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January 10, 2011

The Honorable Michael F. Mundaca
Assistant Treasury Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Douglas Shulman
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20220

Re: New York City Bar Report Requesting Guidance Concerning Various Provisions of Section 7704

Dear Assistant Secretary Mundaca and Commissioner Shulman:

On behalf of the New York City Bar Association, I am pleased to present the report of the Committee on Taxation of Business Entities offering proposed guidance relating to certain provisions and requesting clarification with respect to certain other provisions, relating to publicly traded partnerships under Section 7704 of the Code. The report describes three major main areas of concern – the safe harbor for open-end redemptions, the computation of a partner's percentage interest, and the definition of qualifying income – and makes recommendations for additional guidance that is needed.

Generally, a partnership is a publicly traded partnership, which is treated as a corporation for federal income tax purposes, if interests in the partnership are traded on an established securities exchange or are readily tradeable on a secondary market (or the substantial equivalent thereof). Under the current safe harbor, the transfer of a partnership interest pursuant to a redemption or repurchase agreement (as defined in the regulations) is disregarded in determining whether interests in the partnershp are readily tradeable on a secondary market if:

(a) the agreement provides that the redemption cannot occur until at least 60 days after the partner notifies the partnership, in writing, of his intention to exercise his redemption right,

(b) the agreement requires that the redemption price cannot be established until at least 60 days after the partnership receives such notification from the partner, or the redemption price is established not more than four times a year, and

(c) the percentage interests in partnership capital and profits transferred during the partnership's tax year does not exceed 10% of the total interests.

The Committee believes that the percentage limitation is not necessary to distinguish regular partnership interests from publicly traded interests, especially in light of the other requirements. If deemed appropriate, a partnership relying on this safe harbor could be required to prevent the redeeming partner from re-investing in the partnership for a three-month period. At a minimum, the Committee believes that 10% is too low a threshold, and should be increased (e.g., to 35%, which many funds use for non-tax business reasons). Similarly, the Committee believes that the 60-day notice requirement should be shortened. Most funds determine their net asset values, which is the basis for setting the redemption price, each month. The Committee believes that such changes are necessary to provide a meaningful safe harbor, while still preventing the liquidity equivalence of a secondary market.

The applicability of various safe harbors depends on the percentage interests in partnership capital and profits being transferred. Guidance is needed as to how such percentages are determined, especially where the partner's interest in profits varies. The Committee recommends a safe harbor that allows the partner's interest in capital is equal to the amount the partner would receive upon a hypothetical sale of all of the partnership's assets for cash equal to their fair market value and paying all of the partnership's liabilities, and that treats the partner's interest in profits as being equal to the tax book gain such partner would be allocated upon such hypothetical sale. In addition, with the prevalence of limited liability companies, it should be clarified who is considered to be a general partner for purposes of these rules.

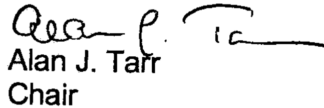
A publicly traded partnership is not treated as a corporation is at least 90% of its income for each year is passive. In light of recent market developments, additional guidance is needed with respect to qualifying income under the passive income exception to publicly traded partnership treatment. In particular, guidance is needed with respect to the treatment of cancellation of indebtedness income. The Committee believes that such income should be excluded from both the numerator and the denominator of the fraction.

The report also describes changes in the securities law that were enacted after the adoption of the private placement safe harbor. The Committee requests that consideration be given as to whether an expanded private placement safe harbor, permitting a greater number of partners, should be allowed.

The report also considers the special issues faced by tiered partnerships. The Committee recommends that procedures be adopted allowing an upper-tier partnership to rely on a certificate from a lower-tier partnership with respect to the characterization of its income. In addition, if the interests of the lower-tier partnership are traded on an established securities market but the lower-tier partnership treats itself as a partnership for federal income tax purposes, in determining the classification of an upper-tier partnership, the upper-tier partnership should be able to assume that 90% of its income from the lower-tier partnership is qualifying income.

Thank you for your consideration. We would be happy to discuss any questions you may have about the report. Please feel free to contact me at 212-407-4900 or atarr@loeb.com, or Jill Darrow at 212-940-7113 or jill.darrow@kattenlaw.com.

Very truly yours,



Alan J. Tarr
Chair

Enclosure

cc: William J. Wilkins
Chief Counsel, Internal Revenue Service and
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NEW YORK CITY BAR REPORT REQUESTING GUIDANCE CONCERNING VARIOUS PROVISIONS OF SECTION 7704

AS REPORTED BY THE COMMITTEE ON TAXATION OF BUSINESS ENTITIES

January 10, 2011

This report, which is submitted on behalf of the New York City Bar by its Committee on Taxation of Business Entities,[1] considers various issues arising under Section 7704 [2] as to which guidance is absent or lacking clarity, and examines whether it is appropriate to expand or liberalize certain safe harbors for avoiding classification as a publicly traded partnership in light of recent legal and market developments. The report identifies the policy considerations that might be relevant in developing such guidance, and in some instances makes recommendations as to the guidance that should be issued.

I. Introduction

A. General Background

An entity classified as a partnership for federal income tax purposes is not itself subject to federal income tax. Instead, its items of income, gain, loss, deduction and credit are passed through to, and includable by, the partners.

Under Section 7704, notwithstanding its classification as a partnership, a "publicly traded partnership" ("PTP"), as defined,[3] is taxable as a corporation for federal income tax purposes[4] unless 90% or more of the PTP's annual gross income consists of "qualifying income," as defined.[5]

B. Definition of "Publicly Traded"

Section 7704(b) defines a PTP as a partnership the interests in which are traded on an established securities market or are readily tradeable on a secondary market (or the substantial

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[1] The report was prepared by the Committee on Taxation of Business Entities of the New York City Bar. The author of the report is Jill Darrow. Helpful comments were provided by John Barrie, Hillel Jacobson, John Kaufmann, Michael Miller, Amanda Nussbaum, Mark Stone, Alan Tarr and Louis Tuchman.

