

NATIONAL ASSOCIATION OF PUBLICLY TRADED PARTNERSHIPS

July 13, 2009

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Requested Comments on Proposed Regulation § 1.706-4

Dear Commissioner Shulman:

I am writing on behalf of the National Association of Publicly Traded Partnerships (“NAPTP”) to provide comments with regard to proposed regulations under section 706(d) (the “Proposed Regulations”).¹ The Proposed Regulations were issued by the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “IRS”) on April 13, 2009 and published in the Federal Register on April 14, 2009.² The Proposed Regulations provide, among other things, specific guidance for determining a partner’s distributive share of partnership items of income, gain, loss, deduction, and credit (“Tax Items”) in a manner that takes into account the varying interests of the partners for the taxable year (the “Varying Interests Rule”).

NAPTP is a trade association representing publicly traded partnerships (“PTPs”) and those who work with them. NAPTP and its members would like to commend Treasury and the IRS for issuing the Proposed Regulations and appreciate the opportunity to comment on the Proposed Regulations. As discussed below, we recommend that:

- The final regulations include a quarterly convention as an additional safe harbor convention that would allow PTPs that make quarterly distributions to allocate Tax Items of a quarter to their unit holders who are the record holders on the date the quarterly distribution is declared.
- The final regulations allow PTPs that use the proration method to prorate their annual aggregate Tax Items by the number of months (instead of by the number of days) during the year as a variation of the calendar day convention.

¹ All “section” references are to the Internal Revenue Code of 1986, as amended (the “Code”) and all “regulation” and “Treas. Reg. §” references are to the Treasury regulations promulgated under the Code.

² 74 Fed. Reg. 17119 (April 14, 2009).

- The final regulations remove the block transfer exclusion and apply the safe harbor conventions (as provided in Prop. Reg. § 1.706-4(b)(3)) to transfers of all PTP units regardless of whether the units are publicly traded. If the final regulations will not apply the Safe Harbor Conventions to transfers of all PTP units, we recommend that the final regulations apply the safe harbor conventions to transfers of all publicly traded PTP units (using an expanded definition) and limit the block transfer exclusion only to transfers of non-publicly traded PTP units.
- The final regulations provide that existing PTPs (as defined in Prop. Reg. § 1.706-4(f)) continue to be grandfathered from having to apply the conventions provided by the Proposed Regulations even if they have one or more “technical” terminations under section 708(b)(1)(B) on or after April 14, 2009.
- The final regulations modify the example of Prop. Reg. § 1.706-4(b)(3) by removing the statement “B will not be considered a partner.”

I. Background

Section 706(d)(1) generally provides that if, during any taxable year of the partnership, there is a change in any partner’s interest in the partnership, each partner’s distributive share of the partnership’s Tax Items for the taxable year is determined under any method prescribed by the Secretary by regulations that takes into account the varying interests of the partners in the partnership during the taxable year.

The Proposed Regulations provide specific guidance in applying the Varying Interests Rule. Prop. Reg. § 1.706-4(a)(1) provides that, if a partner’s interest in a partnership varies during the taxable year, the partnership determines the partner’s distributive share of Tax Items by using either the interim closing method or, by agreement of the partners, the proration method. A partnership using the interim closing method generally may use either the calendar day convention or the semi-monthly convention, whereas a partnership using the proration method generally may use only the calendar day convention.³ The calendar day convention requires that any variation in a partner’s interest is deemed to occur as of the close of the day. The semi-monthly convention requires that any variation in a partner’s interest occurring during the first through the 15th day of the calendar month is deemed to occur at the beginning of the first day of that month, and any variation in a partner’s interest occurring during the 16th through the last day of the calendar month is deemed to occur at the beginning of the 16th day of that month. Under Prop. Reg. § 1.706-4(f), the calendar day convention and the semi-monthly

³ Prop. Reg. §§ 1.706-4(c)(2) and (d)(2). On December 13, 1984, the IRS issued a news release regarding conventions that a partnership can use in applying the Varying Interests Rule. The news release announced, among other things, that, until regulations are issued, partnerships that use the proration method are required to use a “daily convention.” IR-84-129, 84 TNT 255-8 (Dec. 17, 1984). The term “calendar day convention” instead of the term “daily convention” is used in the Proposed Regulations.

convention, when finalized, will not apply to, but can be relied on by, “existing PTPs.” An “existing PTP” is a PTP that was formed before April 14, 2009 (the date the Proposed Regulations were published in the Federal Register).

