

Notice of Proposed Rulemaking and Notice of Public Hearing

Certain Investment Income

REG-105163-97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the treatment of certain investment income under the qualifying income provisions of section 7704(d) and the application of the passive activity loss rules to publicly traded partnerships. The regulations would affect the classification of certain partnerships for federal tax purposes and would also affect the passive activity loss limitations with respect to items attributable to publicly traded partnerships. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by March 19, 1998. Requests to speak (with outlines of oral comments) at a public hearing scheduled for April 28, 1998, at 10 a.m., must be received by April 7, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-105163-97), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-105163-97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Christopher Kelley, (202) 622-3080; concerning submissions and the hearing,

SUPPLEMENTARY INFORMATION:

Introduction

This document proposes to add §1.7704-3 to the Income Tax Regulations (26 CFR part 1) relating to the definition of qualifying income for publicly traded partnerships under section 7704(d) of the Internal Revenue Code (Code). This document also proposes to amend §1.469-10 of the Income Tax Regulations relating to the application of section 469 of the Code to publicly traded partnerships.

Explanation of Provisions

Qualifying Income

Section 7704 of the Code provides that a publicly traded partnership is generally treated as a corporation for federal tax purposes unless 90 percent or more of the gross income of the partnership consists of qualifying income. Section 7704(d) defines qualifying income to include certain types of passive investment income, such as interest, dividends, real property rents, and income that would qualify under the regulated investment company provisions in section 851(b)(2) or the real estate investment trust provisions in section 856(c)(2). Since section 7704 was enacted, however, several new types of financial instruments have been developed that generate passive-type investment income similar to interest and dividends. The preamble to the regulations under §1.7704-1, issued December 4, 1995, (regarding the definition of public trading) requested comments from the public on the definition of qualifying income for investment partnerships and other partnerships engaged in various types of securities transactions.

In response to comments received, the proposed regulations provide that qualifying income for purposes of section 7704(c) includes income from holding annuities, income from notional principal contracts (as defined in §1.446-3), and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner. Qualifying income, however, includes income from a notional principal contract only if the property, income, or cash flow

that measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership. The proposed regulations also confirm that capital gain from the sale of stock is qualifying income, regardless of whether the stock pays dividends. The proposed regulations also provide that qualifying income (as defined in the proposed regulations) does not include income derived in the ordinary course of a trade or business by a broker, dealer, or market maker. Income derived by traders and investors can be qualifying income under the proposed regulations. The proposed regulations, including the trade or business restriction, are consistent with the legislative history of section 7704, which indicates that the exception for passive investment income was intended to distinguish between partnerships engaged in investment activities and those partnerships engaged in active business activities that are more typically conducted in corporate form. See H.R. Rep. No. 391 (Part 2), 100th Cong., 1st Sess. 1066-69 (House Report). The IRS also requests comments on the appropriate way to determine how gains should be measured for purposes of determining whether 90 percent or more of the partnership's gross income is qualifying income when a partnership makes a mixed straddle account election under §1.1092(b)-4T. The IRS believes that use of the daily mark-to-market method provided for by §1.1092(b)-4T would be inconsistent with the congressional purpose behind section 7704.

Passive Activity Loss Rules

Section 469(a) generally provides that if for any taxable year the taxpayer is an individual, estate, trust, closely held C corporation, or personal service corporation, neither the passive activity loss nor the passive activity credit for the taxable year is allowed. Section 469(k) provides that section 469 applies separately with respect to items attributable to each publicly traded partnership. Section 469(k)(2) defines a publicly traded partnership in the same manner as section 7704(b). The legislative history of section 469(k) indicates that the term publicly traded partnership has the same meaning for purposes of section 469(k) as it does for purposes of section 7704. See H.R. Rep.

No. 495, 100th Cong., 1st Sess. 952-53 (1987) (Conference Report). In addition, Notice 88-75 (1988-2 C.B. 386) provided the same guidance on the definition of a publicly traded partnership for purposes of both sections 469(k) and 7704.

The recently issued regulations under §1.7704-1, however, define a publicly traded partnership only for purposes of section 7704. The proposed regulations implement the legislative history of section 469(k) by providing that the definition of a publicly traded partnership for purposes of section 469(k) is the same as the definition of publicly traded partnership under section 7704.

Proposed Effective Date

These regulations are proposed to apply for taxable years of a partnership beginning on or after the date the final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Tuesday, April 28, 1998, at 10 a.m., in Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions,

visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit timely written comments (preferably a signed original and eight (8) copies) by March 19, 1998 and submit an outline of the topics to be discussed and the time to be devoted to each topic by April 7, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Christopher Kelley, Office of Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *.

Par. 2. Section 1.469-10 is revised to read as follows:

§1.469-10 Application of section 469 to publicly traded partnerships.

(a) [Reserved].

(b) *Publicly traded partnership*—(1) *In general.* For purposes of section 469(k), a partnership is a publicly traded partnership only if the partnership is a publicly traded partnership as defined in §1.7704-1.

(2) *Effective date.* This section applies for taxable years of a partnership beginning on or after the date final regulations are published in the **Federal Register**.

Par. 3. Section 1.7704-3 is added to read as follows:

§1.7704-3 Qualifying income.

(a) *Certain investment income*—(1) *In general.* For purposes of section 7704(d)-

(1), qualifying income includes capital gain from the sale of stock, income from holding annuities, income from notional principal contracts (as defined in §1.446-3), and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner. Income from a notional principal contract is included in qualifying income only if the property, income, or cash flow that measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership.

(2) *Limitations.* Qualifying income as defined in paragraph (a)(1) of this section does not include income derived in the ordinary course of a trade or business. For purposes of the preceding sentence, income derived from an asset with respect to which the partnership is a broker, market maker, or dealer is treated as income derived in the ordinary course of a trade or business; income derived from an asset with respect to which the taxpayer is a trader or investor is not treated as income derived in the ordinary course of a trade or business.

(b) *Effective date.* This section applies for taxable years of a partnership beginning on or after the date final regulations are published in the **Federal Register**.

Michael P. Dolan,
*Acting Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on December 18, 1997, 8:45 a.m., and published in the issue of the Federal Register for December 19, 1997, 62 F.R. 66575)