[2] All Section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the regulations promulgated thereunder (the "Regulations"), unless otherwise indicated.

[3] Section 7704(b).

[4] Section 7704(a).

[5] Sections 7704(c), (d).

equivalent thereof).[6] Determining whether partnership interests are traded on an established securities market is relatively straightforward.[7] By contrast, determining whether partnership interests are readily tradeable on a secondary market requires an analysis of the applicable facts and circumstances unless the arrangement or transaction in question is covered by one of the safe harbors provided in the Regulations.

The general rule is that a secondary market exists if, based on the applicable facts and circumstances, the partners are readily able to buy, sell or exchange their partnership interests in a manner that is economically comparable to trading on an established securities market.[8] Partnership interests are considered readily tradeable if a market maker exists,[9] firm quote pricing is regularly provided by one or more third parties,[10] there is a public medium for obtaining or providing information as to offers to buy, sell or exchange the partnership interests,[11] or the interests can be disposed of in a time frame and with the same regularity and continuity as the existence of on an over-the-counter market would provide.[12]

Regulations §§ 1.7704-1(e)-(h) and (j) provide safe harbors for determining whether partnership interests are readily tradeable on a secondary market.[13] The safe harbors in the Section 7704 Regulations were based on the safe harbors provided in Notice 88-75.[14] Some of the safe harbors provided in the Section 7704 Regulations are substantially identical to the corresponding safe harbors provided in the Notice, while others were significantly modified.

C. Qualifying Income Test

A PTP which satisfies the qualifying income test of Section 7704(c) is not subject to the general rule of Section 7704(a) providing for treatment of PTPs as corporations for federal income tax purposes. Section 7704(c) applies to a partnership if, for each taxable year (after 1987) in which the partnership (or a predecessor partnership) is a PTP, at least 90% of its gross income consists of "qualifying income" as defined in Section 7704(d). Qualifying income includes certain interest, dividends, real property rents, real property gains (even if derived from real property held for sale in the ordinary course of business), income and gains from natural

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[6] For purposes of this report, references to a secondary market include the substantial equivalent thereof.

[7] *See*, generally, Treas. Reg. § 1.7704-1(b).

[8] Treas. Reg. § 1.7704-1(c)(1).

[9] Treas. Reg. § 1.7704-1(c)(2)(i).

[10] Treas. Reg. § 1.7704-1(c)(2)(ii).

[11] Treas. Reg. § 1.7704-1(c)(2)(iii).

[12] Treas. Reg. § 1.7704-1(c)(2)(iv).

[13] Treas. Reg. § 1.7704-1(c)(3) provides that the fact that a transfer of a partnership interest falls outside these safe harbors is disregarded in determining whether the partnership is a PTP.

[14] 1988-2 C.B. 386.

resources activities, and, in the case of a partnership a principal activity of which is trading commodities, income and gain from commodities.

D. Areas of Concern

The safe harbors provided in the Section 7704 Regulations were finalized in 1995, and have not been revised to reflect subsequent market and legal developments. As discussed in Part II.A below, the safe harbor for open-end redemptions cannot be relied upon by most hedge funds and commodity pools in today's market because the 10% limitation imposed by the safe harbor is overly -- and, in our view, needlessly -- restrictive. The private placement safe harbor no longer applies to many privately offered securities investment partnerships because, as a result of post-1995 changes in securities laws, such partnerships can now have more than 100 partners without having to register under the Investment Company Act of 1940, as amended (the "1940 Act"), if the only partners in such partnerships are highly sophisticated and high net worth persons.

Many of the safe harbors in the Section 7704 Regulations depend for their application on the percentage represented by the transferred partnership interest(s). However, the Section 7704 Regulations do not provide any rules for determining the percentage of partnership profits or capital that a transferred partnership interest represents. The Section 7704 Regulations also contain a trap for the unwary, in that they exclude the general partner's interests from the denominator for purposes of calculating the percentage of partnership interests transferred if the general partner's interest in partnership capital or profits exceeds 10%. Uncertainty in how the PTP safe harbors should be applied defeats the purpose of providing safe harbors, and forces partnerships to determine whether they satisfy the qualifying income exception to the general rule treating PTPs as corporations for tax purposes.

The provisions of the Section 7704 Regulations interpreting Section 7704(d), which defines qualifying income, likewise have not kept pace with market developments since 1995. Most urgent is the question of whether cancellation of indebtedness income is qualifying income. Another area that should be addressed involves providing procedures for upper-tier partnerships to obtain information from lower-tier partnerships concerning the nature of their gross income, as well as provisions providing presumptive qualifying income treatment of income allocated by exchange-traded partnerships.

E. Summary of Recommendations

The principal recommendations of this report are as follows:

Open-End Redemption Plan Safe Harbor, Treas. Reg. § 1.7704-1(f)

1. The 10% overall limitation on the total interests that can be transferred during the taxable year should be eliminated, and the required notice period (currently 60 days) should be reduced to 45 days. Any concerns that partners could abuse the safe harbor by redeeming and re-investing could be addressed by requiring that a redeemed partner must wait a minimum of three months (e.g., a calendar quarter) before re-investing in the partnership. If this recommendation is not accepted, the allowable percentage should be increased.

Private Placement Safe Harbor, Treas. Reg. § 1.7704-1(h)

2. The securities laws were amended after the Section 7704 Regulations were finalized to permit privately offered partnerships to have an unlimited number of partners without having to register under the 1940 Act if ownership of partnership interests is restricted to "qualified purchasers" under section 3(c)(7) of the 1940 Act. Such partnerships cannot rely on the private placement safe harbor, which imposes a 100-partner limit. In light of this development, it is appropriate to consider whether a private placement safe harbor can be created for these partnerships given that, for this safe harbor to be workable, any ceiling imposed on the number of partners would have to be significantly higher than 100.

Percentage Interests, Treas. Reg. §§ 1.7704-1(f), 1.7704-1(g)(2)(vii), 1.7704-1(j) and 1.7704-1(k)

3. Guidance should be provided concerning how to determine a partner's interest in partnership capital and profits, especially when the partnership's allocations of profits are expected to vary over the term of the partnership.

4. Future guidance should include a safe harbor under which a partner's interest in partnership capital equals the cash proceeds that would be distributed to the partner in complete liquidation of the partnership if the partnership were to sell all of its assets (subject to all of its liabilities) at fair market value for cash.

5. Future guidance should include a safe harbor under which a partner's interest in partnership profits equals the percentage of the total book gain or loss that the partnership would realize on a hypothetical sale at fair market value of all its assets (subject to all of its liabilities) for cash.

Exclusion of General Partner's Interest, Treas. Reg. § 1.7704-1(k)(1)(ii)

6. The rule requiring the general partner's interest in partnership profits or capital, if greater than 10%, to be excluded from the total outstanding partnership interests in applying the percentage limitations imposed by the safe harbors, poses a potential trap for the unwary, particularly because the policy reasons that led to the inclusion of the rule have never been disclosed. The Committee recommends that the policy considerations behind the adoption of this rule be disclosed. Depending on the reasons for the exclusion, the Committee may make further recommendations concerning the scope of the exclusion and its application.

7. Future guidance should provide that, in the case of a limited liability company, only a member who or which is designated as a manager under the entity's operating agreement will be considered to be a "general partner" for these purposes.

Qualifying Income and Commodities, Section 7704(d)(1)(G)

8. The scope of the provision treating income from commodities trading as qualifying income for partnerships a principal activity of which is trading commodities

should be clarified in various respects as it relates to income from trading commodity instruments.

Cancellation of Debt ("COD") Income, Section 7704(d)

9. Using a tracing approach to determine whether COD income is qualifying income creates uncertainty in circumstances where the applicable debt is not traceable to any specific investment. Instead, COD income should be excluded from gross income in applying the qualifying income test. Authority for the adoption of this approach may be found in Section 7704(e), which allows the Internal Revenue Service (the "IRS") to determine the circumstances under which a partnership's inadvertent failure to satisfy the qualifying income test will be excused. In any event, immediate guidance should be provided for determining how COD income is to be treated in applying the qualifying income test.

Income From Lower-Tier Partnerships, Section 7704(d)

10. Procedures should be provided allowing an upper-tier partnership to rely on a lower-tier partnership's certification that the gross income allocated to the upper-tier partnership is qualifying income and providing relief to upper-tier partnerships which are unable to obtain such certification or adequate information on a timely basis to determine whether the income allocated to them is qualifying income.

11. A safe harbor should be provided allowing 90% of an upper-tier partnership's income from a lower-tier partnership the interests in which are traded on a securities exchange to be presumptively treated as qualifying income unless the upper-tier partnership has reason to know that the income allocated to it is not qualifying income.

II. Issues Arising Under Current Safe Harbors

A. Open-End Redemption Plan Safe Harbor

The Section 7704 Regulations adopted, without significant modification, the safe harbor for redemption and repurchase agreements of open-end partnerships provided in Notice 88-75. Notice 88-75 noted that many partnerships maintain plans of redemption for their limited partners, and included two alternative safe harbors covering redemption plans, one of which was limited to closed-end partnerships. The safe harbor provided in the Section 7704 Regulations for open-end partnerships provides that a redemption plan will not cause a partnership to be a PTP if (1) at least 60 calendar days' prior written notice is required in order to exercise the redemption right, (2) the redemption price either is not determined until at least 60 calendar days after the partnership's receipt of the redemption request, or is not determined more frequently than four times during the partnership's taxable year (e.g., quarterly), and (3) the total interests in partnership capital or profits transferred in any taxable year, including transfers (other than

pursuant to a "private transfer" as defined in Regulations § 1.7704-1(e)(1)), that are not pursuant to the redemption plan, does not exceed 10%.[15]

The safe harbor appears to be intended to allow investment partnerships to offer some degree of liquidity to their investors while at the same time imposing sufficient limitations to prevent the redemption right from providing investors with "readily available, regular and ongoing opportunities to dispose of their interests" in a manner comparable to an established securities or over-the-counter market.[16] However, the 10% limitation makes it impossible as a practical matter for most open-end securities and commodities partnerships -- which normally have redemption plans -- to rely on the safe harbor. Eliminating the 10% limitation would allow typical securities and commodities partnerships to rely on the safe harbor. Imposing a minimum notice requirement (which we propose reducing from 60 days to 45 days) and limiting the frequency of redemptions to quarterly redemptions should be sufficient to distinguish such redemption plans from the high level of liquidity afforded by an established securities or over-the-counter market, without the need to also limit the total amount of partnership interests that can be transferred during the year.

The legislative history to Section 7704 describes what Congress meant by trading on a "secondary market" as follows:

> A secondary market is generally indicated by the existence of a person standing ready to make a market in the interest. An interest is treated as readily tradeable if the interest is regularly quoted by persons such as brokers or dealers who are making a market in the interest. *** Thus, for example, an interest is readily tradeable in a secondary market where the interest is *traded on a market essentially equivalent to an over-the-counter market.* (emphasis added.)[17]

Trading on the "substantial equivalent of a secondary market" means:

> The substantial equivalent of a secondary market exists where there is not an identifiable market maker but the holder of an interest has a *readily available, regular and ongoing opportunity* to sell or exchange his interest through a public means of obtaining or providing information of offers to buy, sell or exchange interests. Similarly, the substantial equivalent of a secondary market exists where prospective buyers and sellers have the opportunity to buy, sell or exchange interests in *a time frame and with the regularity and continuity that the existence of a market maker would provide.*

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[15] Treas. Reg. § 1.7704-1(f).

[16] Conf. Rep. No. 100-495, 100th Cong., 1st Sess., 1987-3 C.B. 193 at 229.

[17] *Id.* at 228.

> If interests can be traded in a market that is publicly available, but offers to buy or sell interests are normally not accepted in a time frame comparable to that which would be available on a secondary market, then the interests are not treated as readily tradeable on the substantial equivalent of a secondary market. For example, if interests are quoted and traded on an irregular basis as a result of bid and ask prices listed on a computerized system, and *such interests cannot normally be disposed of within the time that they could be disposed of on an over-the-counter market*, then the interests are not considered as readily tradeable on the substantial equivalent of a secondary market. (emphasis added).[18]

The legislative history specifically provides, in the case of a plan of redemptions, that:

> . . . [T]he occasional and irregular repurchase or redemption by the partnership, or acquisition by the general partner, of interests in the partnership, [will not] cause the partnership to be considered as publicly traded under the provision. A regular plan of redemptions or repurchases, or similar acquisitions of interests in the partnership such that the holders of interests have *readily available, regular and ongoing opportunities to dispose of their interests*, indicates that the interests are readily tradeable on what is the substantial equivalent of a secondary market. (emphasis added).[19]

The limited liquidity afforded by a plan of quarterly redemptions is very different from trading on an over-the-counter market. On an over-the-counter market, as well as any other established securities market, trading may occur on any date and there is no advance notice requirement. Rather, as long as there is an interested buyer and seller, an order will be executed. Moreover, potential buyers and sellers have access to "real time" information on prices and available transactions. Brokers can obtain buy and sell quotations, which are posted electronically.

The open-end redemptions safe harbor requires 60 days' notice and limits the redemption opportunity to four times a year. These restrictions are sufficient to distinguish a covered plan of redemptions from an over-the-counter market or its substantial equivalent. Imposing a further 10% limitation in effect means that partners who do not redeem their interests on the first quarterly redemption date may be unable to redeem their interests for the balance of the year. Even a partnership which permits redemptions only once a year could not assure its partners that they will be able to redeem their interests if a 10% limitation is imposed. The result is that a partnership which offers a quarterly plan of redemptions cannot impose a 10% limitation and, therefore, cannot rely on the safe harbor.

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[18] *Id.* at 228.

[19] *Id.* at 228-29.

The Committee believes that imposing a percentage limitation on the amount of interests that can be redeemed or transferred (with limited exceptions) is not necessary in view of the other restrictions imposed by the safe harbor. (If deemed appropriate, the IRS could require a partnership relying on the safe harbor to refuse to allow a redeeming partner to re-invest in the partnership before the expiration of a 3-month or one-calendar quarter period.) If this recommendation is not accepted, the percentage level should be increased to a level, such as 35%, that many hedge fund and commodity partnerships already impose on redemptions for non-tax business reasons.

A 60-day notice requirement also poses practical issues for partners in hedge funds and commodities partnerships. Virtually all of these partnerships determine their net asset value, which in turn determines the redemption price that a partner will receive on redemption of his interests, on a monthly basis. Assume that the partnership permits redemptions on the first day of each calendar quarter upon 60 days' prior written notice. A partner who wishes to redeem on the first day of the following quarter based on the results of any month (including the first month) of the current quarter cannot do so in most instances if 60 days' notice is required. If the notice requirement were reduced to 45 days, a partner could redeem on the first day of the following quarter based on the results of the first month of the current quarter. For this reason, hedge funds and commodities funds typically require less than 60 days, (e.g., 45 or 30 days). The Committee believes that reducing the required notice period in the safe harbor from 60 days to 45 days would enhance the utility of the safe harbor without providing liquidity equivalent to a secondary market.

B. Private Placement Safe Harbor

The so-called "private placement" safe harbor provides that interests in a partnership are not readily tradeable on a secondary market or the equivalent if the partnership (1) issues interests exclusively in transactions that are exempt from registration under the Securities Act of 1933, as amended and (2) does not have at any time more than 100 partners (after applying a limited "look-through" rule).[20] The private placement safe harbor is typically relied on by privately offered partnerships that are exempt from registration as investment companies under section 3(c)(1) of the 1940 Act. The section 3(c)(1) exemption requires beneficial ownership by not more than 100 persons (after applying various "look-through" rules).

The private placement safe harbor as originally proposed in Notice 88-75 imposed no numerical limit on the number of partners if the initial offering price of each unit of partnership interest was at least $20,000, and otherwise limited the number of partners to 500. The Section 7704 Regulations as originally proposed included a private placement safe harbor but modified the Notice 88-75 safe harbor by imposing a limitation of 10% on the total percentage of partnership interests that could be transferred in any taxable year for a partnership with 50 or more partners. The Preamble stated that a partnership with 50 or fewer partners was unlikely to

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[20] Treas. Reg. § 1.7704-1(h).

develop any public trading, making it unnecessary to adopt a percentage limitation on the number of transfers.[21]

The final Section 7704 Regulations eliminated the 10% limitation and instead imposed a 100-partner limitation. The Preamble to the final Section 7704 Regulations provided no explanation for these changes.[22] Apparently, Treasury concluded that a partnership with 100 or fewer partners (after applying the limited "look-through" rules of the private placement safe harbor) was unlikely to develop any public trading.

