Tax Report #844

New York State Bar Association

One Elk Street, Albany, New York 12207 • 518/463-3200

TAX SECTION

1995-1996 Executive Committee

CAROLYN JOY LEE
Chair
Worldwide Plaza
825 Eighth Ave.
New York, NY 10019
212/903-8761
RICHARD L. REINHOLD
First Vice-Chair
212/701-3672
RICHARD O. LOENGARD, JR.
Second Vice-Chair
212/859-8260
STEVEN C. TODRYS
Secretary
212/715-9331

COMMITTEE CHAIRS:
Bankruptcy
Joel Scharfstein
Linda Z. Swartz
Basis, Gains & Losses
Stephen B. Land
Robert H. Scarborough
CLE and Pro Bono
Damian M. Hovancik
Deborah H. Schenk
Compliance, Practice & Procedure
Robert S. Fink
Arnold Y. Kapiloff
Consolidated Returns
Ann-Elizabeth Purintun
Dennis E. Ross
Corporations
Katherine M. Bristor
Deborah L. Paul
Cost Recovery
Geoffrey R.S. Brown
Elliot Pisem
Estates and Trusts
Carlyn S. McCaffrey
Georgiana J. Slade
Financial Instruments
David P. Hariton
Bruce Kayle
Financial Intermediaries
Richard C. Blake
Thomas A. Humphreys
Foreign Activities of U.S. Taxpayers
Reuven S. Avi-Yonah
Philip R. West
Individuals
Victor F. Keen
Sherry S. Kraus
Multistate Tax Issues
Robert E. Brown
Paul R. Comeau
Net Operating Losses
Stuart J. Goldring
Robert A. Jacobs
New York City Taxes
Robert J. Levinsohn
Robert Plautz
New York State Franchise and Income Taxes
James A. Locke
Arthur R. Rosen
New York State Sales and Misc.
Maria T. Jones
Joanne M. Wilson
Nonqualified Employee Benefits
Stuart N. Alperin
Kenneth C. Edgar, Jr.
Partnerships
Andrew N. Berg
William B. Brannan
Pass-Through Entities
Roger J. Baneman
Stephen L. Millman
Qualified Plans
Stephen T. Lindo
Loran T. Thompson
Real Property
Alan J. Tarr
Lary S. Wolf
Reorganizations
Patrick C. Gallagher
Mary Kate Wold
Tax Accounting
Erika W. Nijenhuis
Jodi J. Schwartz
Tax Exempt Bonds
Linda L. D'Onofrio
Patti T. Wu
Tax Exempt Entities
Michelle P. Scott
Jonathan A. Small
Tax Policy
David H. Brockway
Peter v.Z. Cobb
U.S. Activities of Foreign Taxpayers
Michael Hirschfeld
Charles M. Morgan, III

MEMBERS-AT-LARGE OF EXECUTIVE COMMITTEE:
M. Bernard Aidinoff
Dickson G. Brown
E. Parker Brown, II
Scott F. Cristman
Harold R. Handler
Walter Hellerstein
Sherwin Kamin
Charles I. Kingson
Richard M. Leder
Yaron Z. Reich
Stanley I. Rubenfeld
David R. Sicular
Esta E. Stecher
Eugene L. Vogel
David E. Watts

August 15, 1995

The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Margaret Richardson
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: **Proposed Regulations §1.7704-1 Defining "Publicly Traded" Partnership Interests**

Dear Secretary Samuels and Commissioner Richardson:

I am pleased to submit a report of the Tax Section's Committee on Pass-Through Entities commenting on recently proposed regulations under Code section 7704, which would define whether a partnership is publicly traded. The author of the report is Stephen L. Millman.

The principal recommendation of the report is that the regulations be revised so that a partnership will be treated as publicly traded only if the partnership itself is an active participant in the marketing of its interests. While the evaluation of a partnership's participation in the trading of its interests will not always be a straightforward exercise, we nevertheless believe that the entity must play some role in the marketing of its interests before it can be considered as publicly traded.

In addition to reorienting the definition of public trading to require active partnership participation, the report also recommends that each of the safe harbors for Unrecognized Transfers and Private Placements be broadened in certain respects.

FORMER CHAIRS OF SECTION:
Howard O. Colgan, Jr.
Charles L. Kades
Samuel Brodsky
Thomas C. Plowden-Wardlaw
Edwin M. Jones
Hon. Hugh R. Jones
Peter Miller
John W. Fager
John E. Morrissey, Jr.
Charles E. Heming
Richard H. Appert
Ralph O. Winger
Hewitt A. Conway
Martin D. Ginsburg
Peter L. Faber
Hon. Renato Beghe
Alfred D. Youngwood
Gordon D. Henderson
David Sachs
J. Roger Mentz
Willard B. Taylor
Richard J. Hiegel
Dale S. Collinson
Richard G. Cohen
Donald Schapiro
Herbert L. Camp
William L. Burke
Arthur A. Feder
James M. Peaslee
John A. Corry
Peter C. Canellos
Michael L. Schler

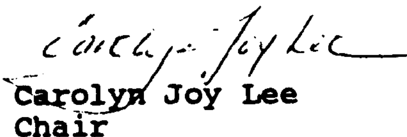
Workable safe harbors are particularly important in the publicly traded partnership context, for the income tax difference between partnership and corporate classification is so dramatic that businesses cannot tolerate any material uncertainty. The safe harbors of the proposed regulations, while premised on reasonable considerations, nevertheless include limitations that undermine their usefulness. The report therefore recommends a number of modifications to the safe harbors.

