

**Internal Revenue Service**

Department of the Treasury

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Person to Contact:

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Date:

February 23, 1999

**LEGEND**

A =

X =

Dear

This letter responds to your letter dated September 23, 1998, submitted on behalf of A, requesting rulings under 1362(d)(3) and 1375(a) of the Internal Revenue Code.

**Facts**

A is a subchapter C corporation that proposes to elect under section 1362 to be taxed as an S corporation for federal income tax purposes. A will have subchapter C earnings and profits remaining after it makes the election. The primary assets owned by A are rental properties, cash, and marketable investments.

A plans to invest in X, a publicly traded limited partnership (PTP) engaged in the purchasing, gathering, transporting, trading, storage and resale of crude oil and refined petroleum products and related activities. A's purpose for this investment is to provide for liquidity and also to diversify investment risk. A represents that X meets the qualifying income exception under section 7704(c)(2) and is taxed as a partnership for federal tax purposes. In addition, A represents that X is not an "electing large partnership" under section 771, and that the normal flow-through provisions of Subchapter K apply to its partners.

A has requested the following rulings:

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- (1) A's distributive share of X's gross receipts will be included in A's gross receipts for the purpose of applying the passive investment income limitations of sections 1362(d)(3) and 1375(a); and
- (2) A's distributive share of partnership gross receipts attributable to X's purchasing, gathering, transporting, trading, storage, and resale of crude oil and refined petroleum products will not constitute passive investment income for purposes of sections 1362(d)(3) and 1375(a).

### **Analysis**

Section 702(a)(7) of the Code 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 requires each partner to take into account separately 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.

Under section 702(b), the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under section 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 section 1361, to elect to be an S corporation. This election, however, terminates under the provisions of section 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 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 and 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 section 7704(c), a publicly traded partnership shall be treated as a corporation for federal income tax purposes.

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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).

Under section 7704(c), section 7704(a) does not apply to any PTP for any taxable year if the partnership met the gross income requirements of section 7704(c)(2) for the 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 the gross income requirement is met for any taxable year if at least 90 percent of the partnership’s gross income for the 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. 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 section 611, but is not a product described in section 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 section 702(b), the character of the gross receipts of the joint venture were not converted into passive investment income upon the distribution to the small business company described in the revenue ruling.

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

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Based solely on the facts as represented, we rule as follows:

- (1) A's distributive share of X's gross receipts will be included in A's gross receipts for the purpose of applying the passive investment income limitations of sections 1362(d)(3) and 1375(a).
- (2) A's distributive share of gross receipts attributable to X's purchasing, gathering, transporting, trading, storage, and resale of crude oil and refined petroleum products will not constitute passive investment income under sections 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 A's distributive share of partnership items satisfies the requirements of section 704(b) or whether X meets the requirements of section 7704(c). In addition, we express no opinion regarding A's ability to elect to be taxed as an S corporation under section 1362(a). Further, the passive investment income rules of section 1362 are completely independent of the passive activity rules of section 469; unless an exception under section 469 applies, X's crude oil and petroleum activity remains passive with respect to A for purposes of section 469.

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

Pursuant to a power of attorney on file with this office, a copy of this ruling is being sent to A.

Sincerely,

Donna M. Young  
Senior Technician Reviewer, Branch 3  
Office of the Assistant Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter  
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