

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Person To Contact:
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Date:
June 08, 2016

Company =

State =

Dear :

This letter responds to a letter dated December 22, 2015, submitted on behalf of Company by Company's authorized representative, requesting a ruling that income derived from interest rate swaps, interest rate cap transactions, forward lock transactions, and Treasury lock transactions is qualifying income within the meaning of § 7704(d)(1) of the Internal Revenue Code (Code).

FACTS

Company is a publicly traded partnership organized under the laws of State. Company has not elected to be taxed as an association for federal tax purposes. Company is not engaged in a "financial or insurance business" within the meaning of § 7704(d)(2)(A). Company has two primary business segments: (i) pipelines and transportation; and (ii) wholesale marketing and terminalling.

In order to finance asset acquisitions and conduct the operations of its business, Company periodically issues both fixed-rate and floating-rate debt securities. To manage its exposure to interest rate movements, Company enters into interest rate swaps, interest rate caps, forward locks, and treasury locks (together, the "Financial Transactions"). In some cases, the Financial Transactions entered into by Company are integrated with the related debt instruments under § 1.1275-6 of the Income Tax

Regulations. Company is requesting a ruling only on Financial Transactions that are not integrated.

The Financial Transactions

1. Interest Rate Swaps

An Interest Rate Swap allows Company to swap a floating rate cash flow for a fixed rate cash flow (a “floating-to-fixed swap”) or a fixed rate cash flow for a floating rate cash flow (a “fixed-to-floating swap”). In a floating-to-fixed swap, Company agrees to pay a counterparty a fixed interest rate on a notional principal amount. The counterparty agrees to pay Company a floating interest rate (determined by reference to an established index, usually the London Interbank Offered Rate, or “LIBOR”) on the notional principal amount. If the floating rate for a given month exceeds the fixed rate, the counterparty owes Company an amount equal to the difference between the two rates multiplied by the notional principal amount. If, instead, the fixed rate exceeds the floating rate, the Company owes the counterparty an amount equal to the difference between the two rates multiplied by the notional principal amount. A fixed-to-floating swap operates in the same manner, except that Company pays the counterparty the difference between the two rates multiplied by the notional principal amount when the floating rate exceeds the fixed rate, and receives a similar amount when the fixed rate exceeds the floating rate. The settlement periods under these swaps can start immediately after executing the transaction (a Spot-Starting Swap), or they can start on a predetermined future date (a Forward-Starting Swap).

2. Interest Rate Caps

When Company wants to put an upper limit on a floating interest rate associated with a floating rate debt instrument, it may enter into an Interest Rate Cap. In an Interest Rate Cap, Company pays a counterparty an upfront fixed payment. The counterparty agrees to pay Company an amount equal to a floating index rate, determined by reference to some established index, less the specified interest rate cap rate, multiplied by a notional principal amount if, and only if, the floating index rate exceeds a specified cap rate on a specified payment date.

3. Forward Locks

To lock in a spot interest rate for a period prior to the issuance of its fixed-debt securities (a Forward Lock), Company agrees to pay the counterparty a fixed interest rate on a notional principal amount. The counterparty agrees to pay Company an amount equal to a floating index rate, determined by reference to some established index, multiplied by the notional principal amount for a fixed period that begins on the date of the anticipated debt issuance. If the index rate exceeds the fixed interest rate on the date of issuance of the debt securities, the counterparty owes Company an

amount equal to the excess of the index interest rate over the fixed interest rate multiplied by the notional principal amount over the term of the forward lock. If, instead, the fixed rate exceeds the floating index rate on the date of issuance of the debt securities, Company owes the counterparty the excess of the fixed rate over the floating index rate multiplied by the notional principal amount over the term of the forward lock. The amounts the parties owe to each other over the term of the forward lock are calculated and netted on the anticipated date of issuance of the debt securities.

Converting an expected floating-rate debt securities offering into a fixed rate instrument operates in a similar manner as exchanging a floating rate cash flow for a fixed rate flow, except its effective date is in the future because its terms coincide with an expected floating-rate debt issuance and not an existing floating-rate debt issuance.