Subsequent to the issuance of the Section 7704 Regulations, the Securities and Exchange Commission adopted rules implementing various provisions of the National Securities Market Improvements Act of 1996. Among other changes, a new exemption from registration (in addition to the existing exemption under section 3(c)(1) of the 1940 Act for partnerships with 100 or fewer investors) was created for privately offered partnerships that sell partnership interests solely to "qualified purchasers" who or which make discretionary investments of a specified minimum amount. The exemption is in effect limited to investors who have sufficient investments so as not to require the level of government protection afforded to other less qualified investors. An investor generally must have more than $5 million in investments, if an individual, or more than $25 million in investments, if a person other than an individual, in order to be a "qualified purchaser." The section 3(c)(7) exemption under the 1940 Act, if applicable, applies to a partnership without regard to the number of persons investing in the partnership.

Because they generally expect to have more than 100 partners, section 3(c)(7) partnerships cannot rely on the private placement safe harbor, which imposes a 100-partner limit. In light of the proliferation of section 3(c)(7) investment partnerships since the Section 7704 Regulations were finalized, it is appropriate to consider whether a private placement safe harbor can be created for these partnerships given that any ceiling on the number of partners imposed by such safe harbor, in order for the safe harbor to be usable, would have to be set at a much higher number than 100.

On the one hand, requiring that all partners in a partnership must be qualified purchasers (as interpreted for purposes of section 3(c)(7) of the 1940 Act) may be a sufficient limitation in and of itself to distinguish such partnership from partnership the interests in which are readily tradeable on a secondary market or its equivalent. If so, then a safe harbor for a section 3(c)(7) partnership that never has no more than a specified number of partners (e.g., a number not less than 250 and not more than 500) should not be overly inclusive.[23]

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[21] PS-13-88, 1995-1 C.B. 994, 996.

[22] T.D. 8629, 1995-2 C.B. 315.

[23] The thrust of the changes made to the private placement safe harbor included in the final Section 7704 Regulations from the safe harbor when first included in Notice 88-75 indicates that, while the IRS is comfortable that an outside limit of 100 partners is sufficient by itself to prevent a secondary market or its equivalent from developing, the IRS is not opposed to a less restrictive number (e.g., 500) if the safe harbor includes other limitations sufficient to prevent partnership interests from trading in a secondary market or its equivalent.

On the other hand, limiting the universe of permissible partners to qualified purchasers might not prevent the equivalent of a secondary market from developing, but instead might only limit the participants in such market to qualified purchasers. If so, a private placement safe harbor that would apply to a section 3(c)(7) partnership might risk being overly inclusive, assuming that the safe harbor permits the partnership to have more than 100 partners, unless additional restrictions were imposed on the transfer of interests in such partnership.

Rather than proposing a safe harbor, the Committee decided to identify the securities law development and outline the issues relevant in considering whether an additional private placement safe harbor might be developed to accommodate section 3(c)(7) partnerships.

C. Percentage Interests

1. Determining the percentage. The applicability of various safe harbors provided in the Section 7704 Regulations depends on the percentage interests in partnership capital or profits represented by the partnership interest(s) being transferred.[24] The goal of the safe harbors is to provide certainly in determining whether a partnership is a PTP. This goal cannot be met unless there is certainty in the application of the safe harbors and the determination of the percentage interest(s) being transferred.

The Section 7704 Regulations generally require the total interest in partnership capital and profits transferred during a year to be determined based on the interests outstanding during each month in which a transfer occurred,[25] and allow partnerships to use any reasonable convention to calculate the interests that were outstanding during the applicable month(s) as long as the convention chosen is applied consistently from month to month and from year to year.[26] However, the Section 7704 Regulations provide no guidance concerning how to calculate the interest being transferred in the case of a partnership that allocates net income other than in proportion to the partners' respective capital contributions. Without such guidance, there is considerable uncertainty whenever a partner's interest in partnership capital differs from the partner's interest in partnership profits. The level of uncertainty is likely to be greatest for partnerships that have varying allocations, such as those depending on the amount or source of the income (e.g., allocations that vary based on internal rates of return, allocations of operating income that differ from allocations of gain from a capital transaction, or allocations that vary depending on the underlying activity or investment).

Other provisions of the Code adopt a hypothetical liquidation construct for determining a partner's interest in partnership capital.[27] Under this construct, a partner's interest in partnership

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[24] *See, e.g.*, Treas. Reg. §§ 1.7704-1(f), discussed at II.A, *supra*, 1.7704-1(g)(2)(vii) (qualified matching service), and 1.7704-1(j) (lack of actual trading).

[25] Treas. Reg. § 1.7704-1(k)(2).

[26] Treas. Reg. § 1.7704-1(k)(3).

[27] *See, e.g.*, Treas. Reg. §§ 1.704-1(e)(1)(v), 1.706-1(b)(4)(iii). *See also* Prop. Treas. Reg. § 1.108-8(b), adopting this approach for purposes of determining the fair market value of a

capital is measured by the percentage of proceeds that the partner would receive in liquidation of the partnership if the partnership sold all of its assets for cash equal to their fair market value on the transfer date, satisfied its liabilities (limited, in the case of nonrecourse debt, to the fair market value of the assets securing the debt), and immediately distributed the remaining proceeds to its partners in complete liquidation. We recommend that guidance be issued confirming that, for purposes of Section 7704, a partner's interest in partnership capital is to be determined in this manner.