The report also comments on the need for guidance for existing partnerships, in particular those which satisfied the safe harbor of Notice 88-75, but would fail to satisfy any different safe harbor included in new regulations. In many cases it will not be possible to amend existing partnership agreements to conform to new safe harbor definitions. We therefore believe such existing partnerships should be "grandfathered" and continue to be protected by the rules articulated in Notice 88-75.

Finally, we urge that the proposed section 7704 regulations be considered in light of the overhaul of the partnership classification system proposed in Notice 95-14. If partnership classification becomes a matter of electing, rather than satisfying the four-factor test of the current regulations, then the definition of public trading will take on considerably more significance as the only substantive barrier to partnership status. Furthermore, given that Notice 95-14 stemmed in large part from concerns about the inefficiencies of the current classification system, care should be taken to avoid defining publicly traded partnerships in an unnecessarily broad fashion, for that could simply result in many partnerships having to substitute a detailed section 7704 analysis for the current four-factor analysis.

Thank you for this opportunity to comment.

Very truly yours,



Carolyn Joy Lee
Chair

Tax Report # 844

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON PROPOSED REGULATIONS DEFINING PUBLICLY-TRADED PARTNERSHIPS

TABLE OF CONTENTS

I. **OVERVIEW OF THE PROPOSED REGULATIONS** 1
- A. Context 1
- B. Proposed Regulations 2
  - 1. Definition of Publicly-Traded 2
  - 2. Safe Harbors 5

II. **SUMMARY OF RECOMMENDATIONS** 6
- A. Absence of Partnership Control 6
- B. Principal Recommendations 8

III. **PRINCIPAL COMMENTS** 9
- A. Definition of "Interests" 9
  - 1. Interests Which Are Not Rights Against the Partnership 9
- B. Definition of an Established Securities Market 11
  - 1. Listing Requests 11
  - 2. Definition of Firm Quotations 13
- C. Readily Tradable on a Secondary Market 13
  - 1. In General 13
  - 2. Specific Definitions 15
    - a. "Regularly Quoted" 15
    - b. "Makes Available Bid or Offer Quotes" 15
- D. Substantial Equivalent Test 15
- E. The Unrecognized Transfer Exception 17
- F. The Private Placement Safe Harbor 20
- G. Treatment of Existing Partnerships 23

IV. **TECHNICAL COMMENTS** 24
- A. General Partners; Derivative Interests 24
- B. Block Transfers 25
- C. Effect of Becoming a Publicly Traded Partnership 25

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Proposed Regulations Defining Publicly-Traded Partnerships[1]

I. OVERVIEW OF THE PROPOSED REGULATIONS

A. Context.

In 1987, Congress, concerned about the trend of corporations to "disincorporate" by transferring their assets to partnerships, enacted section 7704. Section 7704 generally requires a partnership in which interests are "publicly-traded" to be taxed as a corporation. Interests are publicly-traded if they are "traded on an established securities markets" or are "readily tradable" on a "secondary market (or the substantial equivalent thereof)."

The statute exempted existing partnerships for ten years and also exempts most partnerships whose income consists predominantly of specified types of passive income.

In mid-1988, the Internal Revenue Service issued Notice 88-75 (1988-2 C.B. 386), describing a group of safe harbors that would prevent a partnership from being classified as a publicly-traded partnership. The principal safe harbors of Notice 88-75 related to private placements, interests with limited small-size trades, "matching" services and partnership redemptions.

---

[1] This report was prepared by Stephen L. Millman, Co-Chair of the Committee on Pass-Through Entities. Helpful comments were received from Carolyn Joy Lee, Michael L. Schler, Patrick C. Gallagher, James M. Peaslee, Stephen B. Land, Andrew N. Berg, Linda Zan Swartz and Donald Schapiro.

B. Proposed Regulations.

On May 2, 1995, the Treasury Department (hereafter, collectively with the I.R.S., "Treasury"), proposed Regulations §1.7704-1 (the "Proposed Regulations") that would define when a partnership is publicly traded. The Proposed Regulations do not deal with the determination of whether a partnership is exempt from section 7704 either under the grandfathering rule or the passive income rule, nor do they cover any of the ancillary consequences resulting from a determination that a partnership is publicly traded.

1. Definition of Publicly-Traded.

The Proposed Regulations define each of the critical terms of the statute: an "interest" in a partnership, an "established securities market," "readily tradable on a secondary market" and "readily tradable on the substantial equivalent of a secondary market." The Proposed Regulations then provide some safe harbors and special rules.

The basic premise of the Proposed Regulations is that a partnership not exempted under section 7704(c) in which "interests" are publicly traded, as defined in the Proposed Regulation, is a publicly traded partnership. The definition of an interest is, however, much more expansive than the definition of who is a partner under Subchapter K or even the much broader definition of sections 6621-6631: any interest in the capital or profits of a partnership and any financial instrument or contract whose value is determined "in whole or in part by reference to the partnership," other than "nonconvertible debt," is an interest in the partnership,[2]

---

[2] Prop. Reg. §1.7704-1(a)(2). This definition apparently is not exhaustive -- the operative language only states that a "interest" in a partnership "includes" these items. In this context, the regulations should provide a comprehensive definition. If need be, a phrase such as "and similar interests" could be added to the present language of Prop. Reg. §1.7704-1(a)(2).

