Internal Revenue Service

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

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Date:
November 22, 2002

Legend

Taxpayer =

Property =

Date 1 =

State =

A =

B =

C =

Dear :

This letter responds to your letter dated December 28, 2001, and subsequent correspondence, written on behalf of Taxpayer, requesting rulings under §§ 1362(d)(3) and 1375 of the Internal Revenue Code.

Facts

Taxpayer is incorporated under the laws of State and elected to be an S corporation effective Date 1. Prior to Date 1, Taxpayer's primary source of revenue was rental income from leasing office space at Property.

Shortly after Date 1, in order to diversify its business holdings, Taxpayer purchased ownership interests in A, B, and C, each of which is a publicly traded limited partnership.

Taxpayer represents that A, B, and C meet the qualifying income exception of § 7704(c) and thus are treated as partnerships for federal tax purposes. Taxpayer also represents that A, B, and C are not electing large partnerships as defined in § 775 and, thus, the normal flow-through provisions of subchapter K apply to their partners.

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 the regulations.

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 1.702-1(a)(8)(ii) of the Income Tax Regulations requires each partner to take into account separately any partnership item which if separately taken into account by any partner 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 1361(a)(1) states that an "S corporation" generally refers to a small business corporation that has made an election under § 1362(a) to be treated as an S corporation for a taxable year.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) is terminated 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.

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

Section 7704(b) defines a “publicly traded partnership” as any partnership if interests in such partnership are traded on an established securities market, or if interests in such partnership are readily tradable 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, or the marketing of any mineral or natural resource is qualifying income, except as otherwise provided.

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 was not converted into passive investment income upon their allocation to the S corporation.

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

Conclusion

Taxpayer's distributive share of the gross receipts of A, B, and C will be included in the gross receipts for purposes of §§ 1362(a) and 1375(a), and Taxpayer's distributive share of gross receipts of A, B, and C that are attributable to the purchasing, gathering, transporting, trading, storage, and resale of crude oil, refined petroleum, and other mineral or natural resource will not constitute passive investment income as defined by § 1362(d)(3)(C)(i).

Except as specifically set forth above, we express no opinion as to the federal tax consequences of the transaction described above under any other provision of the Code. Further, we express no opinion on whether Taxpayer is eligible to be an S corporation.

Under a power of attorney on file with this office, we are sending the original of this letter to you and a copy to Taxpayer.

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.

Sincerely yours,

/s/

Jeanne M. Sullivan
Senior Technician Reviewer
Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2):

Copy of this letter
Copy for § 6110 purposes