

**IRS Letter Rulings and TAMs (1954-1997), UIL No. 7701.02-00 Definitions, Partnerships v. associations; UIL No. 7701.26-00; UIL No. 7704.03-00, Letter Ruling 9701006, (Sep. 24, 1996), Internal Revenue Service, (Sep. 24, 1996)**

**Letter Ruling 9701006, September 24, 1996**

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**Uniform Issue List Information:**

UIL No. 7701.02-00

Definitions

- Partnerships v. associations

UIL No. 7701.26-00

UIL No. 7704.03-00

[Code Secs. 7701 and 7704 ]

This letter responds to your submission of January 5, 1996, in which you requested rulings concerning: (i) the federal income tax classification, under section 7701 of the Code, of a Delaware limited liability company; (ii) the qualifying income exception to the publicly traded partnership rules under section 7704 ; and (iii) the application of the taxable mortgage pool provisions in section 7701(i) .

Corporation, a real estate investment trust, holds commercial mortgages as investments. Corporation occasionally acquires real property as a result of foreclosure, and generates some additional income from the rental or sale of these properties. Corporation is owned primarily by pension plans of certain labor unions in State. Corporation originates mortgages that are used to finance construction projects in State that generally employ workers from those unions. Corporation does not maintain any material level of debt to finance investments. Corporation currently has only one employee.

Shares in Corporation are listed for trading on a U.S. stock exchange, although the annual trading volume in its shares is generally less than one percent. Corporation intends to convert into a limited liability company, Partnership, which will be the successor in interest to Corporation. Interests in Partnership will not be listed for trading on any exchange. Partnership will continue Corporation's activities and policies. Partnership will sell additional interests in a new offering, which will be registered under the Securities Act of 1933 for pension plan investment purposes. It is anticipated that Partnership will have approximately 100 members. The management of Partnership will be delegated to a Managing Board, and Board Members will be appointed by those Members with an adjusted capital account balance of at least  $\underline{x}$  (Member-Managers).

The interests in Partnership will be represented by two equity classes: Class A Membership Interests and Class B Membership Interests. Class B interests will represent an interest in the proceeds of the new offering. These proceeds will be invested in mortgages. Payments on the mortgages, less expenses allocated to the class, will be distributed to the Class B Members. Class A interests will participate in the assets transferred from Corporation in a similar manner.

A Class A Member may elect on an annual basis to receive its pro rata share of certain cash amounts and

principal repayments held by Partnership. The percentage interest of a Member in Class A will be reduced to reflect any repayments made. No Member of either Class A or Class B is entitled to any form of a guaranteed or preferred return on capital or a guaranteed or preferred return of capital from Partnership.

Partnership may form additional classes of interests in the future. However, no future class may acquire any rights, powers, or duties with respect to existing class assets that are senior to the interests of existing class Members.

The following representations have been made with respect to the operations of Partnership:

- (1) It is anticipated that Partnership will have two or fewer employees.
- (2) Partnership will hold mortgage loans that it originates until maturity or refinancing, except in cases of default. For purposes of this ruling, the term "refinancing" does not include any sale or transfer of a mortgage.
- (3) Partnership will not hold loans or other assets for sale to customers in the ordinary course of business within the meaning of section 1221(1) , with the possible exception of the sale of foreclosure property.
- (4) Partnership will originate on average no more than five new mortgages per year over any five-year period.
- (5) Except as described above, Partnership does not currently have plans for new offerings of interests, and taxpayer agrees that if it does such offerings with an aggregate value of more than y, this ruling will no longer apply.

With respect to this transaction, we have been asked to rule as follows: (i) Partnership will be classified as a partnership for federal tax purposes; (ii) certain interest and rental income derived by Partnership will be qualified income under section 7704(d) ; and (iii) neither the Class A Assets nor Class B Assets of Partnership will be a taxable mortgage pool within the meaning of section 7701(i) .

#### Classification

Section 7701 of the Code sets forth definitions to be used in determining the classification of an organization for federal tax purposes. Organizations are classified as associations taxable as corporations, as partnerships, or as trusts. The classification of any particular organization is determined under the tests and standards set out in Sections 301.7701-2 , 301.7701-3 , and 301.7701-4 of the Procedure and Administration Regulations.

Section 301.7701-2(a)(1) of the regulations sets forth six major characteristics ordinarily found in a pure corporation which, when taken together, distinguish it from other organizations. These are: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests. Section 301.7701-2(a)(1) further provides that an organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership.

Section 301.7701-2(a)(2) of the regulations provides that characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. Section 301.7701-2(a)(3) provides that because associates and an objective to carry on a business and divide the gains therefrom are generally common to corporations and partnerships, an organization that has such characteristics will be classified as a partnership if it lacks at least two of the remaining four characteristics.