The definition of an established securities market covers U.S. securities exchanges registered under the Securities Exchange Act of 1933, analogous foreign securities exchanges and an "interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers".[3]

There is no definition of a secondary market; instead interests are defined to be "readily tradable on a secondary market" if either there are regular quotes by a person "making a market" in the interests, or any person "regularly makes available to the public (including customers or subscribers) bid or offer quotes" as to which it "stands ready" to effect buy or sell transactions "for itself or on behalf of others."[4] Finally, interests are "readily tradable on the substantial equivalent of a secondary market" if a holder of an interest has a readily available, regular and ongoing opportunity to sell through a public means of obtaining or providing information on offers, or prospective buyers and sellers otherwise have the opportunity to buy, sell or exchange "with the regularity and continuity that the existence of a secondary market would provide."[5]

Interests are not readily tradable under the "substantial equivalent" test unless actual transfers in a year, after excluding certain transfers, exceed 2% of partnership interests.[6] The principal categories of excluded transfers are:

---

[3] Prop. Reg. §1.7704-1(b).

[4] Prop. Reg. §1.7704-1(c)(2).

[5] Prop. Reg. §1.7704-1(c)(3).

[6] Prop. Reg. §1.7704-1(h).

(1) Issuance of interests by (or on behalf of) the partnership for cash, property or services;[7]

(2) A transfer or group of transfers by a single "partner" of more than 2% of the total interests in partnership capital or profits ("Block Transfers");[8]

(3) Substituted basis transfers;[9]

(4) Transfers among family members and transfers at death;[10]

(5) Transfers from a qualified retirement plan;[11]

(6) Transfers by a group of partners of more than 50% of the capital and profits of the partnership in one transaction or a series of related transactions;[12]

7/ Prop. Reg. §1.7704-1(d)(iv).

8/ Prop. Reg. §1.7704-1(d)(1)(vi) and (d)(2). In light of the fact that the definition of an "interest" in a partnership covers economic rights owned by persons who are not "partners," presumably the use of the word partner in this context is an error and a Block Transfer should include a greater than 2% sale of an interest by any "person".

9/ Prop. Reg. §1.7704-1(d)(1)(i).

10/ Prop. Reg. §1.7704-1(d)(1)(iii) and (ii).

11/ Prop. Reg. §1.7704-1(d)(1)(v).

12/ Prop. Reg. §1.7704-1(d)(1)(ix). Presumably, the reference to "partners" here should be to "persons".

(7) Transfers pursuant to certain redemption or repurchase agreements designed to deal with death, disability or incompetence or designed to deal with termination of or resignation by a service partner[13] and certain closed-end redemption plans;[14] and

(8) Transfers through a qualified matching service.[15]

2. Safe Harbors.

The Proposed Regulations provide two rules that are intended to provide a partnership with the ability to avoid becoming publicly traded, one relating to partnerships which provide for limited transferability and one relating to private placements.

Proposed Regulation section 1.7704-1(a)(4) provides a rule, referred to in this report as the "Unrecognized Transfer" rule, that for all purposes of section 7704 and the proposed regulation, a transfer is not "taken into account" if the transferee is not admitted as a partner, the partnership does not redeem or repurchase the interest and the partnership does not otherwise "recognize any rights of the transferee" such as a right to partnership distributions or the right of the transferee to acquire an interest in the capital or profits of the partnership.

The "Private Placement" safe harbor exempts from the definition of "readily tradable on the substantial equivalent of a secondary market" interests in a partnership if (i) all of the interests in the partnership were issued in transactions not required to be registered under the Securities Act of 1933, and (ii) there are no more than 500 units, or the initial offering price of each interest is at

---

[13] Prop. Reg. §1.7704-1(d)(1)(vii) and (d)(3); certain other redemption plans are excluded by Prop. Reg. §1.7704-1(e).

[14] Prop. Reg. §1.7704-1(d)(1)(viii) and (d)(4).

[15] Prop. Reg. §1.7704-1(f).

least $20,000 and the partnership agreement forbids subdivision of the interests on resale, but (ii) if the partnership has at least 50 partners, the safe harbor is applicable only if actual trading (other than excluded transfers) does not exceed 10% of capital or profits.[16]

II. SUMMARY OF RECOMMENDATIONS

A. Issues Presented by the Proposed Regulations.

Our principal concern is that the proposals can make it very difficult for a partnership to be certain that it will not become a publicly traded partnership. Although the preamble to the proposed regulations indicates Treasury's interest in "preventing a partnership from becoming publicly traded without the knowledge or participation of the partnership," the Proposed Regulations in fact create numerous circumstances in which a partnership can become publicly traded without the knowledge or participation of the partnership. Nor do the safe harbors provide adequate protection. To the extent that the Proposed Regulations do attempt to protect a partnership that wishes to be certain that it will not become a publicly traded partnership, the protections are almost all directed at limiting transferability, and do so to a degree and in a manner which, in our view, is beyond either the appropriate reach of the statute or the needs of Treasury in seeking enforceable rules.[17]

---

[16] Prop. Reg. §1.7704-1(g).

[17] The Conference Report accompanying the 1987 legislation states that "[t]he 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." H.R. Rep. No. 495, 100th Cong., 1st Sess. 949 (1987). The Report then provides several examples of a partnership's participation (or lack thereof) in transfers of partnership interests. We think the quoted sentence reflects a sound policy judgment. We disagree, however, with the Conference Report's conclusion that a partnership participates in public trading whenever its interests are freely transferable. As noted herein, free transferability is not the same as public

Concerns about the breadth of the public trading definition arise not only in the context of entities that are knowingly formed as partnerships. There are also numerous entities whose tax classification is uncertain. For example, it is common to securitize various types of debt or receivables through the issuance of forms of collateralized obligations by an entity designated as a trust. Although it is generally believed that these entities are properly classified for tax purposes as trusts, the issue is sufficiently uncertain that such vehicles often are designed to qualify, in the alternative, as partnerships, with the debt obligations issued by the entity potentially being considered partnership interests. The practical differences to the holders of the obligations between trust and partnership classification were generally thought to be modest. However, if the consequence of partnership classification under section 7701 is taxation as a corporation under the publicly traded partnership rules, the differences between trust and partnership classification would be very great. Since the absence of predictability in this area can make these products unmarketable, the interpretation of section 7704 is also of great significance to taxpayers investing in these products.

---

trading. We do not believe that the free transferability of partnership interests under the governing documents is sufficient reason to treat a partnership in which, for example, third parties have undertaken trading activities without the cooperation of the partnership, as publicly traded.

We agree, as discussed *infra*, that in some circumstances implicit complicity exists and should be taken into account. For example, where public trading is anticipated from the outset, such as where the underwriter for an offering of interests makes a market from the completion of the offering, we have recommended that the partnership interest generally be treated as publicly traded. However, we have also recommended that in other contexts where the partnership has taken no explicit steps to cause its interests to be publicly traded and public trading is not initially anticipated, and where the partnership refrains from taking steps to cooperate with unanticipated trading, the absence of partnership agreement limitations on transfers should not be fatal.

It also is important to evaluate the impact of the Proposed section 7704 Regulations in light of the overhaul of the entity classification system recently proposed in Notice 95-14. That Notice proposed to simplify and streamline the analysis of partnership-versus-association by permitting entities to elect their classification. This proposal was based in significant part on Treasury's concerns (with which we concur) that an inordinate amount of energy has been devoted, by both taxpayers and the government, to highly formalistic and, in the end, elective analyses of classification. In a separate report we commend Treasury for the initiative reflected by its Notice 95-14. The changes contemplated in Notice 94-14 should, however, be coordinated with regulations promulgated under section 7704, both because of the increased importance that Section will have if classification is otherwise elective, and because the efficiencies achieved by an elective partnership classification system could be eroded if the regulations include broad definitions of publicly traded partnerships that are difficult to satisfy in practice.

B. Principal Recommendations.

The interpretation of the publicly traded partnership rules is an area of the tax law in which there is a great need for certainty and predictability, for the difference between partnership and corporate tax status is so dramatic that prudent business persons cannot accept any material degree of risk as to the outcome. We do not believe that either the Unrecognized Transfer rule or the Private Placement safe harbor is sufficiently broad to provide businesses with the needed level of certainty and predictability that they qualify as partnerships. We recommend broadening both rules.

We also believe, however, that liberalizing such rules is not sufficient, in itself, to provide the required degree of certainty and protection. We further recommend, therefore, that the definitions of "interest" in a partnership, and of trading on an established securities market, a

secondary market, or the substantial equivalent thereof, be revised so that they apply only in circumstances where the partnership itself is an active participant in the marketing of partnership interests. While we recognize that qualitative measurement of a partnership's participation in the marketing of its interests can be a difficult exercise in some circumstances, we nevertheless believe that active participation by the entity is a crucial factor in determining whether the entity's interests are publicly traded, and must be present before any entity can be considered publicly traded.

In a similar vein, we recommend that where the existence of a secondary market was not anticipated when interests in a partnership were issued but later comes into existence, interests should not be considered publicly traded if the partnership takes steps to avoid cooperating with such marketing. The report also suggests that the volume limit for the "substantial equivalent" test should be set at a higher level, and that a minimum number of holders should also be required before an entity can be considered publicly traded.

Finally, we are greatly concerned about the effect of the proposed regulations on existing entities. Existing partnerships that would not be publicly traded under the safe harbors in Notice 88-75, but would be considered publicly traded under the proposed regulations, should continue to be protected by the rules of Notice 88-75.

III. PRINCIPAL COMMENTS

A. Definition of "Interests".

1. Interests Which Are Not Rights Against the Partnership.

The definition of an "interest" in a partnership for the purpose of determining whether a partnership should be treated as "publicly-traded" is not, under the Proposed Regulations, limited

to interests that represent rights in the partnership, nor does it depend on actions taken or not taken by the partnership. This is a cause for considerable concern. Consider an admittedly extreme example:

> Example 1. Individual A and Company B form limited partnership AB with A as the sole, 1%, general partner and B as the sole limited partner. The partnership agreement bars any transfers of partnership interests and treats any purported transfer of interests or rights to capital and distributions as void. Partnership AB represents a very substantial portion of the value of Company B's holdings and as a result, Company B, a reporting company under the securities acts, reports its share of the annual profits of AB publicly. Company B itself has a substantial risk of future liability as a result of its other business.
>
> C, an investment bank unrelated to A or B, determines that there is a greater public market interest in B's interest in AB than in Company B itself and sells a large number of financial contracts obligating C to pay amounts proportional to the distributions made by AB from time to time. C publicly quotes on a daily basis prices at which it stands ready to buy or sell these instruments.

