Internal Revenue Service

Department of the Treasury

Index Number: 1362.02-03, 7704.03-00

Washington, DC 20224

Number: **199935013**
Release Date: 9/3/1999

Person to Contact:

Telephone Number:

Refer Reply To:
CC:DOM:P&SI:3-PLR-107807-99
Date:
May 28, 1999

Legend

A =

X =

Y =

Z =

S1 =

S2 =

S3 =

Exchange =

Date =

a =

b =

P1 =

P2 =

P3 =

P4 =

P5 =

Dear

This letter responds to your letter dated October 6, 1998, submitted on behalf of A, requesting rulings under sections 1362(d)(3) and 1375(a) of the Internal Revenue Code.

Facts

A is an S corporation with Subchapter C accumulated earnings and profits that is in the business of constructing, developing, maintaining, servicing, and operating a self-created, commercial retail marketplace. A owns 5 strip centers, P1, P2, P3, P4, and P5, either directly or through general partnership interests.

A performs a number of services with respect to P1, P2, P3, P4, and P5, either through direct, on-site personnel; through S1, S2, or S3; or through other outside independent contracting firms. Services provided by A include, but are not limited to, the following: common area maintenance; tenant in-line maintenance; food court maintenance; cooling and heating systems service and maintenance; daily inspection of premises; energy management; on-call 24-hour staff; processing tenant requests and concerns; refuse management; remodeling; safety inspections; security personnel; sprinkler system maintenance for fire prevention; janitorial services; plumbing and electrical services; tenant amenities, both seasonal and daily; staffing and personnel services to tenants; structural maintenance; water and sewage services; and other related leasing, management, and administrative services.

A incurs various costs in its leasing businesses. For the taxable year ending Date, A collected approximately $a in gross revenue and incurred approximately $b in relevant operating expenses in the rental business.

From time to time, A has invested or will invest (either directly or indirectly through a general partnership or limited liability company) in certain publicly traded limited partnerships (PTPs) primarily engaged in the exploration and/or production of oil and gas. Also, from time to time, A has invested or will invest (either directly or indirectly through a general partnership or limited liability company) in other PTPs primarily involved in processing various minerals and chemicals. These investments are made to provide for liquidity and also to diversify investment risk.

Presently, A has identified three specific PTPs listed on Exchange that it has or will invest in: X, Y, and Z. X is engaged in the purchasing, gathering, transporting, trading, storage and resale of crude oil and refined petroleum products and related

activities. Y is engaged in the purchasing, gathering, transporting, aggregating, and resale of crude oil. Z is engaged in the operation of various chemical plants. A represents that X and Y meet the qualifying income exception under section 7704(c)(2)

and are taxed as partnerships for federal tax purposes. A further represents that Z is an "electing 1987 partnership" under section 7704(g)(1) and is taxed as a partnership for federal tax purposes. In addition, A represents that X, Y, and Z are not "electing large partnerships" under section 771, and that the normal flow-through provisions of Subchapter K apply to their partners.

A has requested the following rulings:

(1) A's distributive share of partnership gross receipts attributable to the interests it has acquired or will acquire (either directly or indirectly through a general partnership or limited liability company) in X, Y, or Z, 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 partnership gross receipts attributable to the interests it has acquired or will acquire in X, Y, or Z will not constitute passive investment income for purposes of sections 1362(d)(3) and 1375(a) to the extent the gross receipts are derived from the exploration or production of oil and gas or the processing of various minerals and chemicals; and

(3) A's rental income from the leasing of strip centers will not constitute passive investment income under 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 three 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 1.1362-2(c)(5)((ii)(B)(1) provides that “rents” means amounts received for the use of, or the right to use, property (whether real or personal) of the corporation.

Section 1.1362-2(c)(5)(ii)(B)(2) provides that “rents” does not include rents derived in the active trade or business of renting property. Rents received by a corporation are derived in an active trade or business of renting property only if, based on all the facts and circumstances, the corporation provides significant services or incurs substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with net leases. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

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.

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).

Under section 7704(g)(1), section 7704(a) does not apply to an electing 1987 partnership. Section 7704(g)(2) defines an electing 1987 partnership as any PTP if: (A) the PTP is an existing partnership (as defined in section 10211(c)(2) of the Revenue Reconciliation Act of 1987) (generally, a PTP on or before December 19, 1987); (B) section 7704(a) has not applied (and without regard to section 7704(c)(1) would not have applied) to such partnership for all prior taxable years beginning after December 31, 1987, and before January 1, 1998; and (C) such partnership elects the application of section 7704(g), and consents to the application of the tax under section 7704(g)(3) for its first taxable year beginning after December 31, 1997.

Section 7704(g)(3) imposes for each taxable year on the income of each electing 1987 partnership a tax equal to 3.5 percent of such partnership's gross income for the taxable year from the active conduct of trades and businesses by the partnership.

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, Y, or Z, 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, Y, or Z. Thus, pursuant to section 1.702-1(a)(8)(ii), A must separately take into account its distributive share of the gross receipts from X, Y, and Z. The character of the partnership receipts for A will be the same as the character of the partnership receipts for X, Y, and Z.

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

(1) A's distributive share of gross receipts from X, Y, and Z 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 crude oil and petroleum businesses, Y's crude oil businesses, and Z's chemical businesses will not constitute passive investment income under sections 1362(d)(3) and 1375(a).

(3) A's rental income from P1, P2, P3, P4, and P5 is not passive investment income under sections 1362(d)(3) and 1375(a).

Except as specifically set forth above, no opinion is expressed as to the federal tax consequences of the above-described facts. Specifically, we express no opinion on whether A's distributive share determined in accordance with the partnership agreements of X, Y, or Z will be respected under section 704(b) or whether X, Y, or Z meet the requirements of section 7704(c) or (g). In addition, we express no opinion regarding A's status as an S corporation under section 1362(a) nor do we comment on the amount of gross revenue that constitutes rental income for purposes of sections 1362(d)(3) and 1375(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, the rental activity and the crude oil, petroleum, and chemical activities of X, Y, and Z remain 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)