Prop. Reg. § 1.706-4(b)(3) provides two safe harbor conventions (the “Safe Harbor Conventions”) for certain transfers of publicly traded PTP units (as described in Treas. Reg. § 1.7704-1(b)(1)). The first Safe Harbor Convention is the monthly convention. Under the monthly convention, for purposes of making allocations, a PTP may treat all transfers of its publicly traded units during a calendar month as occurring on the first day of the following month under a method consistently applied by that partnership. As a result, a unit holder who owns PTP units on the first day of the month and transfers the units during the month is treated as owning the units for the entire month of the transfer. The second Safe Harbor Convention is the semi-monthly convention (described in the preceding paragraph). The Safe Harbor Conventions do not apply to block transfers of PTP units as described in Treas. Reg. § 1.7704-1(e)(2) or transfers of PTP units that are not described in Treas. Reg. § 1.7704-1(b)(1) (units that are traded on a national securities exchange registered under section 6 of the Securities Exchange Act of 1934).

II. Recommendations

1. Include a Quarterly Convention as an Additional Safe Harbor Convention for PTPs that Make Quarterly Distributions

The preamble to the Proposed Regulations (the “Preamble”) states that “the IRS and the Treasury Department are aware that some publicly traded partnerships (as defined in section 7704) are using conventions other than a monthly or semi-monthly convention and are using these conventions with the proration method” and “the IRS and the Treasury Department are requesting comments concerning the use of conventions other than monthly or semi-monthly convention.”⁴ In response to this request, we recommend that the Proposed Regulations include a quarterly convention as an additional Safe Harbor Convention that would allow PTPs that make quarterly distributions to allocate their Tax Items for a quarter to their unit holders who are the record holders on the date the quarterly distribution is declared. The reason for this recommendation is explained below.

PTPs generally declare cash distributions quarterly to their unit holders of record on the last day of a quarter. This quarterly distribution policy is in line with the PTPs’ quarterly financial reporting. PTPs generally distribute cash to their transfer agents for further distribution to unit holders of record on the last day of the quarter. In general, the distribution is made notwithstanding that another person (*e.g.*, a seller) was the unit holder for a certain period of time during the quarter and would be allocated some of the Tax Items to which the distributed cash

⁴ 74 Fed. Reg. 17119, 17123 (April 14, 2009).

might be attributable. For example, if a seller sells publicly traded PTP units on the 18th day of the second month in a quarter, then for purposes of making allocations, the transfer of the units would be treated as occurring on the first day of the third month of the quarter (under the monthly convention) or on the 16th day of the month of the transfer (under the semi-monthly convention). In either case, the seller would be allocated Tax Items from the PTP for its appropriate period of ownership (*i.e.*, two months under the monthly convention, and one and one half months under the semi-monthly convention). The seller, however, would not receive any cash distribution for that quarter because the seller was not the unit holder of record on the last day of the quarter. Rather, the buyer would receive the entire quarterly distribution because the buyer was the unit holder of record on the last day of the quarter.

This mismatching of income and cash could cause a withholding tax problem if a PTP has U.S. source fixed, determinable, annual, or periodical ("FDAP") income subject to withholding under section 1441(a) and units are transferred from a foreign seller to a U.S. buyer.⁵ In that case, the foreign seller would be allocated certain of the PTP's FDAP income attributable to its period of ownership, but would not receive any cash distribution from which tax could be withheld. As a result, neither the PTP nor its transfer agent would be able to satisfy the withholding obligation that arises from the allocation of FDAP income to the foreign seller under section 1441(a).⁶

In practice, some PTPs with FDAP income that make quarterly distributions have resolved this issue by adopting a quarterly convention. Under the quarterly convention, PTPs allocate their Tax Items of a quarter to their unit holders who are the record holders on the date the quarterly distribution is declared. The PTPs can then identify the source and character of their Tax Items for the quarter, allowing their transfer agents to collect the section 1441(a) withholding tax, if necessary, using the distributed cash.

The quarterly convention links a unit holder's distributive share of Tax Items to the related cash distribution and therefore enables PTPs and their transfer agents to satisfy their withholding obligations under section 1441(a). We recommend that the Proposed Regulations

⁵ Section 1441(a) generally requires that all persons having the control, receipt, custody, disposal, or payment of any of the items of certain income (to the extent that any of such items constitutes gross income from sources within the United States) of any nonresident alien individual or of any foreign partnership deduct and withhold from such items a tax equal to 30 or 14 percent of the items. FDAP income is subject to withholding required under section 1441(a). Section 1441(b).

⁶ If a PTP has effectively connected taxable income ("ECI"), a special withholding rule is provided in section 1446 and its regulations to address this issue. Section 1446 generally provides that, if a partnership has ECI for any taxable year and any portion of the income is allocable under section 704 to a foreign partner, the partnership is required to pay a withholding tax at such time and in such manner as prescribed by the regulations. For PTPs that have ECI, Treas. Reg. § 1.1446-4(f) provides that the withholding is made at the applicable percentage with respect to any distribution made from a PTP to a foreign partner. As a result, a PTP is not required to withhold tax on the allocation of ECI to a foreign partner if the foreign partner does not receive any distribution with respect to that allocation. No similar rule is provided for a PTP that has FDAP income.

include the quarterly convention as an additional Safe Harbor Convention, thus permitting PTPs that make quarterly distributions to allocate Tax Items of a quarter to their unit holders who are the record holders on the date the quarterly distribution is declared.⁷

2. Allow PTPs Using the Proration Method to Prorate Their Annual Aggregate Tax Items by the Number of Months (Instead of the Number of Days) During the Year as a Variation of the Calendar Day Convention

Under Prop. Reg. § 1.706-4(d)(2), a partnership using the proration method to take into account the varying interests of the partners in the partnership would be permitted to use only the calendar day convention. The calendar day convention requires that, with respect to a partner whose interest varies, the variation is deemed to occur as of the close of the day. As a result, a partnership that uses the proration method must divide the partnership's Tax Items by 365 (or 366, if in a leap year) and assign that amount to each day. The monthly convention that is allowed as a Safe Harbor Convention for PTPs is really a calendar day convention that treats all transfers of publicly traded units as occurring at only one time each month. In practice, PTPs that use the proration method divide their Tax Items by 12 and assign that amount to each month.

For administrative convenience, we recommend that the final regulations allow PTPs that use the proration method to prorate their annual aggregate Tax Items by the number of months (instead of by the number of days) during the year as a variation of the calendar day convention.⁸ For example, assume a PTP has aggregate income of \$12,000 for 2009. For purposes of making allocations, under the calendar day convention in the Proposed Regulations, the PTP's income during January would be \$1,019 (*i.e.*, $\$12,000 \times (31 \text{ days}/365 \text{ days})$), and the PTP's income during February would be \$921 (*i.e.*, $\$12,000 \times (28 \text{ days}/365 \text{ days})$). If our recommendation is adopted, the PTP would be considered to have \$1,000 of income during each month of 2009 (*i.e.*, $\$12,000/12$).

⁷ If the IRS and Treasury are concerned that this recommendation is too broad, other options addressing the same issue are: (i) permitting PTPs that have FDAP income (or a threshold amount of FDAP income) and make quarterly distributions to allocate Tax Items of a quarter to their unit holders who are the record holders on the date the quarterly distribution is declared, (ii) permitting PTPs that have FDAP income and make quarterly distributions to allocate only FDAP Tax Items of a quarter to their unit holders who are the record holders on the date the quarterly distribution is declared (an interim closing method with a quarterly convention solely for FDAP income), (iii) permitting PTPs that have FDAP income to allocate FDAP Tax Items as extraordinary items pursuant to Prop. Reg. § 1.706-4(d)(3) to their unit holders who are the record holders on the date the distribution is declared (a proration method with an extraordinary item occurring on the distribution date solely for FDAP income), or (iv) providing a special PTP withholding rule under section 1441 similar to Treas. Reg. § 1.1446-4.

⁸ This might also be achieved by allowing the calendar day convention to assume a 30 day month and a 360 day year, as is common in interest calculations.

3. Apply the Safe Harbor Conventions to Transfers of All PTP Units

As noted above, Prop. Reg. § 1.706-4(b)(3) provides that the Safe Harbor Conventions do not apply to block transfers of PTP units. For this purpose, a block transfer is a transfer by a partner (or one or more related partners) in one or more transactions during any 30 calendar day period of partnership interests representing in the aggregate more than two percent of the total interests in partnership capital or profits.⁹ The Safe Harbor Conventions also only apply to transfers of publicly traded units as described in Treas. Reg. § 1.7704-1(b)(1), which limits the definition of publicly traded units to only those exchanged on a national securities exchange registered under section 6 of the Securities Exchange Act of 1934.

If the Safe Harbor Conventions do not apply to block transfers, the PTP would have to allocate Tax Items attributable to the transferred units between the buyer and the seller based on actual number of days the buyer and the seller own the interests. The exclusion of block transfers from the Safe Harbor Conventions might be administrable if the transferred PTP units are not publicly traded, such that the buyer and the seller are identifiable. For publicly traded PTP units, however, it is administratively impossible to determine which persons are parties to a transfer, even if the transfer is a block transfer. Therefore, it also would be administratively impossible to allocate Tax Items in accordance with the Proposed Regulations.

Furthermore, it is unclear why the definition of publicly traded units was limited to only those that are traded on national securities exchanges registered under section 6 of the Securities Exchange Act of 1934. PTP units that are traded on any of the established securities markets described in Treas. Reg. § 1.7704-1(b), such as foreign or regional exchanges, should clearly be considered “publicly traded units” for purposes of the Safe Harbor Conventions. In addition, PTP units that are traded on a secondary market or the substantial equivalent thereof as described in Treas. Reg. § 1.7704-1(c)(2) should be considered “publicly traded units” for purposes of the Safe Harbor Conventions. These units have the same difficulties in determining the parties to the transfer, which make it administratively impossible to allocate Tax Items between the buyer and the seller in accordance with the Proposed Regulations.

To avoid the situations mentioned in which compliance with the Proposed Regulations would be impossible, and because there is no systematic abuse in applying the Safe Harbor Conventions to all transfers of PTP units, we recommend that the final regulations remove the block transfer exclusion and apply the Safe Harbor Conventions to transfers of all PTP units. If the final regulations will not apply the Safe Harbor Conventions to transfers of all PTP units, we recommend that the final regulations apply the Safe Harbor Conventions to transfers of all publicly traded PTP units (using an expanded definition to include units that are traded on

⁹ Treas. Reg. § 1.7704-1(e)(2).

established securities markets in addition to secondary markets or the substantial equivalent thereof) and limit the block transfer exclusion only to transfers of non-publicly traded PTP units.

4. Continue to Grandfather Existing PTPs Even If They Have “Technical” Terminations on or after April 14, 2009

Under Prop. Reg. § 1.706-4(f), an “existing PTP” does not have to apply the calendar day convention or the semi-monthly convention provided in the Proposed Regulations (the “grandfather rule”). An “existing PTP” is a PTP that was formed before April 14, 2009 (*i.e.*, the date the Proposed Regulations were published in the Federal Register). If an existing PTP terminates under section 708(b)(1)(B) on or after April 14, 2009, it appears that the grandfather rule would not apply to the “new” partnership deemed to be formed under section 708(b)(1)(B).¹⁰

We believe that existing PTPs should continue to qualify under the grandfather rule even if they terminate under section 708(b)(1)(B) on or after April 14, 2009. A technical termination is only a tax construct and does not result in any changes to the partnership agreement of the terminated partnership. To the extent that the partnership agreement of an existing PTP has provided a convention for purposes of section 706, the existing PTP should not be required to change that convention to an applicable convention provided in the Proposed Regulations. We note that, in other situations, Treasury and the IRS have generally disregarded the effect of a technical termination for similar purposes.¹¹ We believe that the final regulations should follow the similar approach adopted in those other regulations and provide that existing PTPs retain

¹⁰ On September 25, 2008, the IRS issued a news release announcing that the IRS plans to issue guidance regarding technical terminations of PTPs. IR-2008-110, 2008 TNT 188-10 (Sep. 26, 2008).

¹¹ See Treas. Reg. § 1.7704-1(l)(4) (providing that the termination of a partnership under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in partnership capital and profits is disregarded in determining whether a partnership qualifies for certain transition period rules); Treas. Reg. § 1.7704-2(g)(2)(i) (in determining whether a partnership is an “existing partnership” for purposes of section 7704, the termination of the partnership under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in partnership capital and profits is not an event that in itself terminates the status of existing partnerships); Treas. Reg. § 1.199-8(e)(1)(ii)(A) (providing that, if property is deemed to be contributed by a partnership (transferor partnership) to another partnership (transferee partnership) as a result of a termination under section 708(b)(1)(B), then the transferee partnership is treated as performing those activities performed by the transferor partnership with respect to the transferred property of the transferor partnership); Treas. Reg. § 1.731-2(g)(2) (providing that, if a partnership termination occurs under section 708(b)(1)(B), the successor partnership is treated as if there had been no termination for purposes of section 731(c)); and Treas. Reg. § 1.752-4(c) (providing that, for purposes of applying Treas. Reg. §§ 1.752-1 through 4, a termination of the partnership under section 708(b)(1)(B) does not cause partnership liabilities incurred or assumed prior to the termination to be treated as incurred or assumed on the date of the termination). Cf. Treas. Reg. § 301.7701-2(d)(3) (provides that an entity that is grandfathered from the treatment as a per se corporation is treated permanently as a corporation if the entity has a technical termination under section 708(b)(1)(B), unless the sale or exchange of interests in the entity is to a related person (within the meaning of sections 267(b) and 707(b)) and occurs no later than twelve months after the date of the formation of the entity).

their grandfather status for purposes of applying the Varying Interests Rule even if they terminate under section 708(b)(1)(B) on or after April 14, 2009.

5. Modify the Example of Prop. Reg. § 1.706-4(b)(3) by Removing the Statement “B Will Not Be Considered a Partner”

Prop. Reg. § 1.706-4(b)(3) contains an example that illustrates the application of the monthly convention. In the example, PRS, a PTP, adopts the monthly convention, treating all transfers of its publicly traded units as occurring on the first day of the month following the transfer date. On May 5, A, a partner in PRS, sells a unit in PRS to B, and, on May 12, B sells that unit to C, who holds the interest after May 31. The example concludes that PRS may allocate all Tax Items with respect to the unit for the month of May to A and may allocate all Tax Items with respect to the unit for the month of June to C. The example further states that “*B will not be considered a partner and will receive no allocation of partnership items.*” (Emphasis added.)

We believe that the statement “B will not be considered a partner” is inconsistent with general U.S. tax principles for determining tax ownership and partner status. If the trading price of the unit that B purchases from A fluctuates during the period from May 5 to May 12, B would realize all of the appreciation or depreciation resulting from the price fluctuation upon the sale to C. Under general U.S. tax principles, B would be treated as an owner of the unit and therefore a partner.¹² We therefore recommend that the final regulations remove the statement “B will not be considered a partner” in the example of Prop. Reg. § 1.706-4(b)(3).

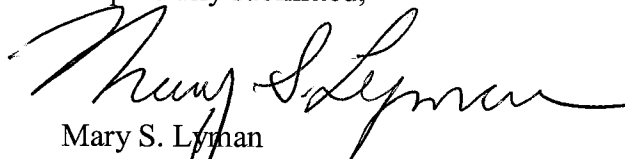
Our comments and recommendations have focused on issues that are specific to PTPs. We understand that the American Bar Association (“ABA”) Section of Taxation and the American Institute of Certified Public Accountants (“AICPA”) plan to comment on issues that are more broadly applicable to all partnerships, including PTPs. We expect that such comments will include recommendations that the definition and treatment of extraordinary items pursuant to Prop. Reg. § 1.706-4(d)(3) allow the partnership more flexibility and discretion. For example, (i) some items currently listed as extraordinary items might be excepted due to materiality, (ii) some items not currently listed might be deemed to be extraordinary items and allocated over time as opposed to being taken into account on a particular day (such as depreciation on assets that were either acquired or disposed of during the year), and (iii) the currently listed extraordinary items addressing dispositions need to confirm that revaluation gain/loss pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(f) is included as an extraordinary item.

¹² *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981) (In determining whether a transaction constitutes a sale for tax purposes, the Tax Court explained that the key was to “determine whether the benefits and burdens of ownership have passed from [the seller] to [the buyer]”); *see also* H.R. Rep. No. 98-432, pt. 2, at 1132 (1984) (“for Federal income tax purposes, the owner of property must possess meaningful burdens and benefits of ownership”).

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NAPTP appreciates the opportunity to comment on the Proposed Regulations and your consideration of our recommendations. If you would like to discuss our recommendations, or would like additional information, please contact me.

Respectfully submitted,



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