4. Treasury Locks

To minimize the risk of an interest rate increase in the time period between Company's decision to issue debt and the actual issuance of the debt (the "exposure period"), Company may enter into Treasury Lock agreements, whereby the counterparty agrees to purchase U.S. Treasury bonds from Company at a contract price that values the Treasury bonds using an interest rate equal to the prevailing interest rate on Treasury bonds in effect on the date of the agreement. If the prevailing interest rate on Treasury bonds increases during the exposure period, Company is entitled to receive a payment from the counterparty that is effectively equal to the excess of the contract price over the lower market price at which Company could purchase Treasury bonds as a result of the increase in prevailing Treasury bond interest rates (offsetting Company's increased cost of issuing its debt resulting from the increase in prevailing Treasury Bond interest rates). If the prevailing interest rate on Treasury bonds decreases during the exposure period, Company is required to make a payment to the counterparty that is effectively equal to the excess of the higher market price at which Company would have to purchase Treasury bonds as a result of the decrease in prevailing Treasury bond interest rates over the contract price (offsetting Company's decreased cost of issuing its debt resulting from the decrease in prevailing Treasury bond interest rates).

While not the intended result, Company may settle a Treasury Lock prior to the issue date for its debt securities if, in its judgment, the risk of an unfavorable movement in interest rates had declined or doing so would maximize its income from the Treasury Lock and thereby effectively minimize the interest cost of the anticipated issuance of debt securities.

LAW

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 that, except as otherwise provided in § 7704(d), the term “qualifying income” includes 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. 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 § 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 as 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.

Section 1.446-3(c)(1) further provides that this definition of a notional principal contract includes interest rate swaps and interest rate caps.

In order to qualify under § 1.7704-3(a)(1), the Financial Transactions must qualify as income from a notional principal contract as defined in § 1.446-3 or as other substantially similar income.

Interest Rate Swaps (except for Forward-Starting Swaps) and Interest Rate Caps are specifically included in the definition of a notional principal contract in § 1.446-3 and therefore produce income from a notional principal contract. However, 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.

Payments due under an Interest Rate Swap or an Interest Rate Cap are measured by reference to an interest rate or interest rate index and would give rise to interest income if held or received directly by Company.

Although a Forward-Starting Swap, Forward Lock, and Treasury Lock are not among the instruments specifically listed in the definition of a notional principal contract, they are ordinary and routine transactions and, in this case, are entered into for the same purpose as a notional principal contract, that is to lock in an interest rate or manage the risk of interest rate movements on Company's borrowings. Section 1.7704-3(a)(1) provides that the Commissioner may determine that income and gain from ordinary and routine investments substantially similar to notional principal contracts may also constitute qualifying income for purposes of § 7704(d)(1). It is therefore unnecessary to determine whether the Forward-Starting Swaps, Forward Locks, and the Treasury Locks meet the definition of a notional principal contract in § 1.446-3.

CONCLUSION

Based solely on the facts and representations submitted, we conclude that the income Company derives from each of the four types of Financial Transactions is qualifying income within the meaning of § 7704(d)(1) and § 1.7704-3(a)(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 Financial Transactions can be integrated with the related debt instruments under § 1.1275-6, as well as to whether Company is taxable as a partnership for federal tax purposes. We also express or imply no opinion as to whether the Forward-Starting Swaps, Forward Locks, or the Treasury Locks meet the definition of a notional principal contract in § 1.446-3. Finally, no opinion is expressed or implied as to whether Company meets the 90 percent gross income requirement of § 7704(c) in any taxable year.

The ruling contained in this letter is based upon information and representations submitted by Company and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the ruling request, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. However, in the event of a technical termination of Company under § 708(b)(1)(B), the resulting partnership may continue to rely on this ruling in determining its qualifying income under § 7704(d)(1). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Holly Porter
Chief, Branch 3
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes

cc: