

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8799]

RIN 1545-AV15

Certain Investment Income under the Qualifying Income Provisions of Section 7704 and the Application of the Passive Activity Loss Rules to Publicly Traded Partnerships

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the treatment of certain investment income under the qualifying income provisions of section 7704 and the application of the passive activity loss rules to publicly traded partnerships. These regulations provide guidance on calculating a publicly traded partnership's qualifying income under section 7704. The regulations will affect the classification of certain partnerships for federal tax purposes and also will affect the passive activity loss limitations with respect to items attributable to publicly traded partnerships.

DATES: Effective Date: These regulations are effective, December 17, 1998.

Applicability Dates: See Effective Dates under SUPPLEMENTARY INFORMATION of the preamble.

FOR FURTHER INFORMATION CONTACT: Christopher Kelley or Terri Belanger at (202) 622-3080 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations 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). The final regulations also amend §1.469-10 of the Income Tax Regulations relating to the application of section 469 to publicly traded partnerships.

On December 19, 1997, proposed regulations (REG-105163-97, 1998-8 I.R.B. 31) were published in the Federal Register (62 FR 66575). A number of written comments were received on the proposed regulations under section 7704(d). Two speakers provided testimony at a public hearing held on April 28, 1998. After consideration of all the comments, the proposed regulations under section 7704 are adopted, as revised by this Treasury decision.

No comments were received on the proposed regulations under section 469. The proposed regulations under section 469 are adopted without revision by this Treasury decision.

Explanation of Revisions and Summary of Comments

1. Determination of Gross Income for Purposes of Section 7704(c)(2)

a. Capital Losses

Section 7704(d)(1)(F) provides that, except as otherwise provided, the term qualifying income includes any gain from the

sale or disposition of a capital asset (or property described in section 1231(b)) held for the production of income described in section 7704(d). Several commentators requested clarification as to how capital losses incurred by the partnership are treated in determining gross income of the partnership for purposes of section 7704(c)(2). The final regulations clarify that, in general, all losses are ignored in the computation of gross income.

b. Straddles

The proposed regulations requested comments on the appropriate way to compute the gross income for a partnership that makes a mixed straddle account election under §1.1092(b)-4T. The final regulations provide that, for purposes of applying the general rule that a capital gain on an investment is taken into account but a capital loss is not, certain rules shall apply that generally net capital gains and losses recognized in a taxable year with respect to a straddle. This treatment applies to all straddles, not just mixed straddle accounts, and to other interests in property that produce a substantial diminution of the partnership's risk of loss similar to that of straddles. In addition, the final regulations contain a wash sale rule for gains in certain straddle and straddle-like transactions. This rule provides that, for purposes of section 7704(c)(2), if a partnership recognizes gain with respect to the disposition of one or more positions of a straddle or similar arrangement, and the partnership acquires a substantially similar position or

positions within a period beginning 30 days before and ending 30 days after the date of the disposition, then the gain shall not be taken into account to the extent of the amount of unrecognized loss (as of the close of the taxable year) in one or more offsetting positions of the straddle or similar arrangement.

c. Mark-to-Market

The proposed regulations provide that qualifying income includes capital gain from the sale of stock. The final regulations clarify that gain recognized with respect to a position that is marked to market (for example, under section 475(f), section 1256, section 1259, or section 1296) will not fail to be qualifying income solely because there is no sale or disposition.

d. Certain Ordinary Income

Under certain provisions of the Code, capital gain or loss with respect to certain transactions is recharacterized as ordinary income or loss. However, such gain or loss may be recognized with respect to a capital asset in a manner that is consistent with section 7704(d)(1)(F). Accordingly, the final regulations provide that gain will not fail to be qualifying income solely because it is characterized as ordinary income under section 475(f), section 988, section 1258, or section 1296.

2. Income Derived from Securities Lending Activities

Several commentators requested that the final regulations clarify that income from securities lending activities of a trader is qualifying income. Section 7704(d)(4) provides that

qualifying income includes income that qualifies under section 851(b)(2). Section 851(b)(2), which includes income from security loans, does not specifically state that it applies to the business of trading, as opposed to the business of investing. Thus, commentators have suggested that there is uncertainty under section 7704 as to whether income from security loans from the business of trading is qualifying income.

