

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Person To Contact:  
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Refer Reply To:  
CC:PSI:B03  
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Date:  
January 23, 2009

LEGEND

Company =

State =

Dear :

This responds to a letter dated August 22, 2008, submitted on behalf of Company, requesting that the income derived by Company from treasury locks and interest rate swaps is qualifying income within the meaning of § 7704(d) of the Internal Revenue Code.

Company is a State limited partnership that is publicly traded. Company has not elected to be taxed as an association for federal tax purposes. Company conducts its business through affiliated operating limited partnerships, limited liability companies or entities that are disregarded entities for federal tax purposes.

Company is principally engaged in the transportation, storage, and marketing of natural gas and propane. Company does not conduct a financial or insurance business, nor is it engaged in the business of entering into notional principal contracts.

To obtain funds for asset acquisitions and to conduct its operations, Company periodically issues debt securities. The interest rate payable on these securities is a function of the prevailing interest rate on a U.S. Treasury bond of the same maturity as Company's proposed debt issue and of Company's credit rating. In the time period between Company's decision to issue debt and its actual issuance (the exposure period), Company is at risk that its cost for such debt capital will be increased by an increase in interest rates on U.S. Treasuries. To minimize this risk, Company may enter

into treasury locks – an arrangement in which an unrelated party agrees to purchase U.S. Treasury bonds from Company at a price certain and with an interest rate equal to the rate in effect on the date of agreement. If the prevailing rate on Treasury bonds increases during the exposure period, Company purchases Treasuries at a lower market price for sale to the counterparty and realizes a gain that offsets Company's increased cost of debt capital. If, however, the prevailing Treasury rate decreases during the exposure period, upon settlement of the treasury lock Company realizes a loss that offsets the lower cost of issuing its debt. (Generally, no Treasury bonds are actually purchased and delivered; the parties settle on a net basis.)

Company's capital structure includes both fixed and floating rate debt. At a given time, Company may determine that market conditions favor paying a floating rate when it has fixed rate debt outstanding. At other times, Company may determine that market conditions favor paying a fixed rate when it has a floating rate debt outstanding. In either case, Company may engage in an interest rate swap.

To obtain a cash flow at a floating rate in exchange for one at a fixed rate, Company will agree to pay an unrelated party, usually a financial institution, a fixed interest rate on a notional principal amount. In return, the counterparty agrees to pay Company a floating interest rate, determined by reference to some established index, on the notional principal amount. If the index rate for a given month exceeds the fixed rate, the counterparty owes Company an amount equal to the excess interest rate multiplied by the notional principal amount. If, however, the fixed rate exceeds the index rate in a month, Company owes the counterparty. Amounts owing are netted at settlement, which occurs at the end of the interest rate swap's term.

Exchanging a floating rate cash flow for a fixed rate flow operates in a similar manner, except that Company will pay the counterparty a floating interest rate on a notional principal amount, and it will receive fixed rate payments in return.

In some cases, the treasury locks and interest rate swaps entered into by Company may be integrated with the related debt instruments under § 1.1275-6 of the Income Tax Regulations. Company is requesting a ruling to apply only where a treasury lock or interest rate swap can not be so integrated.

Section 7704(a) provides generally that a publicly traded partnership shall be treated as a corporation.

Section 7704(b) provides that the term “publicly traded partnership” means any partnership if – (1) interests in such partnership are traded on an established securities market, or (2) interests in such partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 7704(c)(1) provides, in part, that § 7704(a) shall not apply to any publicly traded

partnership for any taxable year if such partnership met the gross income requirements of § 7704(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) provides that a partnership meets the gross income requirements of § 7704(c)(2) for any taxable year if 90% or more of the gross income of such partnership for such taxable year consists of qualifying income.

Section 7704(d)(1)(A) provides, in part, that, except as otherwise provided in § 7704(d), the term “qualifying income” means interest. Section 7704(d)(2) provides that interest shall not be treated as qualifying income if – (A) such interest is derived in the conduct of a financial or insurance business, or (B) such interest would be excluded from the term “interest” under § 856(f).

Section 1.7704-3(a)(1) provides, in part, that for purposes of § 7704(d)(1), qualifying income includes 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. Section 1.7704-3(a)(1) provides further that 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. Section 1.7704-3(a)(2) provides, in part, that qualifying income described in section 1.7704-3(a)(1) does not include income derived in the ordinary course of a trade or business.

Section 1.446-3(c)(1) defines a notional principal contract to include interest rate swaps. Section 1.446-3(c)(1) also provides, in part, that generally a notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.

Payments due under an interest rate swap are not interest. There is no borrowing and, hence, no compensation for use or forbearance of money. However, such payments are measured by reference to an interest rate or interest rate index and have a cash flow that would be treated as interest income and would not be excluded under § 856(f) if held or received directly by Company.

Company's treasury locks are common and routine transactions and, like Company's interest rate swaps, they are entered into for the purpose of managing the risk of interest rate movements on Company's borrowings. Under § 1.7704-3(a)(1), the Commissioner may determine the extent to which income from ordinary and routine investments substantially similar to income from a notional principal contract is included in qualifying income.

Based solely on the facts and representations submitted, we conclude that the income Company derives from the treasury lock and interest rate swap transactions is qualifying income within the meaning of §§ 7704(d)(1).

Except for the specific ruling above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion as to whether Company's treasury locks and interest rate swaps can be integrated with the related debt securities under § 1.1275-6, or whether income derived by Company from transportation, storage and marketing of natural gas and propane is qualifying income within the meaning of § 7704(d), or whether Company is taxable as a partnership for federal tax purposes,.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to Company's authorized representative.

Sincerely,

/s/

Christine Ellison  
Branch Chief, Branch 3  
Associate Chief Counsel  
Passthroughs and Special Industries

Enclosures (2)

Copy of this letter  
Copy for § 6110 purposes

cc: