Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
CC:PSI:3 PLR-120468-00
Date:
February 7, 2001

Company:
Sub A:
Sub B:
P1:
P2:
State:

Dear

This letter responds to a letter from your authorized representative dated September 28, 2000, as well as subsequent correspondence, submitted on behalf of Company, requesting a ruling under §§ 1362(d)(3) and 1375(a) of the Internal Revenue Code. Company represents the following facts.

FACTS

Company, incorporated under the laws of State, elected under § 1362(a) to be an S corporation. It acts as a holding company for two qualified subchapter S subsidiaries (QSubs), Sub A and Sub B. Sub A has accumulated earnings and profits.

In addition to holding the stock of Subs A and B, Company holds interests in two publicly traded limited partnerships (PTPs), P1 and P2. P1 is engaged in the business of purchasing, gathering, transporting, and reselling crude oil. P2 is engaged in the business of purchasing, gathering, transporting, trading, storing, and reselling crude oil, refined petroleum products, and natural gas liquids, as well as the business of blending crude oil.

Company represents that P1 and P2 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.

LAW AND ANALYSIS

Section 1361(b)(3)(B) defines the term “qualified subchapter S subsidiary” as any domestic corporation that is not an ineligible corporation (as defined in §

1361(b)(2)), if (i) 100 percent of the stock of that corporation is held by the S corporation, and (ii) the S corporation elects to treat that corporation as a QSub.

Section 1361(b)(3)(A) provides that (i) a corporation which is a QSub shall not be treated as a separate corporation, and (ii) all assets, liabilities, and items of income, deduction, and credit of a QSub shall be treated as assets, liabilities, and such items (as the case might be) of the S corporation.

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) of the Income Tax 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) 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 first 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 of the joint venture exceeded its gross receipts. The revenue ruling holds that, in computing its gross receipts for purposes of the passive investment income test, the S corporation should include its distributive share of the joint venture's gross receipts and not its share of the venture's loss.

Company's distributive shares of gross receipts from P1 and P2, 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 these PTPs. Thus, pursuant to § 1.702-1(a)(8)(ii), Company must take into account separately its distributive shares of the gross receipts from P1 and P2. The character of these partnership receipts for

Company will be the same as the character of the partnership receipts for P1 and P2, 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 P1 and P2 are included in its gross receipts for purposes of §§ 1362(d)(3) and 1375(a).

(2) Company's distributive shares of the gross receipts of P1 and P2 attributable to purchasing, gathering, transporting, trading, storing, and reselling crude oil, refined petroleum products, and natural gas liquids, as well as crude oil blending, do 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 the S corporation and QSub elections made by or for Company and Subs A and B.

Under a 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,
MARY BETH COLLINS
Assistant to the Chief, Branch 3
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

enclosure: copy for § 6110 purposes