Section 301.7701-2(b)(1) of the regulations provides that an organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member will not cause a dissolution of the organization. On the other hand, if the death, insanity, bankruptcy or expulsion of any member will cause a

dissolution of the organization, continuity of life does not exist. If the death, insanity, bankruptcy, retirement, expulsion or other event of withdrawal of a general partner of a limited partnership causes a dissolution of the partnership, continuity of life does not exist; furthermore, continuity of life does not exist notwithstanding the fact that a dissolution of the partnership may be avoided, upon such an event as the withdrawal of a general partner, by the remaining general partners agreeing to continue the partnership or by at least a majority in interest of the remaining partners agreeing to continue the partnership. See Glensder Textile Company, 46 B.T.A. 176 (1942), acq., 1942-1 C.B. 8[CCH Dec. 12,249 ]; see also Rev. Proc. 94-46 , 1994-2 C.B. 688 (defining "majority in interest").

Rev. Proc. 95-10 , §5.01(1), provides that if the members of the limited liability company (LLC) designate or elect one or more members as managers and the controlling statute, or the operating agreement pursuant to the controlling statute, provides that the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member-manager causes a dissolution of the LLC without further action of the members, unless the LLC is continued by the consent of not less than a majority in interest of the remaining members, the Service will generally rule that the LLC lacks continuity of life.

In this case, under Partnership's operating agreement, Partnership will be dissolved upon, among other things, the death, retirement, resignation, expulsion, bankruptcy, or dissolution of a Member-Manager unless not less than a majority in interest of the remaining Members consent to the continuation of Partnership within 90 days after the dissolution event. If a Member-Manager of Partnership dies, retires, resigns, is expelled, declares bankruptcy, or is dissolved, the continuity of Partnership is not assured, because Members holding a majority of the remaining Members' aggregate Membership interests must agree to continue the business. Consequently, Partnership will lack the corporate characteristic of continuity of life.

Section 301.7701-2(e)(1) provides that an organization has the corporate characteristic of free transferability of interests if each of its members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon his substitute all the attributes of his interest in the organization.

Rev. Proc. 95-10 , §5.02(1) provides that if the members of the LLC designate or elect one or more members as managers, and the controlling statute, or the operating agreement pursuant to the controlling statute, provides that each member, or those members owning more than 20 percent of all interests in the LLC's capital, income, gain, loss, deduction, and credit, does not have the power to confer upon a non-member all the attributes of the member's interests in the LLC without the consent of not less than a majority of the non-transferring member-managers, the Service will generally rule that the LLC lacks free transferability of interests. See Rev. Proc. 92-33 , 1992-1 C.B. 782.

The operating agreement of Partnership designates at least 21 percent of the Membership Interests of each class as Restricted Membership Interests, and provides that an assignee of a Restricted Membership Interest may be admitted as a Member in Partnership only with the consent of not less than a majority of the non-transferring Member-Managers.

More than 20 percent of all interests in Partnership's capital, income, gain, loss, deduction, and credit will be Restricted Membership Interests and not transferable without the consent of a majority of the non-transferring Member Managers. Accordingly, Partnership will lack the corporate characteristic of free transferability of interests.

Partnership will have associates and an objective to carry on business and divide the gains therefrom. Because Partnership will lack the corporate characteristics of continuity of life and free transferability of

interests, Partnership will be classified as a partnership for federal tax purposes.

### Qualifying Income

Section 7704(a) of the Code provides that a publicly traded partnership shall be treated as a corporation. Taxpayer has not requested a ruling that it is not a publicly traded partnership and no determination has been made on that issue.

Section 7704(c)(1) provides that section 7704(a) shall not apply to any publicly traded partnership for any taxable year if such partnership met the gross income requirements of section 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. For purposes of the preceding sentence, a partnership shall not be treated as being in existence during any period before the first taxable year in which such partnership (or a predecessor) was a publicly traded partnership.

Section 7704(c)(2) explains that a partnership meets the gross income requirements of this section for any taxable year if 90 percent or more of the gross income of such partnership for such taxable year is qualifying income.

Section 7704(d)(1) provides that the term "qualifying income" includes, among other things, interest, real property rents, and gain from the sale or other disposition of real property.

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 section 856(f) .

Section 7704(d)(3) provides that the term "real property rent" means amounts which would qualify as rent from real property under section 856(d) if (A) such section were applied without regard to paragraph (2)(C) thereof (relating to independent contractor requirements), and (B) stock owned, directly or indirectly, by or for a partner would not be considered as owned under section 318(a)(3)(A) by the partnership unless five percent or more (by value) of the interests in such partnership are owned, directly or indirectly, by or for such partner.

Section 7704(d)(4) provides that the term "qualifying income" includes any income which would qualify under section 851(b)(2) or 856(c)(2) .