Various approaches are possible for determining a partner's interest in partnership profits.[28] Recognizing that more than one approach may be reasonable, we considered whether it might be possible to fashion a safe harbor that could be relied upon without creating any inference that approaches outside the safe harbor were not equally valid. By its very nature, a safe harbor should be easy to apply and administratively simple. For this reason, we considered and rejected any approach that would require a partnership to project its future profits or apply a weighted average or other method for rationalizing a partner's varying interests in partnership profits within a 12-month period. Instead, we believe that the hypothetical liquidation construct described above provides an appropriate safe harbor because it measures not only a partner's interest in the partnership's equity at any given time but also a partner's interest in residual profits – that is, the partner's share of the book gain or loss under Section 704(b) that the partnership would realize on a hypothetical liquidation of the partnership's assets (subject to liabilities) at their fair market value, with the partnership's basis in its assets being assumed to equal to the carrying value of the partnership's assets immediately before the hypothetical liquidation.

The Section 7704 Regulations should be amended to include guidance, preferably in the form of a safe harbor, for determining how a partner's interest in partnership profits should be determined in circumstances involving varying allocations, and a notice should be issued in advance of the adoption of such regulations setting forth methodology that can be relied upon in advance of amended regulations. For the reasons set forth above, we are proposing a safe harbor under which a partner's interest in partnership profits would be measured as the partner's percentage of the total book gain or book loss under Section 704(b) that the partnership would realize on a hypothetical sale of all of its assets (subject to liabilities) at fair market value for cash on the applicable determination date. As indicated, any safe harbor ultimately adopted should expressly indicate that it is merely a safe harbor and is not intended to imply that other approaches are not reasonable.

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partnership interest transferred by a debtor partnership to a creditor in satisfaction of the partnership's debt.

[28] *See, e.g.*, Treas. Reg. §§ 1.704-1(b)(3) (partner's interest in a partnership providing for varying allocations is determined by taking into account all facts and circumstances), and 1.706-1(b)(4)(ii) (partner's interest in partnerships profits is generally the partner's percentage share of profits for the current taxable year); Rev. Proc. 94-46, 1994-2 C.B. 688 (profits interests of a partner at the time of the partnership's dissolution is determined based on the expected allocation of profits projected to be earned from the date of the dissolution event through the projected date of termination of the partnership).

2. **Exclusion of general partner's interest**. The outstanding interests in partnership capital and profits are determined by excluding interests held by the "general partners" (and related persons) if the interests held by the general partners in partnership capital or profits exceed 10% in the aggregate at any time during the taxable year.[29] An identical exclusion was included in Notice 88-75 (without explanation), and the Section 7704 Regulations simply incorporated the exclusion without explanation. No explanation has been provided as to why and under what circumstances it is appropriate to exclude a general partner's interest from the calculations of partnership capital and profits. Meanwhile, the exclusion frequently presents a trap for the unwary, because it is triggered at a relatively low level (10%) and the policy reasons for the exclusion are opaque, to say the least.

The Committee urges the IRS to disclose the conceptual basis for the exclusion. Depending on what that is, the Committee may then make specific recommendations as to whether and how the exclusion might be more narrowly drawn so as to address the applicable policy concerns without causing a partnership to inadvertently fall outside the safe harbor on which it otherwise expected to rely.

The Section 7704 Regulations also do not address how the exclusion rule should apply to a limited liability company ("LLC") that is classified as a partnership for federal income tax purposes.[30] Whether particular interests are (or are not) excluded from the denominator significantly affects the percentage represented by the interests being transferred. The emergence of LLCs as a customary investment vehicle makes it important to indicate how the rule should apply to LLCs. If the intention is to exclude interests held by person(s) with authority to bind the LLC, then guidance should be issued to the effect that the exclusion applies only to partnership interests held by members of an LLC who or which are named as managers of the LLC (or by persons related to them).[31]

III. Issues Arising Under Qualifying Income Exception

Section 7704(c) provides that a PTP will not be classified as a corporation under Section 7704(a) if at least 90% of its gross income for each taxable year that it is a PTP consists of "qualifying income" as defined in Section 7704(d). Section 7704(d) lists seven categories of qualifying income. The legislative history indicates that the definition of qualifying income is intended to cover income generated from activities that are in the nature of passive investments or are traditionally conducted in partnership form.[32]

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[29] Treas. Reg. § 1.7704-1(k)(1)(ii). For these purposes, all interests held by the general partners, including limited partner interests, are excluded if the interests exceed 10%.

[30] The preamble to the Section 7704 Regulations as proposed invited comments on this issue. PS-13-88, 1995-1 C.B. 994, 997. The Section 7704 Regulations were finalized without any further discussion of this issue (*see* T.D. 8629, 1995-2 C.B. 315).

[31] This approach would be consistent with that taken in determining who can be treated as a tax matters partner in the case of an LLC. Treas. Reg. § 301.6231(a)(7)-2(a).

[32] H.R. Rep. No. 100-391, pt. 2, 100th Cong., 1st Sess., at 1068 (1987).

Certain aspects of the qualifying income test would benefit from clarification, and the classification of certain types of income should be addressed, as described below.

A. Definitional Issues

1. **Commodities**. Qualifying income includes generally income and gains from commodities (not described in Section 1221(a)(1)) or futures, forwards or options on commodities in the case of a partnership not required to be registered under the 1940 Act, a principal activity of which is the buying or selling of such commodities and/or futures, forwards or options on commodities.[33] The legislative history indicates that this exception is intended to apply to "typical" commodity pools.[34]

One area of uncertainty relates to whether and to what extent income generated from commodity swaps and other commodity derivatives held by commodities partnerships are covered by the foregoing exception. In the case of instruments that call for a one-time payment and, as such, are generally classified as forwards or options, the issue is whether the underlying product or index is a "commodity." Minimally, if the instrument references a product or index on which futures contracts are traded, then it should qualify as a "commodity" for these purposes.[35] However, there seems no reason to limit the provision to instruments as to which the Commodity Futures Trading Commission has jurisdiction. Consideration should be given to clarifying that a "commodity" for these purposes includes any forward contract, option or swap not classified as a notional principal contract, in each case referencing either a product which is actively traded and is not stock, or an index each component of which is a commodity or a commodities contract.[36] Based on the legislative history,[37] the application of such guidance could be limited to Section 7704(d) if the IRS considers it appropriate to do so.

Commodity derivatives that are classified as notional principal contracts raise the further issue of whether such contracts, if held by a commodities partnership, are covered by the general rule treating income from a notional principal contract as qualifying income if the reference property, income or cash flow would be qualifying income if held or received directly by the applicable partnership.[38] The IRS should issue guidance confirming that derivatives classified as notional principal contracts generate qualifying income for commodities partnerships as long as the reference for payments on such instruments is a commodity.

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[33] Section 7704(d)(1)(G). Such income is not qualifying income if it is derived in the ordinary course of acting as a market-maker or dealer. Treas. Reg. § 1.7704-3(a)(1).

[34] Conf. Rep. No. 100-495, 100th Cong., 1st Sess., 1987-3 C.B. 193 at 226.

[35] *See* Commodity Exchange Act, 11 U.S.C. Sections 761(1) and (8).

[36] *See* Rev. Rul. 2006-1, 2006-1 C.B. 261, as clarified by Rev. Rul. 2006-31, 2006-1 C.B. 1133.

[37] H.R. Rep. No. 100-391, pt. 2, 100th Cong., 1st Sess., at 1068 (1987), states that the definition of passive-type income for purposes of Section 7704(d) is not co-extensive with other statutory categories of passive income.

[38] Treas. Reg. § 1.7704-3(a)(1).

Another issue raised by the statutory language is how much (if any) actual commodities trading must take place in order for the partnership to qualify as a commodities partnership for these purposes. The availability of commodity derivatives makes it possible for a partnership to have exposure to commodities without actually buying or selling commodities, such as by investing in derivatives that reference commodities indices. Consideration should be given to clarifying that holding derivatives on a commodity index is considered to be "buying and selling" the commodities comprising the referenced index for these purposes.

2. <u>Cancellation of debt ("COD") income</u>. Currently there is no authority concerning whether COD income is qualifying income under Section 7704(c).[39] The need for immediate guidance concerning this issue is obvious. Several approaches to this issue are possible.

One approach, which is the approach taken by Congress for purposes of the real estate investment trust ("REIT") income tests of Sections 856(c)(2) and (3),[40] is to exclude COD income from a PTP's gross income solely for purposes of applying the qualifying income test. The Committee believes this is the most sensible approach. Using this method obviates any need to determine whether COD income comes within any of the enumerated categories of qualifying income, and avoids the administrative and evidentiary difficulties presented by the other alternatives discussed below. It also prevents COD income from distorting the nature of the partnership's annual gross income and removes the incentive for a partnership concerned about satisfying the annual qualifying income test from manipulating the timing or circumstances in which COD income is recognized. For these reasons as well as to avoid having a partnership's recognition of COD income jeopardize its status as a partnership, we recommend that the qualifying income test be applied without regard to COD income. The concerns informally raised by an IRS official to the effect that the IRS might not have the statutory authority to simply exclude COD income[41] are addressed by Section 7704(e), which gives the IRS the authority to determine the circumstances under which a partnership will be treated as continuing to satisfy the gross income test following an inadvertent failure to do so. Pursuant to Section 7704(e), the IRS could issue guidance to the effect that a partnership's failure to satisfy the gross income test will be considered to be inadvertent (and no adjustments or payments will be required) for any taxable year for which the partnership would satisfy the qualifying income test if the COD income recognized by the partnership in that year were excluded from gross income.

Another approach would be to treat COD income as qualifying income if the applicable debt was incurred by the PTP in connection with activities that generate qualifying

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[39] Issuing guidance under Section 7704 relating to COD income is an item on the Treasury's 2010-2011 Priority Guidance Plan. (*See* item (6) under "Partnership".)

[40] Section 108(e)(9).

[41] Comments made January 22, 2010 by Christopher Kelley, special counsel, IRS office of Associate Chief Counsel (Passthroughs and Special Industries), as reported in 2010 TNT (Jan. 27, 2010).

income. In addition to reflecting the approach taken in a recent private letter ruling,[42] this approach is consistent with the general rule provided in the Section 7704 Regulations for determining when a notional principal contract generates qualifying income, under which income from a notional principal contract is included in qualifying income if the reference property, income or cash flow would give rise to qualifying income if held or received directly by the partnership. However, this approach would leave unanswered the question of how to apply the qualifying income test to COD income arising from debt that is not traceable to any particular investment or activity, such as a line of credit or debt the proceeds of which were distributed to the partners.

Yet another approach would be to classify COD income based on the nature of the assets securing the debt (if the debt is non-recourse to the PTP) or held by the PTP (if the debt is recourse to the PTP) when the debt is forgiven. If this approach were adopted, it would be necessary to specify how the asset-based allocation is to be made (e.g., whether it is to be based on the value of the underlying assets, the amount of gain (if any) that the PTP would recognize if it were to sell each of the underlying assets, or some other method).

Additional approaches could be devised. The IRS should provide guidance concerning the application of the qualifying income test to PTPs that recognize COD income. As indicated, we believe that excluding COD income from both the numerator and the denominator for purposes of the qualifying income test has the significant advantages of simplicity and preventing COD income from distorting the nature of a partnership's annual gross income, and is a permissible exercise of authority under Section 7704(e).[43]

B. Applying the Qualifying Income Test to Tiered Partnerships

No guidance is provided in Section 7704, the legislative history or any administrative or regulatory guidance issued to date concerning how the qualifying income test should be applied to a partnership (an "upper-tier partnership") which owns an interest in another partnership (a "lower-tier partnership"). This section of the Report considers certain questions arising in connection with applying the qualifying income test to tiered partnerships as to which IRS guidance would be helpful.

