financial instrument or contract described above. This provision applies only for purposes of determining when a transaction is treated as a transfer for purposes of section 7704(b) and does not apply in determining any other federal tax consequences of a transaction, including whether the transaction is a sale or exchange or whether the transferee is a partner of the partnership for any purpose other than section 7704(b).

The proposed regulations also provide that a transfer of an interest in a partnership is taken into account for purposes of section 7704(b) only if: (1) The partnership redeems the interest; (2) the transferee is admitted as a partner; or (3) the partnership otherwise recognizes any rights of the transferee, such as a right of the transferee to partnership distributions (directly or indirectly) or the right of the transferee to acquire an interest in the capital or profits of the partnership. For example, if a partner enters into a financial contract providing for a payment by the partner in an amount calculated by reference to the amount of partnership distributions, the financial contract is treated as an interest in the partnership and the entering into the contract is treated as a transfer of an interest for purposes of section 7704. The transfer is not taken into account, however, unless the partnership admits the transferee as a partner or otherwise recognizes the rights of the transferee to partnership distributions by, for example, making distributions directly to the transferee or to a third party on behalf of the transferee. This provision is intended to limit transfers for purposes of section 7704(b) to transfers that the partnership is aware of and has recognized, thereby preventing a partnership from becoming publicly traded without the knowledge or participation of the partnership.

Transfers That Do Not Create Public Trading

As discussed above, guidance issued in Notice 88-75 provided certain exclusions for purposes of section 7704(b)(2). The proposed regulations generally adopt these exclusions with certain modifications. The modifications are necessary to more appropriately implement congressional intent and to ensure that any partnership in which interests are subject to firm-quote trading is treated as a publicly traded partnership under section 7704. As in Notice 88–75, none of these exclusions apply in determining whether interests in a partnership are traded on an established securities market.

The proposed regulations adopt the exclusion in section II.A of Notice 88-75 for partnership interests issued in certain private placements with four modifications. First, the proposed regulations provide that the exclusion applies only for purposes of determining whether interests in a partnership are readily tradable on the substantial equivalent of a secondary market. Unlike Notice 88-75, this exclusion does not apply for purposes of determining whether the interests are readily tradable on a secondary market. As a result, a private placement partnership is treated as a publicly traded partnership if the interests in the partnership are readily tradable on a secondary market. This modification was made to ensure that, consistent with the purpose of section 7704(b), all partnerships, including private placement partnerships, are treated as publicly traded if interests in the partnership are subject to firm-quote trading.

Secondly, the proposed regulations provide that the private placement exclusion does not apply if the partnership has more than 50 partners at any time during its taxable year and the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in private transfers described in paragraph (d) of this section) exceeds 10 percent of the total interests in partnership capital or profits. This modification was made because transfers in excess of 10 percent indicate the existence of the type of market that section 7704(b) intended to treat as public trading. This modification does not apply to partnerships with 50 or fewer partners because such partnerships are unlikely to develop any public trading.

Thirdly, as in Notice 88-75, the private placement exclusion applies only if the partnership does not have more than 500 partners or the initial offering price of each unit of partnership interest is at least \$20,000. The proposed regulations clarify that a partnership satisfies the 500 partner requirement only if the partnership does not have more than 500 partners at any time during the taxable year of the partnership. Finally, the proposed regulations provide that the indirect ownership rule for determining the number of partners in a partnership does not apply to persons owning interests in a partnership through a regulated investment company (as defined in section 851) or a real estate investment trust (as defined in section 865).

The proposed regulations adopt, with two additions, the exclusion contained in section II.B of Notice 88-75 for transfers not involving trading (private transfers). Under the proposed regulations, private transfers include all of the transfers described in section II.B of Notice 88-75 plus: (1) distributions from an individual retirement account, and (2) transfers by one or more partners of interests representing more than 50 percent of the total interests in partnership capital and profits in one transaction or a series of related transactions. The proposed regulations also provide that a block transfer means the transfer by a partner in one or more transactions during any 30 calendar day period of partnership interests representing in the aggregate more than 2 percent of the total interests in partnership capital or profits, rather than 5 percent as in Notice 88–75.

In lieu of the 5 percent and 2 percent safe harbors contained in section II.C of Notice 88–75, the proposed regulations provide a more limited de minimis trading exclusion. The percentage safe harbors in Notice 88–75 applied in determining whether interests in a partnership were readily tradable on a secondary market or the substantial equivalent thereof. The Conference Report, however, gives no indication that a *de minimis* level of trading on a secondary market should be permitted, and the IRS and Treasury do not believe that a broad-based *de minimis* rule that allows firm-quote trading on a secondary market is appropriate. Furthermore, the percentage safe harbors contained in Notice 88-75 apparently have encouraged the type of firm-quote trading that Congress intended to prohibit by enacting section 7704.

Accordingly, the proposed regulations provide that interests in a partnership are not readily tradable on a substantial equivalent of a secondary market if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership does not exceed 2 percent of the total interests in partnership capital or profits. All transfers of an interest in a partnership (including redemptions) are taken into account for purposes of this 2 percent rule, except for: (1) Private transfers; (2) transfers pursuant to redemption and repurchase agreements meeting certain requirements as specified in the regulations; and (3) transfers pursuant to a qualified matching service, discussed below. The 2 percent rule differs from the percentage safe harbors in Notice 88–75 because the 2 percent rule applies only for purposes of determining