Under the Proposed Regulations, the acts of C have made AB a publicly-traded partnership, because the financial contracts are "interests" C created and are considered readily tradable on a secondary market. As discussed more fully below, it appears that neither the Unrecognized Transfer rule nor the Private Placement safe harbor apply. The Private Placement safe harbor refers only to the determination of whether an interest is "publicly tradable on the substantial equivalent of a secondary market," and does not provide an exemption from the definition of secondary market trading. Similarly, the Unrecognized Transfer rule does not tie into the definition of secondary market trading,

and seems technically to relate only to the "lack of actual trading" rule, which is an exception only for purposes of the determination of trading on the substantial equivalent of a secondary market.[18]

The broad definition of "interest" can also be a problem where a single partner acts, without the cooperation of the partnership, to create financial instruments that fall within the definition of an "interest." Consider the following example:

> Example 2. D, E and F form partnership DEF as an equal limited partnership. Each is a 1/3 partner; D is the sole general partner. The partnership agreement bars transfers of any interest in the partnership and will not recognize a purported transfer of an interest in capital and profits. F holds its interest in DEF through a trust. The partnership issues publicly traded bonds and, as a result, is required to make securities filings. Some years after the partnership's formation and the bond offerings, F offers proportional interests in the trust to the public. The trust agreement is modified so that the trustee will pay to the holders of the fractional interests the appropriate share of any distributions received by the trust. The fractional interests in the trust are listed on an established securities exchange.

The interests in the trusts are "interests" in the partnership for purposes of the Proposed Regulations; and none of the proposed exemptions is applicable to exchange trading. Consequently, F's actions appear to convert DEF to a corporation.

We do not think that either of these examples should be viewed as public trading of the partnership so as to cause the partnership to be taxed as a corporation.[19] We believe that

---

[18] We hope, however, that consistent with the legislative history, the Unrecognized Transfer rule will be extended to cover secondary market trading as well. The mechanics of such an extension are not trivial, however, as noted later in the report.

[19] There is, clearly, a related issue of whether the trust in Example 2 should itself be treated as a partnership for purposes of determining whether interests in the trust are publicly traded or, in the alternative, should be classified as a corporation. We believe that, rather than treating DEF as a corporation based on the trading in interests in F, the appropriate level at which to address the problem this example illustrates is the classification of F. We also recognize that

"interests" in a partnership generally should not include rights created by persons other than the partnership unless the partnership actively cooperates in the creation or marketing of such instrument. "Active cooperation" would be indicated, for example, by the partnership taking otherwise unnecessary steps to make the financial results on which the instrument depends readily available to the public. Where the partnership takes no such steps, rights created by third parties should not be treated as "interests.".

B. Definition of an Established Securities Market.

1. Listing Requests.

Normally, interests are only traded on a securities market by being listed at the behest of the issuer. This is true, for example, of the various stock exchanges, and of the NASDAQ system, all of which list instruments with the participation of the issuer. The definition of a "established securities market" in the regulations is somewhat broader than this, however. It includes any interdealer quotation system disseminating firm quotations by identified brokers or dealers.[20] We are concerned that this definition includes not only NASDAQ but also other "markets" in which the issuer does not participate in the listing.

Another interdealer quotation mechanism in current use, for example, is the so-called "pink sheets" quoting bid and ask prices of various dealers for various equities. Unlike NASDAQ or a securities exchange, this is a dealer-generated list: many of the items on it are not listed on any

---

the creation of derivative instruments relating to partnership interests gives rise to a number of substantive tax issues, but we do not believe that the tax issues created by such derivatives are an appropriate basis for treating trading in derivatives as giving rise to an entity-level tax on partnerships.

[20] Prop. Reg. §1.7704-1(b)(5).

securities exchange and the issuer has not taken any steps to have the interest quoted in the pink sheets. We believe that the pink sheets as currently in use would not, if extended to interests in a partnership, constitute firm offers and thus would not fall within Proposed Regulation section 1.7704-1(b)(5). We also believe, however, that the basic definition of a securities market should be restricted to markets in which the issuer requests or otherwise participates in the listing, to avoid the possibility that dealer-generated quotations could result in a partnership being considered, without its involvement, to have become publicly traded.

We, therefore, recommend that the definition of "established securities market" be limited to interdealer systems in which the partnership plays an active role in being placed on the list of quoted interests. We would suggest that where the partnership does not originate the listing, it should nonetheless be treated as having an active role if it actively cooperates in the listing or in disseminating information that makes the listing meaningful.

2. Definition of Firm Quotations.

The definition of an interdealer system that constitutes a securities market also requires that the quotations be "firm." This contrasts with the definition of secondary market which speaks of a person who "makes a market" or "stands ready" to effect transactions. The meaning of a firm quote needs further elucidation. In context, this should be more than making a market but less than a legal obligation to buy or sell. We would suggest that, in line with the actual rules of securities exchanges, offers which would indicate the existence of a securities market should be those for which the entity which regulates the purported market will impose penalties if the offeror habitually declines to carry out trades on the quoted terms.

