(b), 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, terminates 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 for each of those taxable years, has passive investment income in excess of 25% of gross receipts.

Section 1362(d)(3)(C)(i) provides that in general the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities as well as from sales and exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of § 1362(d)(3) 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% of which are passive income.

Section 7704(a) requires that, except as provided in § 7704(c), a PTP shall be treated as a corporation for purposes of the Code.

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 tradable on a secondary market (or the substantial equivalent thereof).

Subsection 7704(c) provides that subsection 7704(a) does not apply for any taxable year if the partnership met the gross income requirements of paragraph 7704(c)(2) for such taxable year and each preceding taxable year beginning after

December 31, 1987, during which the partnership or any predecessor was in existence. Paragraph 7704(c)(2) provides that the gross income requirement is met for any taxable year if at least 90% of the partnership's gross income for the taxable year consists of "qualifying income."

Subparagraph 7704(d)(1)(E) provides that, except as otherwise provided in the subsection, qualifying income includes inter alia income and gains derived from the exploration, development, mining, production, processing, refining, transportation, or the marketing of any mineral or natural resource. For purposes subparagraph 7704(d)(1)(E), 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 subparagraphs (A) or (B) of § 613(b)(7).

Revenue Ruling 71-455, 1971-2 C.B. 318, holds that for purposes of the passive investment income limitations of the former § 1372(e)(5), when an electing small business corporation took into account its distributive share gross of receipts from a joint venture, the corporation was correct in taking it into account separately. As noted, under § 702(b) items of income maintain their character when included in a partner's distributive share. Consequently, if the joint venture's gross receipts were not passive investment income with respect to the joint venture, the corporation's distributive share of the gross receipts was not passive investment income with respect to the corporation.

If Taxpayer took into account a distributive share of gross receipts of one of the specified PTPs, whether Taxpayer took the share into account separately could affect Taxpayer's federal income tax liability. Whether Taxpayer would be subject to tax under § 1375 would depend, in part, on the percentage of Taxpayer's gross receipts that are passive investment income. Whether Taxpayer takes into account its distributive share of such a PTP's gross receipts separately, or other than separately, would affect that percentage. Additionally, under § 1362(d)(3), Taxpayer's status as an S corporation would also, in part, depend upon the percentage Taxpayer's gross receipts which are passive investment income. Thus, pursuant to § 1.702-1(a)(8)(ii), Taxpayer should separately take into account its distributive share of such a PTP's gross receipts. Thus, for purposes of the passive income limitations of § 1372(e)(5), the character of the partnership receipts of such a PTP with respect to Taxpayer will be the same as the character of the partnership receipts with respect to that PTP.

CONCLUSION

Based solely on the facts represented, we conclude as follows: (i) Taxpayer's distributive shares of the specified PTPs' gross receipts will be included in Taxpayer's gross receipts for the purpose of applying the passive investment income limitations of §§ 1362(d)(3) and 1375(a), and (ii) Taxpayer's distributive shares of gross receipts attributable to the specified PTPs' purchasing, gathering, transporting, trading, storage, and resale of crude oil and refined petroleum products will not constitute passive investment income under §§ 1362(d)(3) and 1375(a).

Except as specifically set forth above, no opinion is expressed or implied as to the federal tax consequences of the above-described facts under any other provision of the Code. Specifically, we express no opinion on whether Taxpayer's distributive shares of partnership items satisfies the requirements of § 704(b) or whether the PTPs meets the requirements of § 7704(c). In addition, we express no opinion regarding Taxpayer's ability to elect to be taxed as an S corporation under § 1362(a). 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 PTPs' crude oil and petroleum activity remains passive with respect to Taxpayer for purposes of § 469.

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

Sincerely yours,

William P. O'Shea