

Tax Alert

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IRS Hits the “Pause” Button on PTP Rulings

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Recently it has become standard operating procedure for the Internal Revenue Service (“IRS”) to declare moratoriums on the issuance of private letter rulings (“PLR”) in certain areas. These temporary (or, in certain cases, more permanent¹) suspensions typically arise with respect to tax provisions that require further study or that seem to be moving faster than the IRS would like, given its limited resources and the myriad interpretive questions presented to it for ruling each year. The latest IRS action involves the rules governing “publicly traded partnerships” (or “PTPs”) under Section 7704 of the Code.²

The PTP moratorium was not announced through a formal IRS pronouncement. Instead, at a March 28th conference in Washington, an IRS representative confirmed that the IRS is instituting a “pause,” adding that “[w]e’re regrouping. We’re speaking with our counterparts at Treasury. We’re trying to decide what the rules should be.”³

Generally speaking, PTPs are entities that are (in the absence of the PTP rules) treated as partnerships for U.S. federal income tax purposes and whose interests are readily tradable. These entities, which are more commonly known as “master limited partnerships,” or “MLPs,” were proliferating in the late 1980s, and Congress determined that such entities were eroding the U.S. corporate tax base. Accordingly, Section 7704 was enacted, and PTPs are now generally taxed as corporations unless at least 90% of the partnership’s gross income constitutes “qualifying income” (passive income or other types of income generally in the natural resources arena historically conducted through partnerships or other flow-through entities).⁴

Over the past few years, the IRS has issued favorable rulings regarding the qualification of numerous categories of income as “qualifying income” for PTP purposes. Most of these rulings relate to the natural resource exploration prong in Section 7704(d)(1)(E). In one recent ruling, for example, the IRS ruled that income derived from “the wholesale marketing and transportation of commercial silica (also known as frac sand) to customers engaged in the exploration and production of oil and natural gas” is qualifying income under Section 7704(d).⁵

PTP qualifying income also includes “real property rents,”⁶ and the IRS has also expanded the scope of this category through the issuance of private letter rulings. In PLR 201250003, the IRS ruled that a partnership’s lease of an offshore oil and gas platform (along with related machinery and equipment) produced qualifying income for PTP purposes. By necessity, the ruling dealt with the REIT rules as well, since the PTP provisions of the Code cross reference the rules governing “rents from real property,” a permissible category of income for REIT purposes.⁷

In light of the close connection between the PTP and REIT rules, it is not surprising that the IRS had recently suspended (but has since resumed) its policy of granting REIT rulings to “nontraditional” asset classes. Specifically, in the summer of 2013, apparently in connection with REIT conversion rulings requested by Iron Mountain Inc. (which is engaged in document management services) and Equinix Inc. (data centers), the IRS convened a working group to study the issues raised by nontraditional real estate assets.⁸ Although the IRS never confirmed an actual moratorium at the time, it did retrospectively, by commenting later in 2013 that it had “temporarily placed pending ruling requests concerning assets other than land, buildings and structures traditionally held by REITs on hold to

allow for a thorough review to ensure a uniform and consistent approach to addressing the definition of REIT real property based on applicable law.”⁹

The IRS’s review of its PTP ruling guidelines is supposedly expected to be completed next month, but in reality it remains to be seen how long the “pause” will last. In the interim, affected taxpayers will have to proceed with caution. The PTP rules leave only a 10% cushion for non-qualifying income, and the inability to rely on a ruling may increase the risk of engaging in certain activities to unacceptable levels, especially in light of the severe consequences of breaching the 90% floor.

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Endnotes

¹ To be sure, the IRS does regularly publish “no-rule” lists. See, e.g., Rev. Proc. 2014-3, 2014-1 IRB 111 (12/30/2013); Rev. Proc. 2013-32, 2013-28 IRB 55 (06/25/2013). These announcements identify areas in which rulings *will not* be issued, areas in which rulings will not *ordinarily* be issued, and areas under study in which rulings will not be issued.

² All “section” references herein are to the U.S. Internal Revenue Code of 1986, as amended.

³ Amy Elliott, *IRS Has Stopped Ruling on Publicly Traded Partnership Qualifying Income*, Tax Notes Today, March 31, 2014.

⁴ MLPs have historically been associated with oil and gas partnerships, as a result of the explicit reference to “income and gains derived 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 “ in the statutory list of “qualifying income” categories. See Section 7704(d)(1)(E). More recently, several large asset managers have gone public using a PTP structure, making use of the eligibility of capital gains (and, to a lesser extent, dividends) as qualifying income.

⁵ PLR 201414004 (04/04/2014). The way the author understands it, frac sand is one of the components used by oil and gas explorers who employ the “hydraulic fracturing,” or “fracking” technique to extract oil and gas from wells that would otherwise be inaccessible.

⁶ Section 7704(d)(1)(C).

⁷ Section 7704(d)(3).

⁸ There has been a recent flurry in the number of companies expressing an interest in converting to REIT status, spanning such nontraditional REIT industries as prison operation, billboards, and cell towers (in addition to the data center and document storage examples cited above).

⁹ Statement by IRS to Tax Analysts, quoted in Amy Elliott, *IRS Resumes REIT Conversion Rulings*, Tax Notes, Nov. 25, 2013.

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