

**REPORT #780**

**TAX SECTION**

**New York State Bar Association**

Letter on Proposed Franchise

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February 25, 1994

The Honorable James W. Wetzler  
Commissioner of Taxation and Finance  
Building 9, W. A. Harriman Campus  
Albany, New York 12227-1215

Re: Proposed Franchise Tax Regulation  
Relating to Commodity Investment  
Partnerships

Dear Commissioner Wetzler:

Last month the Department proposed an amendment to the Corporation Franchise Tax regulations to provide, essentially, that a foreign corporate limited partner in a "commodity investment partnership" engaging in New York activities would not be treated, solely as a result of such investment, as doing business in New York State. Prop. Reg. section 1-3.2(a)(6)(i) and (iii)(e), copy attached.

A "commodity investment partnership" is defined as a partnership:

(a) described in the second sentence of Internal Revenue Code ("Code") section 7704(c)(3), namely a partnership "a principal activity" of which is the buying and selling of non-inventory commodities, or options, forwards, or futures with respect to commodities, and

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(b) which meets the gross income requirement of section 7704(c)(2) of the Code, namely that 90% or more of its gross income for the taxable year consists of qualifying income, which includes interest, dividends, real property rents, gains from real property sales, oil and gas and other mineral income, and income and gains from non-inventory commodities or futures, forwards, and options with respect to commodities.

We support the proposal, subject to the comments below. We believe that commodities activities are investment type activities and should be treated similarly to portfolio investment activities, which are presently carved out as a type of partnership activity that does not subject foreign corporate partners to New York tax. Our specific comments are as follows.

1. The result of the proposed regulation might be more expansive than intended because of the references to section 7704. Section 7704 is the provision of the Code determining when a publicly traded partnership is taxable as a corporation. In general, passive investment activity is exempt while active business activity can cause corporate taxation. However, in at least two situations section 7704 does permit activities that might be considered to be doing business, etc. in New York, and the proposed regulation may intentionally or inadvertently likewise permit such activity.

The two kinds of activities we have in mind are (i) the trading of physical commodities that might or might not be physically located in New York, and (ii) engaging in off-exchange trades of physical commodities or contracts in commodities. These transactions are clearly permitted by section 7704, and, by cross-reference, by a commodity investment partnership under the proposed regulation.

These two types of transactions are more restricted under section 864 of the Code, which determines when a non-U.S. person is engaged in a trade or business in the U.S. by virtue of investing in a commodity partnership. Section 864 is arguably more analogous to the subject of the proposed regulation than is section 7704. Under section 864(b)(2)(B), the section 864 exemption only applies if the commodities are of a kind customarily dealt in on an organized commodity exchange and if the transaction is of a kind customarily consummated at such place. See also Rev. Rul. 73-158, 1973-1 Cum. Bull. 337, allowing the sales of physical commodities through an independent broker where the sales are of a kind customarily consummated on an exchange.

We support the fact that the proposed regulation permits off-exchange trading of commodities contracts, and see no reason why such trading should not be treated as investment activity. We take no position on whether a commodity investment partnership should be permitted to hold and trade physical commodities that might be located in New York, but we simply wish to raise the question in case the issue was not focused on. See also TSB-A-90(20)C (Cargill Financial Services Corp. Advisory Opinion, Sept. 26, 1990), holding that a foreign commodities trading corporation was not subject to New York tax solely because it occasionally took title to precious metals (and stored them in COMEX-licensed New York City vaults) for short periods of time.

2. Consider a partnership which engages in two significant businesses, (i) a qualifying commodities trading business that meets all the tests for commodities activities, and (ii) a real estate leasing business. The second business might be much larger than the first. It appears that under the proposed regulation the partnership as a whole is a "commodity investment partnership" and that its foreign corporate partners would not be treated as doing business, etc. in New York by virtue of any of the partnership's activities. The reason is that the first test quoted above is satisfied

because "a" principal activity of the partnership is the trading in commodities, and the second test above is satisfied because more than 90% (in fact 100%) of its income is qualifying income under section 7704. We assume the intent of the proposed regulation is that at least 90% of the partnership's income be commodities related income, in which case the requirement could be imposed that the section 7704(c)(2) Income test must be satisfied only taking into account income described in section 7704(d)(1)(G). See the next two comments, however.

3. Consider a partnership that wishes to trade both securities and commodities. The partnership will not qualify as a "portfolio investment partnership" under the existing regulation because such a partnership must in effect have 90% of its income be derived from stocks and securities. The partnership would not qualify under the proposed regulation as a "commodity investment partnership" unless commodities trading was "a" principal activity, which might or might not be true. If the concept in the immediately preceding paragraph was accepted, the partnership would qualify only if 90% of its income was from commodities, even if commodities trading was a principal activity. We see no reason a partnership should be required to fall entirely into one category or the other. We therefore believe the regulation should permit a partnership to qualify for the exemption as long as 90% of its aggregate income is either qualifying securities income or qualifying commodities income.

4. We believe an additional modification should be made to the definition of qualifying income for a commodity investment partnership. The existing regulations define "portfolio investment partnership" to mean a partnership meeting the gross income requirements of Code section 851(b)(2). That section explicitly includes as qualifying income "other income (including but not limited to gains from options, futures, or forward contracts) derived with respect to its business of investing in such stock, securities, or

currencies." See Rev. Rul. 92-56, 1992-2 C.B. 153, interpreting "other income" to include the reimbursement of an investment advisory fee. The proposed regulations provide no such catchall type of permitted income for a commodity investment partnership, however, since Code section 7704 does not have an analogous provision.

We believe a provision should be added to the proposed definition of commodity investment partnership so that qualifying income would include other income derived with respect to its business of engaging in permitted commodity transactions. This type of provision would be necessary even if our suggestion in 3. above was accepted, because merely permitting a single partnership to have both qualifying securities income and qualifying commodities income (as such income is presently defined) would not permit "other" commodities-related income to be qualifying income.

Moreover, if the concept in 2. above is adopted (so that a commodity investment partnership is only permitted to have commodities income as defined in Code section 7704(d)(1)(G)), but our suggestion in 3. above is not adopted (so that a partnership can invest in securities or commodities, but not both), we believe that at the very least qualifying income of a commodities partnership should be expanded to include interest income. Funds of a commodities partnership will frequently be invested in interest-bearing instruments pending investment in commodities. While the existing proposed regulation would permit such interest as qualifying income (through its reference to all income referred to in section 7704(c)(2)), our concern is that this benefit should not be removed if the proposal is modified to avoid the result involving real estate described in 2. above.

5. Finally, while it may be beyond the scope of the proposed regulation, we believe consideration should be given in the near future to a broadening of the definition of qualifying income beyond the types described in Code section 851(b)(2) for both securities and

commodity partnerships. We believe financial-type contracts such as interest rate swaps, equity swaps, and other derivatives should be permissible investments, especially if they are related to an underlying investment in securities or commodities but even if they are not so related. See Treas. Reg. § 1.512(b)-1(a)(1), exempting tax-exempt investors from unrelated business income tax on all notional principal contracts and on "other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner"; PLR 9204015 (trading in interest rate swaps is a permissible activity under section 864 because swaps are closely related to contracts or options to buy or sell securities). We would be happy to work with you further on this proposal.

We hope these comments are useful. If you or your staff have any further questions regarding our comments, please do not hesitate to call me.

Very truly yours,

Michael L. Schler  
Chair

cc: William F. Collins, Esq.

STATE OF NEW YORK  
DEPARTMENT OF TAXATION AND FINANCE  
COMMISSIONER OF TAXATION AND FINANCE  
ALBANY, NEW YORK

Pursuant to the authority contained in subdivision First of section 171 and subsection (a) of section 1096 of the Tax Law, the Commissioner of Taxation and Finance, at an open meeting held on even date with the signing of this proposal, hereby proposes to make and adopt the following amendments to the regulations of the Commissioner of Taxation and Finance, as published in Title 20 of the Official Compilation of Codes, Rules and Regulations of the State of New York, by amending the Business Corporation Franchise Tax regulations, as published in Subchapter A of Chapter I of such title, such amendments to read as follows:

Section 1. The introductory paragraph of subparagraph (i) of paragraph (6) of subdivision (a) of section 1-3.2 of such regulations is amended to read as follows:

(6) (i) A foreign corporation is doing business, employing capital, owning or leasing property or maintaining an office in New York State if it is a limited partner of a partnership, other than a portfolio investment partnership or a commodity investment partnership, which is doing business, employing capital, owning or leasing property or maintaining an office in New York State and if it is engaged, directly or indirectly, in the participation in or the domination or control of all or any portion of the business activities or affairs of the partnership. A foreign corporation is engaged in such manner in the business activities or affairs of the partnership if one



or more of certain factual situations, including but not limited to the following, exist during the taxable year or, except for clause "(a)" of this subparagraph, any previous taxable year:

Section 2. Subparagraph (iii) of paragraph (6) of subdivision (a) of such section is amended by adding a new clause "(e)" to read as follows:

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"(e)" The term "commodity investment partnership" means a limited partnership which is described in the second sentence of section 7704(c)(3) of the Internal Revenue Code (relating to partnerships a principal activity of which is the buying and selling of commodities (not described in section 1221(1) of the Internal Revenue Code), or options, futures, or forwards with respect to commodities) and which meets the gross income requirement of section 7704(c)(2) of the Internal Revenue Code.

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Dated: Albany, New York  
January 3, 1994

/s/ James W. Wetzler

James W. Wetzler

Commissioner of Taxation and Finance