

Internal Revenue Service

Department of the Treasury

Number: **200327004**
Release Date: 7/03/2003
Index Number: 1362.02-03

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:PSI:B1-PLR-159487-02

Date:

March 10, 2003

Legend:

X =

Y1 =

State =

D1 =

P1 =

P2 =

P3 =

Dear :

This letter responds to a letter submitted on behalf of X, dated October 21, 2002, requesting rulings under §§1362(d)(3) and 1375(a) of the Internal Revenue Code.

FACTS

According to the information submitted, X was incorporated in Y1 under the laws of the State and elected under §1362(a) to be an S corporation effective on D1. X has accumulated earnings and profits.

X is in the business of investing in various active trades and businesses. To diversify its investments, X purchased common units in P1, P2, and P3, which are publicly-traded limited partnerships ("PTPs") engaged in various aspects of the crude oil business.

X represents that the PTPs in which it invested meet the qualifying income exception under §7704(c) to the publicly traded partnership requirements under §7704(a). X also represents that the normal flowthrough provisions of subchapter K apply to the PTPs' partners because the PTPs are not electing large partnerships as defined in §775.

LAW AND ANALYSIS

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

Section 1362(d)(3)(A)(i) provides that an election under §1362(a) terminates whenever the corporation has accumulated earnings and profits at the close of each of three consecutive taxable years, and has gross receipts for each of such taxable years more than 25 percent of which are passive investment income. Any termination 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.

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 (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom).

Section 1.1362(c)(4)(i) of the Income Tax Regulations provides, in general, that gross receipts refer to 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 1375(a) of the Code 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.

PLR-159487-02

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) of the Regulations 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) of the Code 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 the 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).

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.

X'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 X as an S corporation could depend upon the character of its distributive shares of gross

PLR-159487-02

receipts from the PTPs. Thus, pursuant to §1.702-1(a)(8)(ii) of the Regulations, X must take into account separately its distributive shares of the gross receipts from the PTPs. The character of these partnership receipts for X will be the same as the character of the partnership receipts for the PTPs, in accordance with §702(b) of the Code.

CONCLUSION

Based solely on the facts and representations submitted, we conclude that:
1) X's distributive share of the gross receipts of the PTPs in which it invested will be included in its gross receipts for purposes of §§1362(d)(3) and 1375(a); and 2) X's distributive shares of the PTP's gross receipts attributable to the purchasing, gathering, transporting, trading, marketing, storing, and reselling of crude oil, refined petroleum products, and natural gas liquids 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. Specifically, we express no opinion on whether X is eligible to be an S corporation.

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 mailed to your authorized representatives.

Sincerely,

/s/ **David R. Haglund**

David R. Haglund
Senior Technician Reviewer
Branch 1
Associate Chief Counsel
(Passthroughs and Special Industries)

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