Legislative History – Section 7704

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HOUSE REPORT NO. 100-391(II) – House Ways and Means Committee
October 26, 1987

B. Partnership Provisions

1. Certain publicly traded partnerships treated as corporations (sec. 10122 of the bill and sec. 7704 of the Code)

Present Law

Under present law, a partnership is not subject to tax at the partnership level, but rather, income and loss of the partnership is subject to tax at the partner's level. A partner's share of partnership income is generally determined without regard to whether he receives any corresponding cash distributions. Similarly, partnership deductions, losses and credits are taken into account at the partner level for tax purposes. A corporation, by contrast, generally is subject to tax at the entity level, and distributions with respect to corporate stock generally are subject to tax at the shareholder level.

The Supreme Court articulated standards applicable in determining whether an entity should be taxed as a corporation in the case of Morrissey v. Commissioner, 296 U.S. 344 (1935). The Court reasoned that the entity in that case resembled a corporation. Thus, the Morrissey case is said to have set forth the 'resemblance' test referred to in the current Treasury regulations regarding entity classification. These regulations govern classification under present law.

These regulations, known as the 'Kintner' regulations, were adopted in 1960 in response to the decision in U.S. v. Kintner, 216 F.2d 418 (9th Cir. 1954). In that case, a physician successfully sought to have his business association classified as a corporation rather than a partnership under the then current regulations, to take advantage of the more favorable pension plan rules applicable to corporations (as compared to partnerships) under the law in effect at that time. The regulations were revised in 1960 in response to the decision, to make it more likely that an association would be classified as a partnership and not a corporation.[7]

[7] The Tax Equity and Fiscal Responsibility Act of 1982 changed the favorable pension plan treatment of shareholders who are also corporate employees (as compared, for example, to partners). Thus, the original reason for changing the partnership classification regulations as they were changed in 1960 was removed. In 1976, the Tax Court suggested that the regulations might not be operating effectively to identify those entities that had an overall corporate resemblance; however, the court concluded it was required to follow the regulations and held that a particular entity was classified as a partnership. Larson v. Commissioner, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1. A proposed revision of the regulations was issued in January 1977 (42 Fed. Reg. 1038, January 5, 1977) but was withdrawn almost immediately (42 Fed. Reg. 1489, January 7, 1977).

The Treasury regulations distinguishing partnerships from corporations currently provide that whether a business entity is taxed as a corporation depends on which form of enterprise the entity 'more nearly' resembles (Treas. Reg. sec. 301.7701-2(a)). The regulations list six corporate characteristics, two of which are common to corporations and partnerships, and the other four of which are: (1) continuity of life, (2) centralization of management, (3) liability for corporate debts limited to corporate property, and (4) free transferability of interests. The regulations provide that an association is treated as a corporation (rather than a partnership) for Federal income tax purposes if it has more corporate than non-corporate characteristics. The effect of the regulations generally is to classify an entity as a partnership if it lacks any two of these four corporate characteristics, without further inquiry as to how strong or weak a particular characteristic is or how the evaluation of the factors might affect overall resemblance.[8]

[8] Treas. Reg. secs. 301.7701-2 and -3; Larson v. Commissioner, supra.

Under present law, if an entity is classified as a partnership, income and loss are subject to tax at the partner level rather than at the partnership level without regard to whether the partnership is engaged in active business activities. Other types of entities that receive passthrough-type tax treatment are subject to significant restrictions.

Regulated investment companies ('RICs') that either meet or are excepted from certain registration requirements under the Investment Company Act of 1940 (15 U.S.C. 80) may elect passthrough tax treatment if they satisfy certain requirements. Generally, a company is treated as a RIC only if it derives at least 90 percent of its ordinary income from specified sources commonly considered passive investment income, has a portfolio of investments that meet diversification requirements, distributes at least 90 percent of its income to its shareholders annually, and also meets certain other requirements.

Any entity (including a corporation, partnership, or trust) that meets specified requirements may elect to be treated as a real estate mortgage investment conduit ('REMIC'). In general, the requirements relate to the composition of assets and the nature of the investors' interests. If the requirements are met, the REMIC generally is not treated as a separate taxable entity, but rather, its income is allocated to and taken into account by the holders of the interests therein under specified rules. A tax is, however, imposed at the entity level on certain prohibited transactions. Further, in enacting the REMIC provisions, Congress intended that REMICs are to be the exclusive means of issuing multiple class real estate mortgage-backed securities without the imposition of two levels of taxation. Present law therefore provides for taxable mortgage pools that are treated as taxable corporations, effective for taxable years beginning after December 31, 1991.

Under present law, a real estate investment trust ('REIT') generally is treated as a conduit for Federal income tax purposes to the extent of the amount of its earnings that are distributed currently to shareholders. In general, an entity may qualify as a REIT if it is a trust or corporation with at least 100 different freely transferable interests and would be taxable as an ordinary domestic corporation but for its meeting certain specified requirements. These requirements relate to the entity's assets being comprised substantially of real estate assets and the entity's

income being, in substantial part, realized from certain passive real estate and real estate related sources.

Present law also provides passthrough-type treatment for certain other entities meeting statutory restrictions. Corporations meeting the requirements of Subchapter S of the Code generally are treated as conduits for Federal income tax purposes. The requirements to elect S corporation status include requirements that the corporation may not have more than one class of stock nor more than 35 shareholders. In the case of S corporations that were formerly C corporations, however, entity-level tax is imposed on excess net passive investment income where the corporation has subchapter C earnings and profits, and on certain built-in gain. If such an S corporation has excess net passive income for 3 consecutive years, its S election is automatically terminated and it is subject to entity-level taxation as a regular corporation under subchapter C of the Code.

Cooperatives and cooperative housing corporations are considered special purpose entities that are permitted to eliminate entity-level income tax to the extent certain qualifying distributions are made to holders of interests in the cooperative or cooperative housing corporation. Thus, although these entities are technically not conduits, they may effectively not be subject to tax at the entity level as a result of making distributions of income meeting certain statutory requirements.

Reasons for Change

The recent proliferation of publicly traded partnerships has come to the committee's attention. The growth in such partnerships has caused concern about long-term erosion of the corporate tax base. To the extent that activities would otherwise be conducted in corporate form, and earnings would be subject to two levels of tax (at the corporate and shareholder levels), the growth of publicly traded partnerships engaged in such activities tends to jeopardize the corporate tax base.

The problem is exacerbated by changes in the Tax Reform Act of 1986 that make conduit entities more attractive as vehicles for business activity than corporations. For example, under the 1986 Act, the maximum regular corporate tax rate is higher than the maximum individual tax rate. Thus, in addition to the fact that corporate earnings bear a second level of tax when distributed, retained earnings are generally taxed at a higher rate than amounts directly earned by an individual. In addition, by increasing the tax rate on capital gains and making that rate generally equivalent to the rate on ordinary income, the Act reduced an investor's incentive to realize income through sales of appreciated stock rather than in the form of current income.

Further, the 1986 Act generally imposed a corporate level tax on certain liquidating sales and distributions that were not taxed under prior law. Appreciation in corporate assets is thus now subject to a corporate level tax on the ultimate disposition of the business. The 1986 Act also included a new corporate minimum tax regime that includes as a preference item a portion of the excess of the income that is reported for financial purposes over the amount of corporate alternative minimum taxable income.

These changes reflect an intent to preserve the corporate level tax.[9] The committee is concerned that the intent of these changes is being circumvented by the growth of publicly traded partnerships that are taking advantage of an unintended opportunity for disincorporation and elective integration of the corporate and shareholder levels of tax.

[9] For example, in repealing the General Utilities rule (which had permitted liquidating distributions free of tax to the distributing corporation), it was Congress' express intent to prevent the corporate tax from being undermined. See H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 331, and H. Rep. 99-426, p. 282.

The committee believes that, in important respects, publicly traded partnerships resemble corporations. Publicly traded partnerships resemble publicly traded corporations in their business functions and in the way their interests are marketed, and limited partners as a practical matter resemble corporate shareholders in that they have limited liability, may freely transfer their interests, generally do not participate in management, and expect continuity of life of the entity for the duration of the conduct of its business enterprise. Consequently, the committee believes that these types of entities and their holders generally should be treated similarly for tax purposes.