1. <u>Gross income certification</u>. Applying a look-through rule requires an upper-tier partnership to request and obtain information from each lower-tier partnership concerning the amount and character of items of gross income allocated to it by the lower-tier partnership. Doing so places an administrative burden on both the upper-tier partnership and the lower-tier partnership, particularly where the lower-tier partnership is widely held.

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[42] This is the approach taken in Ltr. Rul. 201001005 (Sept. 22, 2009), in which the IRS ruled that COD income recognized by a regulated investment company ("RIC") with respect to loans incurred to purchase securities is qualifying income for purposes of Section 851(b)(2).

[43] *See also* Ltr. Rul. 200628001 (April 10, 2006), wherein the IRS exercised its general regulatory authority to prescribe the circumstances under which commodity-linked notes could generate qualifying income for a regulated investment company under Section 851(b)(2).

In order to ease the administrative burden of having to determine the amount and character of each item of gross income, the IRS should provide certification rules which, if complied with, would allow an upper-tier partnership to rely on a lower-tier partnership's certification that at least 90% of the gross income allocated to the upper-tier partnership is qualifying income, as defined, and thereby obviate the need for a more detailed accounting of the specific items of gross income. Providing certification procedures would be far less burdensome than requiring the inclusion of such information in annual Schedule K-1s issued by a partnership to its partners. It may be appropriate to preclude reliance on a qualifying income certification by a lower-tier partnership in circumstances where the upper-tier partnership can reasonably be expected to have access to more detailed information, such as where the upper-tier partnership (or a related person) is the tax matters partner or a general partner or managing member, or holds a substantial (greater than 10%) interest in the lower-tier partnership.[44]

An acceptable alternative to permitting reliance on a lower-tier partnership's certification would be to require that information concerning whether gross income allocated to a partner is qualifying income must be provided as part of the annual tax information reported by a partnership to its partners. Such information should not have to be provided to every partner that is itself a partnership, because such information would be relevant only to a relatively small number of upper-tier partnerships, namely, partnerships that are reporting as publicly traded partnerships. Instead, if a reporting requirement is adopted, it should be limited to lower-tier partnerships that receive timely written notification that such information is required by a direct or indirect upper-tier partnership in order for the upper-tier partnership to prepare its own tax returns, and should be required only as to the requesting partner(s), and (ii) provide appropriate relief to the upper-tier partnership if the lower-tier partnership fails to timely provide the required information.[45]

2. **Interests in PTPs that are exchange-traded**. The administrative burden of having to determine and substantiate the amount and character of items of gross income allocated to an upper-tier partnership is perhaps greatest in the case of a lower-tier partnership which is traded on an established securities market. An upper-tier partnership holding common interests in an exchange-traded partnership is unlikely to be able to compel the partnership to provide detailed information concerning its gross income, and an exchange-traded partnership may be unable to provide a breakdown of the particular items of gross income allocated to the lower-tier partnership (even if it were willing to do so) without expending significant time and expense (in terms of outside accounting fees) given the complexity of its allocations.

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44 *See, e.g.*, Rev. Proc. 2007-59, 2007-2 C.B. 745, at § 3.02, concerning when non-exchange traded interests in a lower-tier partnership may be treated as qualified financial assets under Treas. Reg. § 1.704-3(e)(3)(i).

45 An example of relief provisions for a partnership that requests but is unable to obtain information necessary to make required adjustments (to the tax basis of its assets) may be found in Treas. Reg. § 1.743-1(k)(5), concerning procedures that a partnership may follow in the event a transferee partner' fails to provide the partnership with the required notice of transfer and related information.

Section 7704 was enacted to address Congress' view that PTPs resemble corporations in important aspects.[46] The policy decision to treat PTPs as corporations (unless they satisfy the qualifying income test) may argue in favor of treating an upper-tier partnership's interests in exchange-traded partnerships as stock for purposes of applying the qualifying income test to the upper-tier partnership so long as the upper-tier partnership's interest is of a type traded on the applicable exchange. In effect, all taxable income and gain generated from the investment would presumptively be qualifying income, because it would be either dividends (to the extent of distributions) or capital gain. Another -- and we think sounder -- approach would be to permit an upper-tier partnership to presumptively treat 90% of its net income from a lower-tier exchange-traded partnership (that is taxable as a partnership) as qualifying income unless the upper-tier partnership has reason to know that a lesser percentage of the income allocated to it is non-qualifying income. An exchange-traded partnership must itself satisfy the qualifying income test in order to maintain flow-through status, and will typically limit its exposure to non-qualifying income by holding assets that could generate non-qualifying income through "blocker" corporations.[47] Accordingly, allowing an upper-tier partnership to assume that 90% of its net income from lower-tier exchange-traded partnerships is qualifying income would facilitate an upper-tier partnership's ability to satisfy the qualifying income test without creating a "loophole" for otherwise non-compliant partnerships.

IV. Conclusion

The Committee has endeavored to identify and in some instances make recommendations concerning certain aspects of Section 7704 and the Regulations thereunder as to which interpretative or clarifying guidance would be beneficial, as well as certain safe harbors that should be re-examined in light of recent legal and market developments. We appreciate Treasury's consideration of our recommendations, and would be pleased to discuss them with the appropriate persons.

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[46] H.R. Rep. No. 100-391, pt. 2, 100th Cong., 1st Sess., at 1066 (1987).

[47] Exchange-traded partnerships using corporate subsidiaries to hold activities generating non-qualifying income include Fortress Investment Group LLC, Och-Ziff Capital Management Group LLC, KKR Private Equity Investors LP and Blackstone Group LP.