The IRS and Treasury Department believe that section 851(b)(2) generally encompasses income from the business of trading as well as investing. Thus, income from the securities lending activities of a trader will be qualifying income under section 7704. A special provision in these final regulations for this income is not necessary and could create a negative implication as to the qualification of trading income under section 851(b)(2) generally. Accordingly, the final regulations do not adopt this comment.

3. Income Derived from Investments in Foreign Corporations

One commentator requested that the final regulations clarify that income from investments in foreign corporations is qualifying income. Because taxable income may arise with respect to an investment in a foreign corporation that may not literally constitute a dividend, the commentator suggested that it is unclear whether these investments generate qualifying income under section 7704(d). Specifically, the commentator requested clarification regarding whether a U.S. shareholder would have qualifying income from an inclusion under (1) section 551

(foreign personal holding company income); (2) section 951(a)(1)(A) or (B)(subpart F income or a section 956 amount); (3) section 1291 (excess distributions of a passive foreign investment company (PFIC)); and (4) section 1293 (earnings of a PFIC that is a qualified electing fund). The commentator requested that the final regulations clarify that income realized under these tax regimes with respect to stock ownership in a foreign corporation is included in the definition of qualifying income under section 7704(d).

Section 551(b) characterizes amounts included in gross income under section 551(a) as dividends for federal tax purposes. Thus, an inclusion under section 551 is qualifying income under section 7704(d)(1)(B). No clarification is necessary in the final regulations.

Section 851(b)(2), which is cross-referenced in section 7704(d), provides rules on the extent to which certain inclusions of subpart F income under section 951(a)(1)(A)(i) and certain inclusions under section 1293(a) are treated as dividends and, thus, qualifying income for purposes of section 851(b)(2). Any expansion of qualifying income with respect to investments in foreign corporations should be addressed under section 851(b)(2) and the regulations thereunder. Accordingly, the final regulations do not adopt this comment.

4. Limitation on the Definition of Qualifying Income

The proposed regulations provide that qualifying income includes capital gain from the sale of stock, income from holding

annuities, income from notional principal contracts, and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner.

Several commentators stated that partnerships must know that an investment generates qualifying income before entering into the transaction. Because passive-type investments evolve constantly and rapidly, the commentators suggested that a requirement that a type of investment generates qualifying income only to the extent determined by the Commissioner creates uncertainty for partnerships considering new investments. Thus, these commentators requested that the final regulations not include this restriction in the definition of qualifying income.

The IRS and Treasury Department do not believe that the language in the proposed regulations creates significant uncertainty in the definition of qualifying income. Instead, the standard in the proposed regulations provides necessary flexibility to consider the effect of new types of financial investments as such investments evolve. The IRS and Treasury Department do not believe that it would be appropriate to create a broader and more generic rule that would allow taxpayers to determine for themselves whether new types of investments generate qualifying income. Thus, the final regulations do not adopt this comment.

5. List of Specific Items Generating Qualifying Income

Several commentators requested that the final regulations expand the list of specific investments that generate qualifying

income. The IRS and Treasury Department do not believe that it is appropriate to expand the list of specific investments enumerated in the proposed regulations. Therefore, the final regulations do not adopt this comment.

6. Partnership Reporting Requirements

Several commentators indicated that the current reporting requirements for partnerships do not specifically compel a lower-tier partnership to provide the data necessary for an upper-tier partnership to determine whether it meets the gross income requirement of section 7704(c)(2). These commentators requested that the final regulations specifically require a lower-tier partnership to report in a level of detail that would permit an upper-tier partnership to make the necessary calculations.

The final regulations do not adopt this comment. The current reporting requirements for a partnership in §1.6031(b)-1T(a)(3)(ii) require a partnership to furnish its partners with statements that include, to the extent provided by form or the accompanying instructions, any additional information that a partner may need to apply particular provisions of the Code with respect to items related to the partnership. The instructions to Form 1065, "U.S. Partnership Return of Income," specifically require a partnership to include on a Schedule K-1 any information a partner may need to file its return that is not shown anywhere else on the schedule. The information that an upper-tier partnership needs to make its gross income calculations must be provided by the lower-tier partnership under

the current reporting requirements. An additional reporting requirement in these final regulations is not necessary.

7. Private Placement Safe Harbor under §1.7704-1(h)(1)(ii)

Several commentators requested that the final regulations amend the requirements of the private placement safe harbor under §1.7704-1(h)(1) to reflect the adoption of new rules by the Securities and Exchange Commission regarding knowledgeable employees. Specifically, the commentators requested that the private placement safe harbor be amended to provide that knowledgeable employees are not counted for purposes of the 100 partner limitation. This issue is beyond the scope of these final regulations. Therefore, the final regulations do not adopt this comment.