The committee is also concerned that the availability of publicly traded partnerships as an alternative to corporations creates an unintended unfair competitive advantage for certain types of businesses. Mature businesses with a steady cash flow, that can be marketed effectively as public partnerships because of the tax-advantaged yield, are unfairly favored over shart-up companies or those with high capital expenditures, which cannot take advantage of the publicly traded partnership structure. Favoring one type of business investment over another creates new economic inefficiencies of the type that the 1986 Act was designed to reduce.

In certain circumstances, however, the committee believes that the tax-created competitive advantage of publicly traded partnerships may be less significant. If the publicly traded partnership's income is from sources that are commonly considered to be passive investments, then there is less reason to treat the publicly traded partnership as a corporation, either because investors could earn such income directly (e.g., interest income), or because it is already subject to corporate-level tax (in the case of dividends). Therefore, under the bill, an exception is provided to the treatment of publicly traded partnerships as corporations in the case of partnerships whose income is principally from passive-type investments.

Further, certain types of natural resources and rental real estate activities have commonly or typically been conducted in partnership form, and the committee considers that disruption of present practices in such activities is currently inadvisable due to general economic conditions in these industries. The committee does not intend to treat tax benefits from such activities more favorably than under present law, but at the same time considers it inappropriate to subject net income from such activities to the two-level corporate tax regime to the extent the activities are conducted in forms that permit a single level of tax under present law.

The provision affects partnerships whose interests are publicly traded, or in which a market is effectively made. The committee believes it is appropriate to classify partnerships as corporations if interests in the partnership are publicly traded or a market is effectively made in them for several reasons.

Historically, free transferability of interests has been one of several factors that have been considered important in entity classification. As a practical matter, publicly traded partnerships have many or most of the attributes of corporations, and are accessing capital markets in a manner similar to that traditionally performed by corporations. Further, because of the trading in interests, these partnerships present unique administrative difficulties and enforcement concerns if the tax law relating to partnerships is applied to them. The partnership tax rules under present law contemplate an entity in which the identity of the investors is known and transfers of interests are easily identifiable, and public trading in partnership interests does not conform to this model.

Thus, the committee concluded that public trading involves a degree of lack of identity of the investor with the entity that particularly justifies separate taxation of the entity, rather than partnership conduit treatment.

The committee has observed that public trading takes place not only on national or local exchanges and over the counter, but also where a market is effectively made through less formal means. Therefore, the committee intends that publicly traded partnerships encompass those partnerships which are designed to be or in fact are publicly traded, whether through an established securities market (including over the counter) or through the making of a market for interests in the partnership.

The provision in the bill addresses the concerns of the committee by treating certain publicly traded partnerships as corporations.

Explanation of Provision

Under the provision, publicly traded partnerships are treated as corporations for Federal income tax purposes. An exception is provided for certain partnerships, 90 percent or more of whose gross income is passive-type income (as defined for purposes of the provision).

Passive-type income

Passive-type income, for purposes of the provision, is defined as certain interest, dividends, real property rents, gains from the sale or other disposition of real property, and income and gains from certain natural resources activities. Also treated as passive-type income is any gain from the sale or disposition of a capital asset or property described in sec. 1231(b) that is held for the production of income that is treated as passive-type income (e.g., typical commodity pools).

The bill provides that the exception for partnerships with passive-type income does not apply to entities that would be described in section 851(a) if they were domestic corporations. It is not intended to alter the requirements for conduit tax treatment set forth in the present law applicable to regulated investment companies. Similarly, it is not intended that the provisions of present law applicable to real estate mortgage investment conduits be made non-exclusive by this provision once the rules of present law relating to taxable mortgage pools become effective (for taxable years beginning after December 31, 1991). The exception under the bill from treatment as a corporation in the case of publicly traded partnerships with passive-type income applies to entities otherwise properly characterized as partnerships. The passive-type income exception is not intended to imply that entities with such income are presumed to be partnerships.

The definition of passive-type income for purposes of this provision is not coextensive with existing statutory categories of passive income (e.g., the passive loss rule or the S corporation rules), but rather, is specific to the purposes of this provision.

In general, the purpose of distinguishing between passive-type income and other income 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. In the former case, the rationale for imposing an additional corporate-level tax on investments in publicly traded partnership form is less compelling, because purchasers of such partnership interests could in most cases independently acquire such investments (or the income has already been subject to corporate-level tax, in the case of dividends). Where the activity of the partnership does not fall into the category of generating passive-type income, however, it is less likely that direct interests in the activity would be available to investors; rather, it is more likely that such activities would be conducted in corporate form and would therefore be subject to corporate level tax before profits reached the hands of investors. In the case of other types of activities treated under the provision as giving rise to passive-type income (i.e., those where the provision more broadly defines passive-type income), the rationale relates to the traditional conduct of such activities in partnership form, and the consequent reluctance to impose entity-level tax in such circumstances.

In determining whether income is treated as passive-type income under the provision, in the case of interest and real property rents, it is not intended that amounts contingent on profits be treated as interest or rent. Similarly, amounts based on gross income earned in connection with a non-real estate related activity such as a fast food operation are not treated as passive-type income. Interest or rent (or other amounts) contingent on profits involves a greater degree of risk, and also a greater potential for economic gain, than fixed (or even a market-indexed) rate of interest or rent, and thus is more properly regarded as from an underlying active business activity. Passive-type rental income also does not include income from rental or leasing of personal property.

Similarly, interest is not treated as passive-type income if it is derived in the conduct of a financial or insurance business. Thus, for example, interest income from the conduct of a banking business is not treated as passive-type income, as deriving interest is an integral part of the active conduct of the business. Similarly, it is not intended that dividend income derived in the ordinary conduct of a business in which dividend income is an integral part (e.g., a securities broker/dealer) be treated as passive-type income under the provision.

In the case of natural resources activities, special considerations apply. Thus, passive-type income from such activities is considerably broader, and includes income and gains from exploration, development, mining or production, refining, transportation (including through pipelines transporting gas, oil, or products thereof), or marketing of, any mineral or natural resource, including geothermal energy and timber. For purposes of this provision, refining any natural resource is intended to include the production of fertilizer.

In addition, the scope of passive-type income in the case of real estate activities encompasses rental income from real property and income and gains from the sale or other disposition of real property (including real property described in sec. 1221(1), such as residential real property held for sale to customers). Passive-type income does not, however, include gain on income from the sale of inventory personal property or other personal property held for sale in the ordinary course

of a trade or business (other than in the case of natural resources activities). Real property rent includes rents from interests in real property, charges for services customarily furnished in connection with the rental of real property, and rent attributable to personal property in connection with a lease of real property provided the rent attributable to the personal property does not exceed 15 percent of the total rent for the year, within the meaning of sec. 856(d) (other than sec. 856(d)(2)(C), relating to independent contractors). Thus, generally, amounts contingent on income or profits are not treated as rent for purposes of this provision.

Inadvertent terminations

The bill provides relief from classification as a corporation for tax purposes, where a partnership inadvertently fails to meet the requirement that 90 percent of its gross income be passive-type income. Under this relief provision, if (1) the Secretary determines that the failure was inadvertent, (2) the partnership takes steps within a reasonable time to meet the 90 percent requirement, and (3) the partnership and each holder of an interest in the partnership during the failure period agree to make adjustments determined by the Secretary, then the partnership will be treated as continuing to meet the 90 percent requirement during the failure period. A reasonable time, for this purpose, would be one year, unless otherwise determined in regulations.

Publicly traded partnerships

Publicly traded partnerships are defined for purposes of the provision as partnerships whose interests are (1) traded on an established securities market, or (2) offered with the expectation that there will be a secondary market for such interests, or (3) readily tradeable in a secondary market (or the substantial equivalent thereof).