C. Readily Tradable on a Secondary Market.

1. In General.

The definition of readily tradable on a secondary market suffers the same deficiency as that of established securities markets in not requiring any activity by the partnership. Unlike the definition of a securities market, however, the archetypes of a secondary market do not normally require action by the issuer:

> Example. U, an underwriter, wants to raise capital for partnership P by means of a public offering of new partnership units. The units will not be listed on a securities exchange or on NASDAQ, because the offering does not meet the listing rules of these institutions. The prospectus, however, indicates that U anticipates making a market in the partnership units, although there can be no assurance that U will continue to do so.

Public offerings on these terms are very common. And in this example, although P itself may not be doing anything directly to create a market in its partnership units, the expectation that an underwriter will make a market in a stock gives the initial buyers some comfort as to liquidity and thus expands the group of people willing to invest in the units P is issuing. We agree with the position of the Proposed Regulations insofar as it would treat the partnership in these types of circumstances as publicly traded. Where a partnership issued interests with the expectation that the underwriter will make a market or otherwise facilitate trading in the interests issued, the partnership's involvement in the trading is sufficient that it should be a publicly traded partnership.

However, the scope of the proposed definition is broader than this. It is possible that, subsequent to a partnership's issuance of interests a broker may decide that there is enough public interest in the existing partnership to make a market in it, without any other involvement by the partnership. The regulations should provide a mechanism for a partnership to avoid becoming a publicly traded partnership as a result of some development in which the partnership does not

participate. We suggest that where a partnership does not issue interests with the expectation that a secondary market will exist in such interests, the interests should not be treated as publicly-traded, even if trading on a secondary (or equivalent) market subsequently develops, unless the partnership actively cooperates in the quotation or marketing. Examples of such cooperation might include providing financial data to analysts, approving transfers on a regular basis (if the partnership agreement gives the partnership the power to reject transfers), and disseminating financial data to the public.

2. Specific Definitions.

Several critical phrases determining whether interests are readily tradable on a secondary market are sufficiently unclear as to be troublesome. Taken as a whole the lack of clarity rises to a significant issue because the cumulative impact of the vagueness of these terms makes it difficult to compare them with actual situations.

a. "Regularly Quoted".

As used in Proposed Regulation section 1.7704-1(c)(2)(i), a secondary market exists if interests are "regularly quoted" by a person making a market in the interests. Does "regularly quoted" mean something more than that such person will normally quote a price if asked? If that is all the phrase means, it is not clear what it adds to the statement that the person is "making a market."

b. "Makes Available Bid or Offer Quotes".

The alternative definition in Proposed Regulation section 1.7704-1(c)(2)(ii) uses the phrase "regularly makes available to the public (including customers or subscribers)" as the standard for availability of quotes. Presumably this means something more than that the person will provide

a quote if asked, but it would be helpful to clarify that this refers, for example, to dissemination of quotes through print or electronic means.

D. Substantial Equivalent Test.

The basic definition in Proposed Regulation section 1.7704-1(c)(3) of "readily tradable on the substantial equivalent of a secondary market" is quite broad. Mirroring the legislative history, the proposed regulation attempts to cover mechanisms which provide the practical equivalent of having a secondary market.[21/] We agree with the general thrust of these definitions.

The substantial equivalent test has, however, a second part: the occurrence of a sufficiently large volume of transfers. In concept this is a useful limitation, However, the threshold -- in this instance, qualifying transfers of partnership interests must aggregate more than 2% of total capital and profits interests in a year -- is quite low.[22/] A single transfer of more than 2% is excluded as a "Block Transfer," but this still means that a partnership can be treated as publicly traded with as few as two transfers.

> Example. Partnership X has two classes of partners. The general partner holds 1% of the partnership interests. The "Corporate Limited Partner" holds 79% of the partnership interests and 10 individuals each hold a 2% interest in the partnership as "Individual Limited Partners."
>
> The partnership agreement provides that the partnership will redeem the interest of any Individual Limited Partner at a price based on a

---

21/ The language of Proposed Regulation section 1.7704-1(c)(3)(i), unlike that of Proposed Regulation section 1.7704-1(c)(3)(ii), could be read as extending even to instances where the opportunity to sell or exchange interests was substantially less than that provided by a secondary market. We do not believe that a substantially more limited opportunity to sell or exchange is "substantially" equivalent.

22/ Proposed Regulation section 1.7704-1(h).

formula computed from the earnings of the partnership for the six previous quarters, at any time on ten days notice.

The redemption plan does not meet the rules of Proposed Regulation section 1.7704-1(e).[23] Accordingly, the redemptions are not disregarded in testing for public trading. If two redemptions occur in a year, the partnership will exceed the 2% test of Proposed Regulation section 1.7704-1(h), and may be treated as a publicly-traded partnership.

We do not believe that, whatever the level of information and opportunity, a partnership with only two transfers in a year should be treated as publicly traded. In general, we believe that where neither an established securities market nor a secondary market exists for interests in a partnership, the standard for when the "substantial equivalent" of a secondary market exists should be set so that activities which fall within it clearly demonstrate the level of trading that the phrase "publicly traded" implies.

We think that this means, first, that there must exist a relatively large number of interests, and second, there must be a significant number of trades. While we do not wish to propose specific values for these two numbers, we understand that realistic minimums for a market maker are probably of the magnitude of several hundred holders of interests and several tens of trades. It may be appropriate for Treasury to select values somewhat below the minimum realistic values in order to prevent manipulation, but we do not think that the proposed rule, which in effect can be met with as little as three holders of interests and two actual trades, accurately defines public trading.