8. Effective Dates

The proposed regulations provide that the regulations will be effective for taxable years of a partnership beginning on or after the date final regulations are published in the **Federal Register**. Commentators stated that this effective date would preclude taxpayers from relying upon the revised definition of qualifying income in the proposed regulations until the regulations are final. These commentators requested that the effective date of the regulations be changed so that a partnership may rely upon the revised definition of qualifying income for taxable years beginning on or after the date the regulations were published as proposed regulations in the **Federal Register**.

The final regulations provide that these regulations apply to taxable years of a partnership beginning on or after, December 17, 1998. However, in response to the comments, the final regulations also include a provision that allows a partnership to apply the regulations retroactively.

Special Analyses

It has been determined that this Treasury decision 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, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

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, December 17, 1998.

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 described 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 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 income derived in the ordinary course of a trade or business.

(b) Calculation of gross income and qualifying income--(1) Treatment of losses. Except as otherwise provided in this section, in computing the gross income and qualifying income of a partnership for purposes of section 7704(c)(2) and this section, losses do not enter into the computation.

(2) Certain positions that are marked to market. Gain recognized with respect to a position that is marked to market (for example, under section 475(f), 1256, 1259, or 1296) shall not fail to be qualifying income solely because there is no sale or disposition of the position.

(3) Certain items of ordinary income. Gain recognized with respect to a capital asset shall not fail to be qualifying income solely because it is characterized as ordinary income under section 475(f), 988, 1258, or 1296.

(4) Straddles. In computing the gross income and qualifying income of a partnership for purposes of section 7704(c)(2) and

this section, a straddle (as defined in section 1092(c)) shall be treated as set forth in this paragraph (b)(4). For purposes of the preceding sentence, two or more straddles that are part of a larger straddle shall be treated as a single straddle. The amount of the gain from any straddle to be taken into account shall be computed as follows:

(i) Straddles other than mixed straddle accounts. With respect to each straddle (whether or not a straddle during the taxable year) other than a mixed straddle account, the amount of gain taken into account shall be the excess, if any, of gain recognized during the taxable year with respect to property that was at any time a position in that straddle over any loss recognized during the taxable year with respect to property that was at any time a position in that straddle (including loss realized in an earlier taxable year).

(ii) Mixed straddle accounts. With respect to each mixed straddle account (as defined in §1.1092(b)-4T(b)), the amount of gain taken into account shall be the annual account gain for that mixed straddle account, computed pursuant to §1.1092(b)-4T(c)(2).

(5) Certain transactions similar to straddles. In computing the gross income and qualifying income of a partnership for purposes of section 7704(c)(2) and this section, related interests in property (whether or not personal property as defined in section 1092(d)(1)) that produce a substantial diminution of the partnership's risk of loss similar to that of a straddle (as defined in section 1092(c)) shall be combined so

that the amount of gain taken into account by the partnership in computing its gross income shall be the excess, if any, of gain recognized during the taxable year with respect to such interests over any loss recognized during the taxable year with respect to such interests.

(6) Wash sale rule--(i) Gain not taken into account. Solely for purposes of section 7704(c)(2) and this section, if a partnership recognizes gain in a section 7704 wash sale transaction with respect to one or more positions in either a straddle (as defined in section 1092(c)) or an arrangement described in paragraph (b)(5) of this section, then the gain shall not be taken into account to the extent of the amount of unrecognized loss (as of the close of the taxable year) in one or more offsetting positions of the straddle or arrangement described in paragraph (b)(5) of this section.

(ii) Section 7704 wash sale transaction. For purposes of this paragraph (b)(6), a section 7704 wash sale transaction is a transaction in which--

(A) A partnership disposes of one or more positions of a straddle (as defined in section 1092(c)) or one or more related positions described in paragraph (b)(5) of this section; and

(B) The partnership acquires a substantially similar position or positions within a period beginning 30 days before the date of the disposition and ending 30 days after such date.

(c) Effective date. This section applies to taxable years of a partnership beginning on or after, December 17, 1998.

However, a partnership may apply this section in its entirety for all of the partnership's open taxable years beginning after any earlier date selected by the partnership.

Deputy Commissioner of Internal Revenue
Robert E. Wenzel

Approved: December 7, 1998

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