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Legend:

X =

A =

B =

C =

D =

E =

F =

G =

H =

I =

J =

LLC =

Year 1 =

State =

Date 1 =

Business 1 =

M =

N =

O =

Business 2 =

k% =

P =

Property 1 =

Property 2 =

\$M =

\$N =

Year 2 =

Dear :

This letter is in response to your letter, on behalf of X, dated May 12, 2006, seeking a ruling regarding passive investment income under § 1362(d)(3) and § 1375 of the Internal Revenue Code

Facts

Based on the materials submitted and representations within, we understand the relevant facts to be as follows. X was incorporated in Year 1 in accordance with the laws of State. X made an election to be treated as an S corporation effective Date 1. X has accumulated earnings and profits (AE&P) from prior years. X, directly or indirectly, owns A, B, C, D, E, F, G, H, I and J, all of which X has elected to treat as Qualified Subchapter S Subsidiaries (QSubs). In addition, LLC, is treated as a disregarded entity of X for Federal income tax purposes (LLC, along with A, B, C, D, E, F, G, H, I, and J, collectively, "disregarded entities"). X and certain disregarded entities are engaged in the active trade of Business 1.

From time to time, X has invested or will invest in certain publicly traded limited partnerships (PTPs) primarily engaged in the purchasing, transportation, storage and marketing of oil and gas. X's investment strategy is to provide for liquidity and also to diversify its investment risk.

Presently, X has identified three specific PTPs, M, N, and O, which are engaged in the active trade of purchasing, gathering, transporting, trading, storage and/or resale of crude oil and refined petroleum products and related activities. X represents that M, N, and O each meets the qualifying income exception of § 7704(c) and, thus, each is taxed as a partnership for federal income tax purposes. X also represents that neither M, N, nor O is an electing large partnership (as defined by § 775) and, thus, the normal flowthrough provisions of subchapter K apply to their partners.

X, through several of X's disregarded entities, also owns k% of P, a general partnership that is treated as a partnership for federal tax purposes. P owns Property 1 and Property 2, commercial real estate properties that P leases to tenants. P, through a management company and various independent contractors, provides various services with respect to the leasing of the property. These services include janitorial and engineering services; inspection and maintenance of utilities, landscaping, and elevator service; security, fire, life and safety training; trash and recycling service; pest control; rental and service billing; provision of reserved and valet parking for tenants and their visitors; improvement and maintenance of plumbing, electrical, mechanical, and HVAC systems; and compliance with governmental building regulations.

In Year 2, P collected approximately \$M in gross rents and incurred approximately \$N in relevant operating expenses.

Law and Analysis

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

Section 1361(b)(3)(B) provides that a qualified subchapter S subsidiary means any domestic corporation which is not an ineligible corporation if 100 percent of the stock of such corporation is held by the S corporation, and the S corporation elects to treat such corporation as a qualified subchapter S subsidiary.

Section 301.7701-2(a) of the Regulations defines a business entity as any entity recognized for federal tax purposes that is not properly classified as a trust under § 301.7701-4 or otherwise subject to special treatment under the Code.

Section 301.7701-3(a) provides that a business entity that is not classified as a corporation under § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) (an (eligible entity)) can elect its classification for federal tax purposes as provided in this section.

Section 301.7701-3(b)(1) provides that, except as otherwise provided in paragraph (b)(3) of that section, unless the entity elects otherwise, a domestic eligible entity is (i) a partnership if it has two or more members; or (ii) disregarded as an entity separate from its owner if it has a single owner.

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 S corporation election shall be terminated whenever the corporation (I) has accumulated earnings and profits at the close of each of 3 consecutive taxable years, and (II) has gross receipts for each of such taxable years more than 25 percent of which are passive investment income. The termination is effective on and after the first date of the first taxable year beginning after the third consecutive taxable year referred to in § 1362(d)(3)(A)(i). Section 1362(d)(3)(A)(ii).

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) imposes a tax on the income of an S corporation if the S corporation has (1) accumulated earnings and profits at the close of such taxable year, and (2) gross receipts more than 25 percent of which are passive investment income.

Section 1362(d)(3)(C)(i) provides that, except as otherwise provided, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 702(a) 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) 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.

Section 7704(a) provides that, except as provided in subsection (c), a publicly traded partnership (PTP) shall be treated as a corporation.

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 subsection (a) shall not apply to any publicly traded partnership for any taxable year of such partnership meets the gross income requirements of paragraph (c)(2) for such 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) states that a partnership meets the gross income requirements of this paragraph for any taxable year 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, in relevant part, the term "qualifying income" means 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). 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).

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

Section 1.1362-2(c)(5)(ii)(B)(1) defines "rent" as amounts received for the use of, or right to use, property (whether real or personal) of the corporation.

Section 1.1362-2(c)(5)(ii)(B)(2) provides that the term "rents" does not include rents derived in the active trade or business of renting property. Rents 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 types and amounts of costs and expenses incurred (other than depreciation).

Conclusion

Based solely on the facts as presented in the ruling request, and viewed in light of the applicable law and regulations, we conclude the following: (1) X's distributive shares of the gross receipts of M, N and O will be included in its gross receipts for purposes of sections 1362(d)(3) and 1375(a); (2) X's distributive shares of M, N and O's gross receipts attributable to 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 will not constitute passive investment income as defined by § 1362(d)(3)(C); (3) that the income that X derives from the rental activities of P is income from the active trade or business of renting property and is not passive investment income as described in 1362(d)(3)(C)(i) because P provides significant services and incurs substantial costs in its rental business.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed concerning whether X satisfies the S corporation eligibility requirements of § 1361. Further, the passive investment income rules of § 1362 are completely independent of the passive activity rules of § 469; unless an exception under § 469 applies, the rental activity remains passive for purposes of § 469.

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.

Pursuant to the power of attorney on file with this office, a copy of this letter will be sent to the taxpayer's representative.

Sincerely,

David R. Haglund
Senior Technician Reviewer, Branch 1
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

Copy of this letter for § 6110 purposes