

## Internal Revenue Service

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Washington, DC 20224

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Date: January 4, 2013

### LEGEND

Company =

State =

Dear :

This letter responds to a letter dated September 5, 2012, submitted on behalf of Company, requesting that income derived from treasury locks, interest rate swaps, forward-start interest rate swaps, and interest rate caps is qualifying income within the meaning of § 7704(d)(1) of the Internal Revenue Code.

### FACTS

Company is a publicly-traded limited partnership organized under the laws of State. Company has not elected to be taxed as an association for federal tax purposes. Company, through affiliated operating limited partnerships and limited liability companies that are disregarded entities or partnerships for federal tax purposes, engages in a variety of activities, including terminaling and storage services for petroleum products and by-products and natural gas services.

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

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

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

To obtain a cash flow at a floating rate in exchange for one at a fixed rate, Company will agree to pay to an unrelated party, typically a financial institution, a fixed interest rate on a notional principal amount. In return, the counterparty agrees to pay Company a floating index rate, determined by reference to some established index, on the notional principal amount. If the index rate for a given month exceeds the fixed rate, the counterparty owes Company an amount equal to the excess interest rate multiplied by the notional principal amount. If, however, the fixed rate exceeds the index rate in a month, Company owes the counterparty. The amounts the parties owe to each other are netted and settled periodically according to the swap's terms.

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

As an alternative to interest rate swaps, Company may desire to lock in a current rate with respect to a future issuance, in which case, one of its available options is to enter into a forward-start interest rate swap. To lock in a spot interest rate for a period prior to the issuance of its fixed-debt securities (a forward lock), Company will agree to pay a counterparty a fixed interest rate on a notional principal amount. The counterparty, typically a financial institution, would agree to pay Company an amount equal to a floating index rate, determined by reference to some established index, multiplied by the notional principal amount for a fixed period that begins on the date of the anticipated debt issuance. If the index rate exceeds the fixed interest rate on the date of issuance of the debt securities, the counterparty owes Company an amount equal to the excess of the excess interest rate multiplied by the notional principal amount over the term of the forward lock. On the other hand, if the fixed rate exceeds the floating index rate on the date of issuance of the debt securities, Company owes the counterparty the excess of the fixed rate over the floating index rate multiplied by the notional principal amount over the term of the forward lock. The amounts the parties

owe to each other over the term of the forward lock are calculated and netted on the anticipated date of issuance of the debt securities.

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

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

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

### LAW AND ANALYSIS

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

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

Section 7704(c)(1) provides, in part, that § 7704(a) shall not apply to any publicly traded partnership for any taxable year if such partnership met the gross income requirements of § 7704(c)(2) for such taxable year and each preceding taxable year beginning after December 31, 1987, during which the partnership (or any predecessor) was in existence. Section 7704(c)(2) provides that a partnership meets the gross income requirements of § 7704(c)(2) for any taxable year if 90% or more of the gross income of such partnership for such taxable year consists of qualifying income.

Section 7704(d)(1)(A) provides, in part, that, except as otherwise provided in § 7704(d), the term “qualifying income” means interest. Section 7704(d)(2) provides that interest shall not be treated as qualifying income if – (A) such interest is derived in

the conduct of a financial or insurance business, or (B) such interest would be excluded from the term “interest” under § 856(f).

Section 1.7704-3(a)(1) provides, in part, that for purposes of § 7704(d)(1), qualifying income includes income from notional principal contracts (as defined in § 1.446-3) and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner. Income from a notional principal contract is included in qualifying income only if the property, income, or cash flow that measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership. Section 1.7704-3(a)(2) provides, in part, that qualifying income described in § 1.7704-3(a)(1) does not include income derived in the ordinary course of a trade or business.

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

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

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

### CONCLUSION

Based solely on the facts and representations submitted, we conclude that the income Company derives from the treasury lock, interest rate swap, forward-start interest rate swap, and interest rate cap transactions is qualifying income within the meaning of § 7704(d)(1) and § 1.7704-3(a)(1).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion as to whether Company's treasury locks, interest rate swaps, forward-start interest rate swaps, or

interest rate caps can be integrated with the related debt securities under § 1.1275-6, as well as to whether Company is taxable as a partnership for federal tax purposes.

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

In accordance with a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

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

Sincerely,

James A. Quinn  
Senior Counsel, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosures (2):

Copy of this letter  
Copy for § 6110 purposes