E. The Unrecognized Transfer Exception.

---

[23] One of the rules of Proposed Regulation section 1.7704-1(e) is that an excluded redemption plan must require 60 days notice of a redemption.

The Proposed Regulations offer a partnership some ability to protect itself against becoming publicly traded. Under the Unrecognized Transfer rule, a transfer does not count for purposes of the regulations if the partnership does not admit the partner, redeem or repurchase the interest, or otherwise recognize the transfer. This rule might provide automatic protection, for example, against financial instruments not issued by the partnership being treated as caught by the "substantial equivalent" test because, after applying the Unrecognized Transfer rule, no transfers would have occurred, and the "lack of trading" exception could then apply. If a partnership agreement gives the general partner the power to refuse to recognize transfers, the Unrecognized Transfer rule can also provide some protection against any actual interest in the partnership being treated as tradable on the "substantial equivalent" of a secondary market.

The rule as drafted does not, however, provide any protection against a partnership becoming publicly traded by virtue of the existence of an actual securities market or a secondary market, since no "transfers" are needed in those cases. Furthermore, if recognized transfers aggregate more than 2%, it is not clear that unrecognized transfers would be disregarded in testing whether trading on a substantial equivalent of a secondary market had taken place.

We believe a more appropriate articulation of an Unrecognized Transfer would be that unrecognized transfers are not taken into account in determining trading activity. Thus, the rule should be extended to apply to established securities markets and secondary markets, as well as the "substantial equivalent" markets. In addition, some elaboration should be provided as to whether there are any circumstances in which a partnership would be considered to recognize derivative interests created by third parties.

We also believe that the relevant issue is whether the partnership actually chooses not to recognize certain transfers, and not what the partnership agreement permits. A partnership agreement which merely provides a general partner the power to deny recognition of transfers should not automatically exempt a partnership from the publicly traded partnership rules, for the partnership might make it clear to potential buyers that it will customarily recognize transfers. Indeed, most partnerships already listed on a securities exchange provide that a general partner can refuse to recognize a transfer if it determines that the transfer may affect the taxation of the partnership.[24] This power to refuse to recognize transfers is not significant where the pattern of partnership decisions has been to recognize transfers. A better choice is to treat a partnership which has provision for not recognizing transfers as protected in the case its interests come to be traded unless the partnership provides notice or establishes a pattern of behavior indicating that it will generally recognize transfers in that market.

Even with such changes, we do not feel that a broader Unrecognized Transfer rule is, of itself, a cure for the other infirmities of the Proposed Regulation. In the first place, neither the "listed on an established securities exchange" nor the "readily tradeable on a secondary market" rule requires actual trading. Hence, it may be necessary to determine the application of a broadened Unrecognized Transfer rule at a time when the restrictions in the partnership agreement have never had occasion to be enforced. Second, partnerships often have good business reasons for recognizing partnership interest transfers, and the fact of recognition does not necessarily imply complicity in

[24] The most common clause allows the general partner not to recognize transfers that would cause the partnership to be terminated under the rule of §708(b) as a result of more than 50% of the partnership being transferred within one year.

public trading. There also are legitimate reasons why a partnership may want some or all of its interests to be freely transferable. Free transferability is generally only one factor in classification, and free transferability is not the same as public trading. In addition, under the Service's proposal to change classification of entities to a check the box standard, there may be types of entities which can elect to be taxed as a partnership but which cannot under local law impose a nonrecognition rule in the governing agreement. It will therefore not be practical or possible for partnerships to avoid public trading simply by prohibiting all transfers, or refusing to recognize transfers. We believe that even a partnership in which transfers are generally recognized, or interests are freely transferable, should be able to avoid becoming a publicly traded partnership if the partnership does not participate in activities that otherwise facilitate public trading. Accordingly, while we believe changes in the Unrecognized Transfer rule are necessary, we do not believe they are sufficient.

F. The Private Placement Safe Harbor.

The private placement safe harbor of the Proposed Regulations adds to the safe harbor of Notice 88-75 a volume limit on actual trades. The Private Placement safe harbor exempts from the reach of the "substantially equivalent" test, interests in a partnership if all the interests in the partnership were issued in transactions exempt from registration under the Securities Act of 1933 and either the partnership has no more than 500 partners or the initial offering price of each unit is at least $20,000 and the partnership agreement bars subdivision of the units upon resale. This aspect of the safe harbor is the same as Notice 88-75, and is generally consistent with the safe harbor recommended in our report dated June 17, 1988. The Proposed Regulations impose a further limitation, however, under which, if the partnership has at least 50 partners, the exception only applies if aggregate transfers in each year, other than excluded trades, represent no more than 10% of capital or profits.

We believe that the basic rule of Notice 88-75 safe harbor that either the partnership have no more than 500 partners or its units be issued in divisible denominations no smaller than $20,000 provides adequate assurance that interest will not be publicly traded. We feel that if the maximum number of holders is small enough, the requisite degree of liquidity is not present. Similarly, we think it extremely unlikely that there could be public trading in instruments in which the minimum unit of investment is $20,000. We note that there are some private placements at unit prices of more than $20,000 in which a secondary market may exist in the sense that the initial sponsor agrees to participate in some fashion in providing liquidity for the interests.[25/] We nonetheless feel that such offerings should not be treated as publicly traded, for the size of the required investment is such that it seems unlikely the partners are readily able to sell their interests in a manner comparable to trading on established markets.

We recognize that the scope of public placement exemptions under the securities laws has widened somewhat since 1988, but we continue to believe that the limitations contained in the original safe harbor are sufficient protection against public trading. We, therefore, urge that the 10% volume restriction be removed.

One further comment should be made about the definition of a private placement. The proposal applies to all issuances which are exempt from the 1933 Securities Act, regardless of why the issuance is exempt. Thus, for example, most foreign partnerships in which units are not marketed in the United States (and indeed any U.S. partnership if the units are only marketed overseas in

---

25/ For example, the sponsors often provide such services for collateralized pass-through trusts used to "securitize" a company's receivables. In many instances the resulting entity is exempt from section 7704 even if classified as a partnership, because its income consists wholly of interest income (provided the entity would not be classified as a RIC if incorporated).

conformity with Regulation S) are entitled to the benefit of this safe harbor. This is so regardless of the characteristics of the offering or the investors. We do not think that this is the appropriate in the context of a private placement exemption. We think that the focus should be on offerings which are (or, if otherwise subject to the Securities Act of 1933, would be) exempt by virtue of the so-called private placement exemption of Regulation D or similar exemptions designed to limited the number of unsophisticated or small investors.

An argument could be made that a partnership whose interests are issued in a private placement should never be treated as publicly traded unless the interests are subsequently registered. The liquidity needed for public trading implies a great of deal of information being publicly available. Such information is normally available for registered securities and normally is not for securities not subject to either the U.S. registration rules or the corresponding rules of a foreign jurisdiction. We accept, however, that the ongoing information available for some privately placed offerings may be sufficiently comparable to that available for registered entities to create similar liquidity. As a result, it is appropriate for the Service to determine that a blanket exemption of private placements should not be available. However, we believe, first, that an exemption should be available which applies even to situations where a broker or dealer makes a market in the interests, and second, that the volume limitation is not appropriate.

G. Treatment of Existing Partnerships.

If retained, the addition of the volume restriction to the Private Placement safe-harbor is the most glaring of several instances in which the proposed rules are more restrictive than Notice 88-75. An attempt to comply with many of the changes that the Proposed Regulations would make to the Notice would require amendment of most existing partnership agreements. In many instances,

such an amendment would be impractical or impossible. The proposed regulations do not provide any grandfathering exception.

We believe that existing partnerships that relied upon rules of Notice 88-75 should continue to be protected, and that subjecting such partnerships to new rules under the Proposed Regulations is an unjustifiable hardship. We, therefore, believe that, to the extent the regulations impose greater restrictions than set forth in the Notice, existing partnerships should be given some grandfathering relief. It may be appropriate, however, to limit such protection to situations where the partnership does not issue new interests after the date the regulations were first proposed, and does not thereafter take on a new line of business or otherwise make a material change in its operations.

IV. TECHNICAL COMMENTS

A. General Partners; Derivative Interests.

The Proposed Regulations contain one minor rule treating interests as a general partner differently from limited partnership interests. Proposed Regulation section 1.7704-1(j) excludes from the calculation of the total partnership interests, the interest of general partners (and of related limited partners) if they hold less than 10% of the capital or profits interests in the partnership. As a technical matter the rule appears, however, to exclude the ownership of a general partnership interest, or of a limited partnership interest held by a person related to the general partner, from the denominator of the fraction used in computing the percentage of interest transferred, while nothing seems to preclude such interests from being included in the numerator as interests transferred. We believe that in computing the percentage of the total interests in a partnership that have been

traded during a period, the "total interests" in the partnership should always include all the interests in the partnership. The fact that some interests are owned or controlled by the general partner does not mean it is appropriate to test the volume of trading by reference only to the other interests in the partnership.

We are troubled, however, by the suggestion that general partner interests can in fact be publicly traded. Assuming that for this purpose a general partner means a partner who is liable jointly and severally for the debts of the partnership, it is hard to imagine such an interest being sufficiently liquid as to qualify as publicly traded.

We also note that, if "interest" continues to be defined to include derivatives in which the partnership has not participated, and without further elucidation of what it means for a partnership to recognize such interests, it will be very difficult for the partnership to know, from time to time, the total number of interests in profits or capital, or the amount of the interests transferred.

B. Block Transfers.

The definition of a block transfer in the proposed regulations is limited to a transfer or series of transfers within 30 days by a single person. We think this is an unrealistically narrow definition. It is not uncommon for several affiliated investors to invest in a single partnership. The investors may be family members, related entities, or persons with the same financial adviser. In such cases, where the interests in a partnership are relatively illiquid, the entire group often liquidates its interest in the partnership in a single transaction or series of transactions. It may well be that the ability to assemble a large enough block of partnership interests makes the sale possible. A block transfer should, therefore be defined, as a transfer or a related group of transfers made in anticipation of one another which aggregate more than 2% and occur within 30 days.

C. Effect of Becoming a Publicly Traded Partnership.

The proposed regulations do not describe the effect of a partnership becoming a publicly treated partnership. In most regards, it is appropriate to defer consideration of this ancillary issue to later regulations. However, the proposed regulations should clarify the effect of a partnership first becoming a publicly traded partnership and, in a subsequent year, ceasing to meet the definition of publicly traded. A partnership which becomes a publicly traded partnership should be treated as having become a corporation and therefore, should no longer subject to recharacterization (and a deemed liquidation) under Section 7704 when trading ceases.