For this purpose, an established securities market includes any national securities exchange registered under the Securities Exchange Act of 1934 or exempted from registration because of the limited volume of transactions, and any local exchange. It also includes any over the counter market. An over the counter market is characterized by an interdealer quotation system which regularly disseminates quotations of obligations by identified brokers or dealers, by electronic means or otherwise.

Interests in partnerships are offered with the expectation that there will be a secondary market for such interests where the interests are marketed with representations that there is likely to be a ready market for resale or other disposition of the interests or rights to income or other attributes thereof (or that the promoter or issuer intends to take steps so that such a market is created). On the other hand, if the partnership agreement, offering materials, or other marketing materials merely provide that the partnership may be listed on an exchange in the future at the discretion of the general partner, upon a vote of interest holders, or the like, then the partnership is not treated as publicly traded upon issue (but will be treated as publicly traded when it becomes exchange-listed).

In general, the determination of whether interests in a partnership are offered with the expectation that there will be a secondary market is ordinarily made at the time partnership interests are initially offered for sale. If subsequent to the initial offering, a secondary market is provided for the interests, and interests are actually exchanged or disposed of in such a market, then the partnership will be treated as publicly traded at such subsequent time.

An interest is treated as readily tradeable on a secondary market (or the substantial equivalent thereof) if the interest is regularly quoted by brokers or dealers making a market in the interest.

(See Treas. Reg. section 1.453- 3(d)(3).) Thus, for example, an interest is readily tradeable in a secondary market where the interest is traded on a market essentially equivalent to an over the counter market, or where the holder has a readily available, regular and ongoing opportunity to sell or exchange his interest.

A partner's ability to trade the interest, without more, will not cause the interest to be treated as readily tradeable, nor will occasional sales of interests in the partnership, the terms of which are not widely publicized, indicate the existence of a secondary market.

The existence of a buy-sell agreement among the partners, without more, will not cause a partnership to be treated as publicly traded. Nor will the occasional and irregular repurchase or redemption by the partnership, or acquisition by the general partner, of interests in the partnership, cause the partnership to be considered as publicly traded under the provision. A regular plan of redemptions or repurchases, or similar acquisitions of interests in the partnership such that holders of interests have readily available opportunities to dispose of their interests, that is essentially equivalent to a secondary market, indicates that the interests are readily tradeable on what is the substantial equivalent of a secondary market.

In general, a provision for the discretion of the general partner or the partnership to refuse consent to transfer of an interest in the partnership (or of rights to income or other attributes of an interest in the partnership) does not, without more, prevent a partnership from being considered publicly traded. For example, the discretion of the general partner to refuse consent to a transfer if the transfer would cause a termination of the partnership for Federal income tax purposes does not cause the partnership to be treated as not publicly traded. Similarly, if the general partner must consent to any transfer of an interest in the partnership, but the assignment of rights to income (or other attributes) of the partnership is not so limited, the consent requirement does not cause the partnership to be considered as not publicly traded.

Treatment as a corporation

The bill provides that, in the case of a partnership that is treated as a corporation under this provision, the partnership is treated as contributing all of its assets (subject to all of its liabilities) to a newly formed corporation in exchange for all of the corporation's stock. The stock of the corporation is treated as distributed to the corporation in complete liquidation of the partnership. In general, the tax consequences to the partnership, the corporation, and the distributee holders of interests in the partnership who become shareholders in the new corporation are governed by secs. 351 (permitting tax-free contributions to corporations that are controlled immediately after the contribution transaction), 731 and 732 (governing the treatment of liquidating distributions from partnerships). Rules applicable to recognition of income upon recapture of tax benefits also apply.

Income from publicly traded partnerships that are classified as corporations under the bill generally is treated as dividend income. Regardless of whether such income is characterized as income or gain (e.g., depending on whether it represents a distribution of earnings and profits under section 301), income from such entities is properly treated as portfolio income for purposes of the passive loss rule.

Effective Date

The provision is effective after October 13, 1987, except for existing partnerships. An existing partnership is any partnership publicly traded on October 13, 1987.

An existing partnership also includes a partnership with respect to which a registration statement was filed with the Securities and Exchange Commission on or before October 13, 1987, stating in such registration statement as of October 13, 1987, that the partnership will or intends to publicly trade interests or units including by application for listing on any national securities exchange or local exchange or by trading in an over-the-counter market which results in interests or units so registered to be listed on such exchange or available for trading in an over-the-counter market within a reasonable time after such registration becomes effective. The committee does not intend to grandfather partnerships where registration statements filed on or before October 13, 1987, indicate that there is a possibility (e.g., the general partner may determine) that the interests or units may trade in the future, as opposed to indicating a determination that at the time the partnership is registered with the SEC, trading will occur within a reasonable time after the registration becoming effective.

An existing partnership ceases to be treated as such on the first day after October 13, 1987, on which there has been a substantial expansion of the partnership, or the activities of the partnership have been substantially changed. Any partnership not treated as an existing partnership, that becomes publicly traded after October 13, 1987, is treated as a corporation for tax purposes upon being publicly traded (unless the exception relating to passive- type income applies).

The provision becomes effective with respect to partnerships theretofore grandfathered under the provision for taxable years beginning after December 31, 1994.

JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE.

TITLE X - REVENUES.

PART 1. REVENUE-INCREASE PROVISIONS.

II. BUSINESS TAX PROVISIONS.

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HOUSE OF REPRESENTATIVES REPORT NO. 100-495; 100th CONGRESS 1st SESSION; H.R. 3545; CONFERENCE REPORT; (Part 113 of 127 parts)

{943} B. PARTNERSHIP PROVISIONS

1. Certain publicly traded partnerships treated as corporations

Present law

Under present law, a partnership is not subject to tax at the partnership level, but rather, income and loss of the partnership is subject to tax at the partner's level. A partner's share of partnership income is generally determined without regard to whether he receives any corresponding cash distributions. Similarly, partnership deductions, losses and credits are taken into account at the partner level for tax purposes. A corporation, by contrast, generally is subject to tax at the entity level, and distributions with respect to corporate stock generally are subject to tax at the shareholder level.

The Treasury regulations distinguishing partnerships from corporations currently provide that whether a business entity is taxed as a corporation depends on which form of enterprise the entity "more nearly" resembles (Treas. Reg. sec. 301.7701-2(a)). The regulations list six corporate characteristics, two of which are common to corporations and partnerships, and the other four of which are: (1) continuity of life, (2) centralization of management, (3) liability {944} for corporate debts limited to corporate property, and (4) free transferability of interests. The regulations provide that an association is treated as a corporation (rather than a partnership) for Federal income tax purposes if it has more corporate than non-corporate characteristics. The effect of the regulations generally is to classify an entity as a partnership if it lacks any two of these four corporate characteristics, without further inquiry as to how strong or weak a particular characteristic is or how th evaluation of the factors might affect overall resemblance. n1

n1 Treas. Reg. secs. 301.7701-2 and -3; *Larson* v. *Commissioner*, 66 T.C. 159 (1976), acq. 1979-1 C.B. 1.

Under present law, if an entity is classified as a partnership, income and loss are subject to tax at the partner level rather than at the partnership level without regard to whether the partnership is engaged in active business activities.

House bill

Under the provision, publicly traded partnerships are treated as corporations for Federal income tax purposes. An exception is provided for certain partnerships, 90 percent or more of whose gross income is passive-type income (as defined for purposes of the provision).

Passive-type income

Passive-type income, for purposes of the provision, is defined as certain interest, dividends, real property rents, gains from the sale or other disposition of real property, and income and gains from certain natural resources activities. Also treated as passive-type income is any gain from the sale or disposition of a capital asset or property described in sec. 1231(b) that is held for the production of income that is treated as passive-type income (e.g., typical commodity pools).

Inadvertent terminations

The bill provides relief from classification as a corporation for tax purposes, where a partnership inadvertently fails to meet the requirement that 90 percent of its gross income be passive-type income. Under this relief provision, if (1) the Secretary determines that the failure was inadvertent, (2) the partnership takes steps within a reasonable time to meet the 90 percent requirement, and (3) the partnership and each holder of an interest in the partnership during the failure period agree to make adjustments determined by the Secretary, then the partnership will be treated as continuing to meet the 90 percent requirement during the failure period. A reasonable time, for this purpose, would be one year, unless otherwise determined in regulations.

Publicly traded partnerships

Publicly traded partnerships are defined for purposes of the provision as partnerships whose interests are (1) traded on an established securities market, or (2) offered with the expectation that there will be a secondary market for such interests, or (3) readily {945} tradable in a secondary market (or the substantial equivalent thereof).

Treatment as a corporation

The bill provides that, in the case of a partnership that is treated as a corporation under this provision, the partnership is treated as contributing all of its assets (subject to all of its liabilities) to a newly formed corporation in exchange for all of the corporation's stock. The stock of the corporation is treated as distributed to the corporation in complete liquidation of the partnership. In general, the tax consequences to the partnership, the corporation, and the distributee holders of interests in the partnership who become shareholders in the new corporation are governed by secs. 351 (permitting tax-free contributions to corporations that are controlled immediately after the contribution transaction), 731 and 732 (governing the treatment of liquidating distributions from partnerships). Rules applicable to recognition of income upon recapture of tax benefits also apply.

Income from publicly traded partnerships that are classified as corporations under the bill generally is treated as dividend income. Regardless of whether such income is characterized as income or gain (e.g., depending on whether it represents a distribution of earnings and profits under section 301), income from such entities is properly treated as portfolio income for purposes of the passive loss rule.

The provision is effective after October 13, 1987, except for existing partnerships. An existing partnership is any partnership publicly traded on October 13, 1987.

An existing partnership also includes a partnership with respect to which a registration statement was filed with the Securities and Exchange Commission on or before October 13, 1987, stating in such registration statement as of October 13, 1987, that the partnership will or intends to publicly trade interests or units including by application for listing on any national securities exchange or local exchange or by trading in an over-the-counter market which results in interests or units so registered to be listed on such exchange or available for trading in an over-the-counter market within a reasonable time after such registration becomes effective. The committee does not intend to grandfather partnerships where registration statements filed on or before October 13, 1987, indicate that there is a possibility (e.g., the general partner may determine) that the interests or units may trade in the future, as opposed to indicating a determination that at the time the partnership is registered with the SEC, trading will occur within a reasonable time after the registration becoming effective.

An existing partnership ceases to be treated as such on the first day after October 13, 1987, on which there has been a substantial expansion of the partnership, or the activities of the partnership have been substantially changed. Any partnership not treated as an existing partnership, that becomes publicly traded after October 13, 1987, is treated as a corporation for tax purposes upon being publicly traded (unless the exception relating to passive-type income applies).

{946} The provision becomes effective with respect to partnerships theretofore grandfathered under the provision for taxable years beginning after December 31, 1994.

Senate amendment

No provision.

Conference agreement

The conference agreement follows the House bill, with modifications.

Under the conference agreement, as under the House bill, a publicly traded partnership is treated as a corporation unless 90 percent or more of its gross income consists of qualifying income.

As under the House bill, the provision does not apply to any partnership that would be described in sec. 851(a) if it were a domestic corporation. Thus, a publicly traded partnership that is registered under the Investment Company Act of 1940 generally is treated as a corporation under the provision. The conference agreement provides an exception to this rule, however, to the extent provided in regulations, in the case of a partnership that is registered under the Investment Company Act of 1940, and a principal activity of which is the buying and selling of commodities or options, futures or forward contracts with respect to commodities (including foreign currency transactions of a commodity pool). Thus, for example, an existing partnership that is required to register under the 1940 Act because it is engaged in the business of investing in securities, and a principal activity of which is the buying and selling of such commodities (or futures, options or forward contracts with respect to such commodities), is treated as a partnership as provided in Treasury regulations.

Passive-type income

Under the conference agreement, passive-type income includes interest, dividends, real property rents, gain from the disposition of real property, and income and gains from certain natural resources activities. Passive-type income also includes gain from disposition of a capital asset or property described in section 1231(b) that is held for the production of income that is passive-type income. In addition, passive-type income includes income and gains from commodities (not described in section 1221(1)) or futures, options or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) in the case of partnerships, a principal activity of which is the buying and selling of such commodities, futures, options or forward contracts (i.e., typical commodity pools).

In determining whether 90 percent of a partnership's gross income is passive-type income in the case of the sale or other disposition of real property described in section 1221(1) (i.e., inventory-type property or property held primarily for sale to customers), gross income is not reduced by inventory costs taken into account in determining the gain from the disposition of the real property.

Income and gains from certain activities with respect to minerals or natural resources are treated as passive-type income. Specifically, natural resources include fertilizer geothermal energy, and {947} timber, as well as oil, gas or products thereof. For this purpose, fertilizer, includes plant nutrients such as sulphur, phosphate, potash and nitrogen that are used for the production of crops and phosphate-based livestock feed. For this purpose, oil, gas, or products thereof means gasoline, kerosene, number 2 fuel oil, refined lubricating oils, diesel fuel, methane, butane, propane, and similar products which are recovered from petroleum refineries or field facilities. Oil, gas, or products thereof are not intended to encompass oil or gas products that are produced by additional processing beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives. Income of certain partnerships whose exclusive activities are transportation and marketing activities is not treated as passive-type income. For example, the income of a partnership whose exclusive activity is transporting refined petroleum products by pipeline is intended to be treated as passive-type income, but the income of a partnership whose exclusive activities are transporting refined petroleum products by truck, or retail marketing with respect to refined petroleum products (e.g., gas station operations) is not intended to be treated as passive-type income.

In determining whether income is treated as passive-type income under the provision, in the case of interest and real property rents, it is not intended that amounts contingent on profits be treated as interest or rent. Interest or rent (or other amounts) contingent on profits involves a greater degree of risk, and also a greater potential for economic gain, than a fixed (or even a market-indexed) rate of interest or rent, and thus is more properly regarded as from an underlying active business activity. Under the provision, the determination of whether real property rents based on gross sales are passive-type income is made in accordance with the rules of section 856(d), without regard to section 856(d)(2)(C). Thus, real property rents based on a fixed percentage of receipts or of gross sales are not excluded from rents that are treated as passive-type income. Passive-type rental income does not include income from rental or leasing of personal property.

Publicly traded partnerships

Under the conference agreement, publicly traded partnerships are defined as partnerships whose interests are (1) traded on an established securities market, or (2) readily tradable on a secondary market (or the substantial equivalent thereof).

For this purpose, an established securities market includes any national securities exchange registered under the Securities Exchange Act of 1934 or exempted from registration because of the limited volume of transactions, and any local exchange. It also includes any over the counter market. An over the counter market is characterized by an interdealer quotation system which regularly disseminates quotations of obligations by identified brokers or dealers, by electronic means or otherwise.

A publicly traded partnership also includes a partnership whose interests are readily tradable on a secondary market (or the substantial equivalent thereof). The conferees intend that this test be applied to encompass in the definition of publicly traded partnerships those partnerships that are not traded on established securities {948} markets, but whose partners are nevertheless readily able to buy, sell or exchange their partnership interests in a manner that is comparable, economically, to trading on established securities markets. The conferees intend that substance rather than form determine whether a partnership is treated as publicly traded; whether public trading takes place on an established securities market or elsewhere is not determinative.

A secondary market is generally indicated by the existence of a person standing ready to make a market in the interest. An interest is treated as readily tradable if the interest is regularly quoted by persons such as brokers or dealers who are making a market in the interest. (See Temp. Treas. Reg. section 15a.453-1(e)(4)(iii).) Thus, for example, an interest is readily tradable in a secondary market where the interest is traded on a market essentially equivalent to an over the counter market.

The substantial equivalent of a secondary market exists where there is not an identifiable market maker but the holder of an interest has a readily available, regular and ongoing opportunity to sell or exchange his interest through a public means of obtaining or providing information of offers to buy, sell or exchange interests. Similarly, the substantial equivalent of a secondary market exists where prospective buyers and sellers have the opportunity to buy, sell or exchange interests in a time frame and with the regularity and continuity that the existence of a market maker would provide.

If interests can be traded in a market that is publicly available, but offers to buy or sell interests are normally not accepted in a time frame comparable to that which would be available on a secondary market, then the interests are not treated as readily tradeable on the substantial equivalent of a secondary market. For example, if interests are quoted and traded on an irregular basis as a result of bid and asked prices listed on a computerized system, and such interests cannot normally be disposed of within the time that they could be disposed of on an over the counter market, then the interests are not considered as readily tradeable on the substantial equivalent of a secondary market.

In addition, it is not intended that partnership interests be treated as readily tradable on a secondary market or the substantial equivalent of a secondary market where there are occasional accommodation trades of partnership interests (e.g., where the general partner or the partnership sometimes purchases interests from other partners, not pursuant to a put or call right, or where the underwriter that handled the issuance of the partnership interests occasionally arranges such

accommodation trades. Similarly, where the general partner provides information to its partners regarding such partners' desire to buy or sell interests to each other, or arranges such transfers between partners, without offering to buy or redeem interests or issue additional interests to such partners, a secondary market or the substantial equivalent of a secondary market is not created.

The existence of a buy-sell agreement among the partners, without more, will not cause a partnership to be treated as publicly traded. Nor will the occasional and irregular repurchase or redemption by the partnership, or acquisition by the general partner, {949} of interests in the partnership, cause the partnership to be considered as publicly traded under the provision. A regular plan of redemptions or repurchases, or similar acquisitions of interests in the partnership such that holders of interests have readily available, regular and ongoing opportunities to dispose of their interests, indicates that the interests are readily tradable on what is the substantial equivalent of a secondary market.

The conferees intend that the complicity or participation (express or tacit) of the partnership or the general partner is relevant in determining whether there is public trading of its interests. Thus, for example, if the partnership acts to list its interests on an exchange, it is clearly participating in causing its interests to be publicly traded.

A partnership is considered as participating in public trading of its interests where trading is in fact taking place (even though the partnership may not have taken explicit action to permit trading, such as by listing on an exchange), and the partnership agreement imposes no meaningful limitation on partners' ability to readily transfer their interests. For example, a provision for the discretion of the general partner or the partnership to refuse consent to the transfer of an interest in the partnership (or of rights to income or other attributes of an interest in the partnership) does not, without more, prevent a partnership from being considered publicly traded. Similarly, the discretion of the general partner to refuse consent to a transfer if the transfer would cause a termination of the partnership for Federal income tax purposes does not cause the partnership to be treated as not publicly traded. Likewise, if the general partner must consent to any transfer of an interest in the partnership, but the assignment of rights to income (or other attributes) of the partnership is not so limited, the consent requirement does not cause the partnership to be considered as not publicly traded.

Conversely, if the partnership agreement provides that partnership interests may not be transferred (and rights to partnership income or other attributes may not be assigned), or provides that partners have only a restricted and limited right to transfer partnership interests or assign partnership income or other attributes, then the conferees intend that occasional actual transfers of interests or assignments of rights generally will not cause the partnership to be treated as publicly traded. A partner's right to transfer an interest or assign rights is considered as restricted and limited, for this purpose, where the transfer of interests or assignment of rights is permitted only in circumstances such as death or divorce of a partner, gifts, certain types of transfers to related parties (such as intrafamily transfers or transfers within an affiliated group where the ownership of the interest or rights is effectively unchanged), or in the case of an occasional accommodation transfer by a partner.

If interests in a partnership are not traded on an established securities market, and the general partner and the partnership have the right to refuse to recognize trades in a secondary market or the substantial equivalent thereof, and exercise the right by taking such actions as are necessary so that trades or assignments of rights are not in fact recognized (either by the general partner,

the partnership, the underwriter, or the depositary or any other agent {950} of the partnership or general partner), then the partnership interests are not intended to be treated as publicly traded under the provision.

Inadvertent terminations

The relief provision in the case of inadvertent terminations is the same as the House bill, except that the Treasury regulatory authority with respect to adjustments is modified. The conference agreement provides that the partnership may be treated as continuing to meet the 90 percent test with respect to gross income if the partnership agrees to make such adjustments (including adjustments with respect to the partners) as are required by the Treasury Secretary with respect to the period of inadvertent termination (and provided the other two requirements imposed under the House bill and the conference agreement are also satisfied).

Effective date. - The provision is effective for taxable years after December 31, 1987.

The conference agreement provides a grandfather rule similar to the House bill, for partnerships existing on December 17, 1987, and the provision applies to existing partnerships for taxable years beginning after December 31, 1997. A partnership is not treated as an existing partnership if there has been an addition of a substantial new line of business. Dropping a line of business does not cause an existing partnership to cease to be treated as such. For this purpose, a substantial new line of business does not include a line of business which was specifically described as a proposed business activity of the partnership (not including a general grant of authority to conduct any business) in a registration statement or amendment thereto filed on behalf of the partnership with the SEC on or before December 17, 1987, but in which the partnership had not actively engaged on or before December 17, 1987.

As provided in the House bill, an existing partnership includes a partnership that filed a registration statement with the Securities and Exchange Commission on or before December 17, 1987 indicating that the partnership was to be a publicly traded partnership. For this purpose, the tranfer of assets to the partnership and commencement of business, substantially as described or provided for in the registration statement (including subsequent amendments and filings related thereto that do not add descriptions of new lines of business), and the sale of interests in the partnership will not be treated as the addition of a substantial new line of business. It is not intended that the termination (within the meaning of section 708) of such a partnership as a result of the issuance or sale of partnership interests cause the partnership not to be treated as an existing partnership. An existing partnership also includes a partnership that filed a statement with a State regulatory commission on or before December 17, 1987 seeking permission to restructure a portion of a corporation as a publicly traded partnership (whether or not such partnership was actually in existence on December 17, 1987).

MISCELLANEOUS REVENUE ACT OF 1988

July 26, 1988. -- Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

HOUSE OF REPRESENTATIVES; REPORT 100-795; 100TH CONGRESS 2d Session

D. Revenue Act of 1987 (sec. 204 of the Bill)

3. Partnership provisions (sec. 204(f)-(h) of the bill)

a. Certain publicly traded partnerships treated as corporations (sec. 204(f) of the bill, sec. 10211 of the Revenue Act, and sec. 7704 of the Code)

Present Law

Under present law, a publicly traded partnership is treated as a corporation for Federal tax purposes unless 90 percent or more of its gross income consists of qualifying income. A partnership is publicly traded if (1) interests in the partnership are traded on an established securities market, or (2) interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

In general, qualifying income under the provision means interest, dividends, real property rents, gain from the disposition of real property, and income and gains from certain natural resources activities. Qualifying income also includes gain from disposition of a capital asset or section 1231(b) property that is held for the production of qualifying income. It also includes income and gains from certain commodities and commodities futures, options and forward contracts of partnerships, a principal activity of which is buying and selling such commodities or commodities futures, options or forward contracts.

For purposes of treatment as qualifying income, real property rent means amounts that would qualify as rent from real property under the rules applicable to real estate investment trusts (section 856(d)), without regard to the independent contractor rule (section 7704(d)(3)). Thus, real property rent includes rents from interests in real property, and does not include either (1) charges for services that are not customarily furnished or rendered in connection with the rental of real property, or (2) rent attributable to leased personal property if such rent exceeds 15 percent of the rent from the personal and real property under the lease (section 856(d)(1)). For example, under present law, services customarily furnished (regardless of whether performed by an independent contractor) in connection with rental of real property include those which, in the geographic market in which the building is located, tenants in buildings of a similar class are customarily provided with. n105 Thus, under present law, if an amount does not constitute real property rent under sec. 856(d) because excessive services are furnished (or for any other reason other than the independent contractor rule), then such an amount similarly does not constitute real property rent under section 7704(d).

n105 Tres. Reg. sec. 1.856-4(b)(1).

Real property rent does not include amounts received or accrued from any person or entity by the partnership if the partnership owns, directly or indirectly, an interest of 10 percent or more in such entity or person. Present law does not provide a de minimis rule for attribution to the partnership of holdings by its partners, for this purpose.