The legislative history to section 7704 explains that the purpose of the qualifying income exception is "to distinguish those partnerships that are engaged in activities commonly considered as essentially no more than investments, and those activities more typically conducted in corporate form that are in the nature of active business activities." H.R. Rep. No. 391 (Part 2), 100th Cong., 1st Sess. 1068. Interest derived from the conduct of a financial business, such as a bank, is thus excluded from the definition of qualifying income, because "deriving interest is an integral part of the active conduct of the business." Id.

Thus, whether an entity is engaged in a "financial business" is determined based on the facts and circumstances surrounding the conduct of the entity's business. In light of the expressed legislative intent, the key question is whether the lending activity is in the nature of creating investments, or in the nature of an active business enterprise that is normally carried on by a corporation.

Interests in Partnership will continue to be primarily owned by State labor union pension plans. Partnership will continue to invest in construction projects in State that employ predominantly union labor. Partnership will not hold mortgages or other assets for sale in the ordinary course of business as defined in section 1221(1) , and it will hold its mortgages until maturity or refinancing, except in cases of default. In addition, Partnership will originate on average no more than five mortgages per year over any five-year period. Partnership will

have very few employees.

Based on the facts as represented, we conclude that Partnership will not be engaged in the conduct of a financial business for purposes of section 7704(d)(2) . Accordingly, any interest derived from mortgages held by Partnership will be considered qualifying income under section 7704(d) . In addition, any income generated from the rental or sale of foreclosure property will be considered qualifying income under section 7704(d) .

Provided that at least 90 percent of Partnership's gross income is qualifying income under section 7704(d) , Partnership will not be treated as a corporation under section 7704(a) .

#### Taxable Mortgage Pool

Section 7701(i)(2)(A) of the Code defines the term "taxable mortgage pool" (TMP) as any entity (other than a REMIC) having the following qualifications: (i) substantially all of the entity's assets consists of debt obligations and more than 50 percent of these are real estate mortgages, (ii) the entity has issued debt obligations with two or more maturities, and (iii) the payments the entity makes as a debtor are related to the payments the entity receives as a creditor.

The purpose of section 7701(i) of the Code is to support the REMIC provisions found in sections 860A through 860G and prevent income generated by a pool of real estate mortgages from escaping Federal income taxation when the pool is used to issue multiple class mortgage-backed securities. Section 301.7701(i)-1(a) of the Procedure and Administration Regulations. Any arrangement that functions like a REMIC but fails to qualify under section 860D is classified as a TMP. Its earnings are then subject to tax at the entity level and at the shareholder level and it may not be treated as an includible corporation for purposes of the consolidated return rules. Section 7701(i)(1) .

In order for an entity to be a TMP, the entity must issue debt obligations with two or more maturities. Section 301.7701(i)-1(e)(1) of the regulations provides that debt obligations have two or more maturities if they have different stated maturities or if the holders of the obligations possess different rights concerning the acceleration of or delay in the maturities of the obligations.

Section 7701(i)(2)(D) of the Code allows the Secretary to issue regulations that treat equity interests of varying classes as debt when the interests correspond to maturity classes of debt. Section 301.7701(i)-1(g) provides authority for the Commissioner to disregard a transaction which is entered into with a view to achieving the same economic effect as that of a taxable mortgage pool while avoiding the application of section 7701(i) . This authority includes treating equity interests as debt if the equity interests correspond to maturity classes of debt.

Section 7701(i)(2)(B) of the Code provides that any portion of an entity which meets the definition of a TMP will be treated as a TMP. Section 301.7701(i)-2(a) of the regulations defines a portion of an entity as all assets that support one or more of the same issues of debt obligations. Under §301.7701(i)-2(c) , a portion of an entity is treated as the obligor of all debt obligations supported by the assets in that portion.

In the present case, the partnership is structured in a way that creates two distinct pools of assets. Each pool supports a single class of equity interest. Under the circumstances described, the Class A interests and the Class B interests will not be treated as other than equity for purposes of section 7701(i) of the Code. Therefore, for purposes of section 7701(i)(2)(A) , Partnership will not be treated as issuing debt obligations with two or more maturities. Further, even if the interests were debt obligations, Partnership would be viewed as two portions, each supporting a separate debt issue.

Therefore, based on the facts as represented, we conclude that neither Partnership, the Class A Assets, nor

the Class B Assets, will be a taxable mortgage pool for purposes of section 7701(i) of the Code. No opinion is expressed as to the effect of issuing debt or additional classes of membership interests that have rights with respect to the Class A and Class B assets.

Except as specifically ruled on above, no opinion is expressed concerning the federal income tax consequences of the transactions described under any other provision of the Code. Taxpayer did not request a ruling as to whether the issuance of the Class B interests creates a second partnership for federal tax purposes and no determination was made on that issue.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(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, we are sending copies of this letter to your authorized representatives.

Sincerely yours, William P. O'Shea, Chief, Branch 3, Office of the Assistant Chief Counsel (Passthroughs and Special Industries)