Present law provides relief from classification as a corporation for Federal tax purposes, in the case of inadvertent failure to meet the requirement that 90 percent or more of the partnership's gross income consist of qualifying income. The partnership may be treated as continuing to meet the 90 percent test with respect to gross income if (1) the Treasury Secretary determines that failure to meet the 90 percent requirement was inadvertent, (2) the partnership takes steps within a reasonable time after the discovery of such failure to meet the 90 percent requirement, and (3) the partnership agrees to make such adjustments (including adjustments with respect to the partners) as are required by the Treasury Secretary with respect to the period of inadvertent failure to meet the 90 percent requirement.

Generally, section 7704 is effective with respect to taxable years beginning after December 31, 1997. A 10-year grandfather rule is provided in the case of existing partnerships; the provision is effective for existing partnerships for taxable years beginning after December 31, 1997. The grandfather rule ceases to apply in the case of partnerships that otherwise would be treated as existing partnerships, with respect to which there has been an addition of a substantial new line of business. For this purpose, the transfer of assets to the partnership and commencement of business, substantially as described or provided for in the registration statement and filed exhibits thereto (including subsequent amendments and filings related thereto that do not add descriptions of new lines of business), and the sale of interests in the partnership will not be treated as the addition of a substantial new line of business. It is not intended that the termination (within the meaning of section 708) of such a partnership as a result of the issuance or sale of partnership interests cause the partnership not to be treated as an existing partnership.

Explanation of Provisions

Inadvertent failures. -- The bill clarifies the Treasury regulatory authority to implement relief from classification as a corporation in the event of inadvertent failure to meet the requirement that 90 percent or more of a publicly traded partnership's gross income consist of qualifying income. Regulatory authority is provided under the bill to cause the partnership to make adjustments or to pay amounts required by the Treasury Secretary. The amounts of such payments are intended to represent an appropriate portion of tax liability that would be imposed on the partnership if it were treated as a corporation during the period of failure to meet the 90 percent requirement. In implementing this rule, the Treasury Department may withhold the relief where a publicly traded partnership inadvertently fails to meet the 90 percent test in each of several successive years, or in several years within a longer period, n106 thus causing the partnership to be treated as a corporation in such circumstances.

n106 Cf. sec. 1362(d), imposing a 3-consecutive-year limit on excess net passive income of certain S corporations.

This grant of regulatory authority carries out the intention of the provision to provide relief for temporary, inadvertent failures, without permitting partnerships to conduct substantial activities not contemplated under the rules describing qualifying income.

It is also expected that under the regulatory authority provided with respect to inadvertent failures of the 90 percent requirement, the Treasury Department will provide rules for determining the application of the 90 percent test in the case of short taxable years of a partnership.

Coordination of grandfather rule. -- The bill also provides a rule coordinating the 90 percent requirement with the 10-year grandfather rule for existing partnerships. The bill provides that, in the case of an existing (i.e., grandfathered) publicly traded partnership, the 90 percent requirement need not be met until the earlier of (1) its first taxable year beginning after December 31, 1997, or (2) its first taxable year beginning after the day (if any) that the partnership ceases to be treated as an existing partnership by reason of the addition of a substantial new line of business with respect to such partnership. An existing partnership becomes subject to the provisions of section 7704 (e.g., the 90 percent requirement) upon the earlier of these to occur. If an existing publicly traded partnership ceases to be treated as an existing partnership, but satisfies the 90 percent requirement (and the other requirements of sec. 7704) for that year and all succeeding years, then such a partnership is not reclassified as a corporation for tax purposes under the provision.

Thus, for example, a publicly traded partnership that is an existing partnership within the meaning of the provision for the entire period between December 31, 1987 and December 31, 1997, and meets the 90 percent requirement for the first time for its entire taxable year beginning January 1, 1998, is not treated as a corporation under the provision either for the period 1988-1997, or for its taxable year 1998.

It is intended that a publicly traded partnership not be treated as ceasing to be an existing partnership solely by reason of a termination of the partnership (within the meaning of sec. 708) caused by the issuance or other sale or exchange of 50 percent or more of the partnership interests.

The bill also provides that the 90 percent requirement applies only in and after the first taxable year in which the partnership (or a predecessor) is a publicly traded partnership. Thus, for example, if a partnership is in existence starting January 1, 1988, and first becomes publicly traded in its taxable year beginning January 1, 1990, then the 90 percent test need be met only after January 1, 1990.

Natural resources. -- The bill clarifies the definition of income qualifying under the 90 percent requirement from certain activities with respect to a mineral or natural resource. Such qualifying income encompasses income from natural deposits listed in section 613(b) as well as oil and gas, fertilizer, geothermal energy property, and timber. Such qualifying income does not include, for example, income from fishing, farming (including the cultivation of fruits or nuts), or from hydroelectric, solar, wind, or nuclear power production.

The reference provided in the bill to depletable products is intended only to identify what income from them is treated as qualifying income. Consequently, whether income is taken into account in determining percentage depletion under section 613 is not necessarily relevant in determining whether such income is qualifying income under section 7704(d).

In the case of transportation activities with respect to oil and gas, the Committee intends that, in general, income from transportation of oil and gas to a bulk distribution center (whether by pipeline, truck, barge or rail) be treated as qualifying income. Income from any transportation of

oil or gas by pipeline is treated as qualifying income. Except in the case of pipeline transport, however, transportation of oil or gas to a place from which it is dispensed or sold to retail customers is generally not intended to be treated as qualifying income. A retail customer does not include a person who acquires the oil or gas for refining or processing, nor does a retail customer include a utility providing power to customers. For example, income from transporting refined petroleum products by truck to retail customers is not qualifying income. n107

> n107 Income from transportation and marketing of liquefied petroleum gas in trucks and rail cars or by pipeline, however, may be treated as qualifying income. See Statement of Mr. Rostenkowski, 133 Cong. Rec. H 11,968 (December 21, 1987); see also Statement of Senator Bentsen, 133 Cong. Rec. S 18,651 (December 22, 1987) (substantially similar language).

Similarly, with respect to marketing of oil and gas, the Committee intends that qualifying income from marketing oil and gas be income from marketing at the level of exploration, development, processing or refining oil and gas. By contrast, income from marketing oil and gas and products thereof to end users, or at the retail level, is not intended to be qualifying income. For example, income from retail marketing with respect to refined petroleum products (e.g., gas station operations) is not intended to be treated as qualifying income.

Real property rents. -- The bill provides a 5 percent de minimis rule for attribution of holdings to partnerships. This de minimis rule applies for purposes of determining whether amounts that would otherwise constitute real property rents (i.e., qualifying income) are not treated as qualifying income because the amounts are received or accrued from a person in which the partnership holds an interest of 10 percent or more (section 7704(d)(3) and 856(d)(2)(B)). Thus, for example, if a partner in a publicly traded partnership has less than a 5 percent interest in that partnership, his holdings in other entities or persons, from whom the partnership may receive rental income, are not attributed to the partnership, for purposes of determining whether the partnership owns a 10 percent or more interest in such other entity or person.

With respect to the definition of real property rents, it is clarified that non-application of the independent contractor rule (section 856(d)(2)(C)) does not affect the requirement that the nature of the income be rent. Thus, the fact that the independent contractor rule does not apply for purposes of determining the qualifying income of a partnership does not mean that amounts received by a partnership, which amounts include amounts for services that are not customarily furnished in connection with the rental of real property, constitute real property rents (section 856(d)(1)(B)). For example, where the partnership receives or accrues amounts attributable to the performance of services that are not customarily furnished in connection with the rental of real property (e.g., to the extent that the furnishing of hotel or motel services causes amounts not to be treated as rents from real property under present law), then the partnership is treated as not receiving qualifying income.

TECHNICAL CORRECTIONS ACT OF 1988

August 3, 1988 (legislative day, August 1) -- Ordered to be printed

SENATE REPORT 100-445; 100TH Congress 2d Session; S. 2238

TITLE II -- TECHNICAL CORRECTIONS TO OTHER TAX LEGISLATION

D. Revenue Act of 1987 (sec. 204 of the Bill)

3. Partnership provisions (sec. 204(f)-(h) of the bill)

a. Certain publicly traded partnerships treated as corporations (sec. 204(f) of the bill, sec. 10211 of the Revenue Act, and sec. 7704 of the Code)

Present Law

Under present law, a publicly traded partnership is treated as a corporation for Federal tax purposes unless 90 percent or more of its gross income consists of qualifying income. A partnership is publicly traded if (1) interests in the partnership are traded on an established securities market, or (2) interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

In general, qualifying income under the provision means interest, dividends, real property rents, gain from the disposition of real property, and income and gains from certain natural resources activities. Qualifying income also includes gain from disposition of a capital asset or section 1231(b) property that is held for the production of qualifying income. It also includes income and gains from certain commodities and commodities futures, options and forward contracts or partnerships, a principal activity of which is buying and selling such commodities or commodities futures, options or forward contracts.

For purposes of treatment as qualifying income, real property rent means amounts that would qualify as rent from real property under the rules applicable to real estate investment trusts (section 856(d)), without regard to the independent contractor rule (section 7704(d)(3)). Thus, real property rent includes rents from interests in real property, and does not include either (1) charges for services that are not customarily furnished or rendered in connection with the rental of real property, or (2) rent attributable to leased personal property if such rent exceeds 15 percent of the rent from the personal and real property under the lease (section 856(d)(1). For example, under present law, services customarily furnished (regardless of whether performed by an independent contractor) in connection with rental of real property include those which, in the geographic market in which the building is located, tenants in buildings of a similar class are customarily provided with. n109 Thus, under present law, if an amount does not constitute real property rent under sec. 856(d) because excessive services are furnished (or for any other reason other than the independent contractor rule), then such an amount similarly does not constitute real property rent under section 7704(d).

n109 Treas. Reg. sec. 1.856-4(b)(1).

Real property rent does not include amounts received or accrued from any person or entity by the partnership if the partnership owns, directly or indirectly, an interest of 10 percent or more in such entity or person. Present law does not provide a de minimis rule for attribution to the partnership of holdings by its partners, for this purpose.

Present law provides relief from classification as a corporation for Federal tax purposes, in the case of inadvertent failure to meet the requirement that 90 percent or more of the partnership's gross income consist of qualifying income. The partnership may be treated as continuing to meet the 90 percent test with respect to gross income if (1) the Treasury Secretary determines that failure to meet the 90 percent requirement was inadvertent, (2) the partnership takes steps within a reasonable time after the discovery of such failure to meet the 90 percent requirement, and (3) the partnership agrees to make such adjustments (including adjustments with respect to the partners) as are required by the Treasury Secretary with respect to the period of inadvertent failure to meet the 90 percent requirement.

Generally, section 7704 is effective with respect to taxable years beginning after December 31, 1997. A 10-year grandfather rule is provided in the case of existing partnerships; the provision is effective for existing partnerships for taxable years beginning after December 31, 1997. The grandfather rule ceases to apply in the case of partnerships that otherwise would be treated as existing partnerships, with respect to which there has been an addition of a substantial new line of business. For this purpose, the transfer of assets to the partnership and commencement of business, substantially as described or provided for in the registration statement and filed exhibits thereto (including subsequent amendments and filings related thereto that do not add descriptions of new lines of business), and the sale of interests in the partnership will not be treated as the addition of a substantial new line of business. It is not intended that the termination (within the meaning of section 708) of such a partnership as a result of the issuance or sale of partnership interests cause the partnership not to be treated as an existing partnership.

Explanation of Provisions

Inadvertent failures. -- The bill clarifies the Treasury regulatory authority to implement relief from classification as a corporation in the event of inadvertent failure to meet the requirement that 90 percent or more of a publicly traded partnership's gross income consist of qualifying income. Regulatory authority is provided under the bill the cause the partnership to make adjustments or to pay amounts required by the Treasury Secretary. The amounts of such payments are intended to represent an appropriate portion of tax liability that would be imposed on the partnership if it were treated as a corporation during the period of failure to meet the 90 percent requirement. In implementing this rule, the Treasury Department may withhold the relief where a publicly traded partnership inadvertently fails to meet the 90 percent test in each of several successive years, or in several years within a longer period, n110 thus causing the partnership to be treated as a corporation in such circumstances.

n110 Cf. sec. 1362(d), imposing a 3-consecutive year limit on excess net passive income of certain S corporations.

This grant of regulatory authority carries out the intention of the provision to provide relief for temporary, inadvertent failures, without permitting partnerships to conduct substantial activities not contemplated under the rules describing qualifying income.

It is also expected that under the regulatory authority provided with respect to inadvertent failures of the 90 percent requirement, the Treasury Department will provide rules for determining the application of the 90 percent test in the case of short taxable years of a partnership.

Coordination of grandfather rule. -- The bill also provides a rule coordinating the 90 percent requirement with the 10-year grandfather rule for existing partnerships. The bill provides that, in the case of an existing (i.e., grandfathered) publicly traded partnership, the 90 percent requirement need not be met until the earlier of (1) its first taxable year beginning after December 31, 1997, or (2) its first taxable year beginning after the day (if any) that the partnership ceases to be treated as an existing partnership by reason of the addition of a substantial new line of business with respect to such partnership. An existing partnership becomes subject to the provisions of section 7704 (e.g., the 90 percent requirement) upon the earlier of these to occur. If an existing publicly traded partnership ceases to be treated as an existing partnership, but satisfies the 90 percent requirement (and the other requirements of sec. 7704) for that year and all succeeding years, then such a partnership is not reclassified as a corporation for tax purposes under the provision.

Thus, for example, a publicly traded partnership that is an existing partnership within the meaning of the provision for the entire period between December 31, 1987 and December 31, 1997, and meets the 90 percent requirement for the first time for its entire taxable year beginning January 1, 1998, is not treated as a corporation under the provision either for the period 1988-1997, or for its taxable year 1998.

It is intended that a publicly traded partnership not be treated as ceasing to be an existing partnership solely by reason of a termination of the partnership (within the meaning of sec. 708) caused by the issuance or other sale or exchange of 50 percent or more of the partnership interests.

The bill also provides that the 90 percent requirement applies only in and after the first taxable year in which the partnership (or a predecessor) is a publicly traded partnership. Thus, for example, if a partnership is in existence starting January 1, 1988, and first becomes publicly traded in its taxable year beginning January 1, 1990, then the 90 percent test need be met only after January 1, 1990.

Natural resources. -- The bill clarifies the definition of income qualifying under the 90 percent requirement from certain activities with respect to a mineral or natural resource. For this purpose, a mineral or natural resource means any product of a character with respect to which a deduction for depletion is allowable under section 611, and also includes fertilizer. Such qualifying income does not include, for example, income from fishing, farming (including the cultivation of fruits or nuts), or from hydroelectric, solar, wind, or nuclear power production.

The reference in the bill to products for which a depletion deduction is allowed is intended only to identify the minerals or natural resources and not to identify what income from them is treated as qualifying income. Consequently, whether income is taken into account in

determining percentage depletion under section 613 does not necessarily determine whether such income is qualifying income under section 7704(d).

In the case of transportation activities with respect to oil and gas and products thereof, the Committee intends that, in general, income from bulk transportation of oil and gas and products thereof be treated as qualifying income. n111 Transportation of oil and gas and products thereof that would constitute a bulk transfer (within the meaning of section 4081), as well as bulk transportation of oil and gas and products thereof by rail car, is considered bulk transportation for this purpose.

> n111 Income from transportation and marketing of liquefied petroleum gas in trucks (as well as in railcars or by pipeline), however, may be treated as qualifying income. See Statement of Mr. Rostenkowski, 133 Cong. Rec. H 11,968 (December 21, 1987); see also Statement of Senator Bentsen, 133 Cong. Rec. S 18,651 (December 22, 1987) (substantially similar language).

With respect to marketing of minerals and natural resources (e.g., oil and gas and products thereof), the Committee intends that qualifying income be income from marketing at the level of exploration, development, processing or refining the mineral or natural resource. By contrast, income from marketing minerals and natural resources to end users at the retail level is not intended to be qualifying income. For example, income from retail marketing with respect to refined petroleum products (e.g., gas station operations) is not intended to be treated as qualifying income. n112

> n112 *Id.*

Real property rents. -- The bill provides a 5 percent de minimis rule for attribution of holdings to partnerships. This de minimis rule applies for purposes of determining whether amounts that would otherwise constitute real property rents (i.e., qualifying income) are not treated as qualifying income because the amounts are received or accrued from a person in which the partnership holds an interest of 10 percent or more (section 7704(d)(3) and 856(d)(2)(B)). Thus, for example, if a partner in a publicly traded partnership has less than a 5 percent interest in that partnership, his holdings in other entities or persons, from whom the partnership may receive rental income, are not attributed to the partnership, for purposes of determining whether the partnership owns a 10 percent or more interest in such other entity or person.

With respect to the definition of real property rents, it is clarified that non-application of the independent contractor rule (section 853(d)(2)(C)) does not affect the requirement that the nature of the income be rent. Thus, the fact that the independent contractor rule does not apply for purposes of determining the qualifying income of a partnership does not mean that amounts received by a partnership, which amounts include amounts for services that are not customarily furnished in connection with the rental of real property, constitute real property rents (section 856(d)(B)). For example, where the partnership receives or accrues amounts attributable to the performance of services that are not customarily furnished in connection with the rental of real property (e.g., to the extent that the furnishing of hotel or motel services causes amounts not to be treated as rents from real property, under present law), then the partnership is treated as not receiving qualifying income.

Present Law

Present law provides that net income and loss from **b. Treatment of publicly traded partnerships under the passive loss rules (sec. 204(g) of the bill, sec. 10212 of the Revenue Act, and sec. 469(k) of the Code)**each publicly traded partnership (that is not treated as a corporation for Federal tax purposes) is subject to separate application of the passive loss rules. Each partner in a publicly traded partnership treats his share of net income or loss from the partnership (other than portfolio income or loss from the partnership) as separate from the net income or loss from any other passive activity. Thus, a partner's share of non-portfolio income from the partnership cannot be offset by losses from other publicly traded partnerships or other passive activities; and a partner's share of losses from the partnership (other than losses described in sec. 469(e)(1) is suspended.

The legislative history to the 1987 Act provides that upon a complete disposition of the partner's entire interest in a publicly traded partnership, any remaining suspended losses are allowed. n113

n113 See H.R. Rpt. No. 100-495, Conference Report to Accompany H.R. 3545, Omnibus Budget Reconciliation Act of 1987 (100th Cong., 1st Sess.) at 951.

TECHNICAL AND MISCELLANEOUS REVENUE ACT OF 1988

October 21, 1988. -- Ordered to be printed

HOUSE OF REPRESENTATIVES; 100TH CONGRESS 2d SESSION; H.R. 4333; CONFERENCE REPORT 100-1104; Volume II of 2 Volumes

II. Technical Corrections to Other Tax Legislation

Revenue Act of 1987

Accounting item

The conference agreement follows the Senate amendment.

Partnership item

The conference agreement follows the Senate amendment; except that (1) soil, sod, turf, water, mosses and (2) minerals from sea water, the air, or similar inexhaustible sources, shall not be treated as a mineral or natural resource.

In addition, the conference agreement follows the legislative history of the House bill with respect to income from certain transportation activities, with certain modifications. In the case of transportation activities with respect to oil and gas and products thereof, the conferees intend that, in general, income from transportation of oil and gas and products thereof to a bulk distribution center such as a terminal or a refinery (whether by pipeline, truck, barge, or rail) be treated as qualifying income. Income from any transportation of oil or gas or products thereof by pipeline is treated as qualifying income. Except in the case of pipeline transport, however, transportation of oil or gas or products thereof to a place from which it is dispensed or sold to retail customers is generally not intended to be treated as qualifying income. Solely for this purpose, a retail customer does not include a person who acquires the oil or gas for refining or processing, or partially refined or processed products thereof for further refining or processing, nor does a retail customer include a utility providing power to customers. For example, income from transporting refined petroleum products by truck to retail customers is not qualifying income. n1

n1 Income from transportation and marketing of liquefied petroleum gas in trucks and rail cars or by pipeline, however, may be treated as qualifying income. See statement of Mr. Rostenkowski, 133 Cong. Rec. H 11968 (December 21, 1987); see also statement of Senator Bentsen, 133 Cong. Rec. S 18651 (December 22, 1987) (substantially similar language).

The conference agreement also clarifies that, in the case of income from marketing of fertilizer, bulk or truckload sales to farmers in amounts of 1 ton or more are not considered retail sales giving rise to non-qualifying income.
With respect to what constitutes the addition of a substantial new line of business, it is the intention of the conferees that the Treasury Department provide prompt guidance to taxpayers, whether through the private ruling process or through the promulgation of revenue rulings or other announcements or regulations.

TECHNICAL EXPLANATION OF H.R. 7060, THE "RENEWABLE ENERGY AND JOB CREATION TAX ACT OF 2008," AS SCHEDULED FOR CONSIDERATION BY THE HOUSE OF REPRESENTATIVES ON SEPTEMBER 25, 2008

September 25, 2008

[JOINT COMMITTEE PRINT]; H.R. 7060; JCX-75-08

INTRODUCTION

This document, n1 prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of H.R. 7060, the "Renewable Energy and Job Creation Tax Act of 2008" as scheduled for consideration by the House of Representatives on September 25, 2008.

n1 This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of H.R. 7060, the "Renewable Energy and Job Creation Tax Act of 2008," as Scheduled for Consideration by the House of Representatives on September 25, 2008* (JCX-75-08), September 25, 2008. This document can also be found on our website at www.jct.gov.

TITLE I

B. Transportation and Domestic Fuel Security Provisions

8. Certain income and gains relating to alcohol fuels and mixtures, biodiesel fuels and mixtures, and alternative fuels and mixtures treated as qualifying income for purposes of the exception from treatment of publicly traded partnerships as corporations (sec. 128 of the bill and sec. 7704 of the Code)

Present Law

Partnerships in general

A partnership generally is not treated as a taxable entity (except for certain publicly traded partnerships), but rather, is treated as a pass-through entity. Income earned by a partnership, whether distributed or not, is taxed to the partners. n44 The character of partnership items passes through to the partners, as if the items were realized directly by the partners. n45 For example, a partner's share of the partnership's dividend income is generally treated as dividend income in the hands of the partner.

n44 Section 701.

n45 Section 702.

Publicly traded partnerships

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes (sec. 7704(a)). For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market, or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income (sec. 7704(c)(2)). However, this exception does not apply to any partnership that would be described in section 851(a) if it were a domestic corporation, which includes a corporation registered under the Investment Company Act of 1940 as a management company or unit investment trust.

Qualifying income includes interest, dividends, and gains from the disposition of a capital asset (or of property described in section 1231(b)) that is held for the production of income that is qualifying income. Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber). It also includes income and gains from commodities (not described in section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) in the case of partnership, a principal activity of which is the buying and selling of such commodities, futures, options or forward contracts.

Explanation of Provision

The provision provides that qualifying income of a publicly traded partnership includes income or gains from the transportation or storage of certain fuels. Specifically, the fuels are: (1) any fuel described in subsection (b), (c), (d) or (e) of section 6426, namely, alcohol fuel mixtures, biodiesel mixtures, alternative fuels (which include liquefied petroleum gas, P Series Fuels, compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process, and liquid fuel derived from biomass), and alternative fuel mixtures; (2) neat alcohol other than alcohol derived from petroleum, natural gas, or coal, or having a proof of less than 190 (as defined in section 6426(b)(4)(A)), and (3) neat biodiesel (as defined in section 40A(d)(1)).

Effective Date

The provision applies to taxable years beginning after the date of enactment.