commentators suggested expanding this safe harbor to apply to the determination of a secondary market. Other commentators suggested eliminating the 10-percent limitation. Several commentators suggested increasing the 50-partner limit, such as to 100, and modifying the rule for counting the number of partners that looked through partners that were partnerships, grantor trusts, or S corporations. In response to these comments, the final regulations modify the private placement exception in the following respects.

First, the safe harbor is expanded to apply to a secondary market as well as the substantial equivalent of a secondary market. As a result, interests in a partnership that qualifies for the private placement safe harbor will not be readily tradable on a secondary market or the substantial equivalent thereof.

Second, the final regulations provide that the safe harbor does not apply to partnerships subject to Regulation S (17 CFR 230.901 et seq.), unless the offering and sale of interests in the partnership would not have been required to be registered if offered and sold within the United States. Regulation S, adopted after the issuance of Notice 88-75, provides an exception from registration for any offerings and sales outside of the United States, even if registration would have been required if the interests were offered and sold within the United States. This modification ensures that the private placement exception applies in a similar manner to offerings within and outside of the United States.

Third, the 10-percent limitation is not adopted in the final regulations. Instead, the final regulations provide that the safe harbor applies only if the partnership has no more than 100 partners at any time during the taxable year of the partnership.

Finally, the final regulations provide a new rule for determining the number of partners in a partnership. Under the proposed regulations, each person owning an interest in a partnership (lower-tier partnership) through another partnership, an S corporation, or a grantor trust (flow-through entity) is treated as a partner in the lower-tier partnership. The final regulations provide that an owner of a flow-through entity is treated as a partner in the lower-tier partnership only if (i) substantially all of the value of the flowthrough entity is attributable to the lower-tier partnership interest, and (ii) a principal purpose for the tiered arrangement is to permit the partnership to satisfy the 100-partner requirement.

The requirement that substantially all of the value of the flow-through entity be attributable to the lower-tier partnership is intended to limit the look-through rule to flow-through entities that are economically equivalent to an interest in the lower-tier partnership. For example, if the only asset held by a flow-through entity is an interest in a lower-tier partnership, an interest in the flow-through entity is economically equivalent to an interest in the lower-tier partnership and the members of the flow-through entity should be counted as partners in the partnership. The requirement that there be a principal purpose to avoid the 100 partner rule recognizes that looking through a flow-through entity is not appropriate in all cases, even if the flow-through entity owns no interest other than an interest in the lower-tier partnership, but should be limited to situations in which a principal purpose of the flow-through entity is to avoid the 100 partner limitation.

Lack of Actual Trading

The proposed regulations provide that interests in a partnership are not readily tradable on the substantial equivalent of a secondary market if the sum of the percentage interests transferred during the taxable year does not exceed two percent. Several commentators suggested expanding this safe harbor to secondary markets so that partnerships could be assured that some level of trading would not result in public trading. This comment is adopted in the final regulations.

Qualifying Income

Several commentators requested guidance on the definition of *qualifying* income and financial business for purposes of the qualifying income exception of section 7704. These regulations are intended to address only the definition of public trading and therefore do not provide guidance on the definition of qualifying income. The IRS and Treasury, however, are actively considering guidance on the definition of qualifying income and financial businesses for investment partnerships and other partnerships engaged in various types of securities transactions. The IRS and Treasury invite comments on the scope and form of such guidance.

Transitional Relief

The proposed regulations provide that they will be effective for taxable years of a partnership beginning on or after the date final regulations are published. The preamble to the proposed regulations requests comments on whether transitional relief is necessary for partnerships that qualified for an exclusion under Notice 88–75. Many commentators suggested some form of transitional relief, ranging from 180 days to a permanent grandfather provision.

The final regulations provide that, for partnerships that were actively engaged in an activity before December 4, 1995, the regulations apply for taxable years beginning after December 31, 2005. This ten-year grandfather provision is similar to the grandfather rule provided on the enactment of section 7704. The final regulations provide that this transitional relief expires if the partnership adds a substantial new line of business within the meaning of §1.7704-2. The transitional relief is not affected by a termination of the partnership under section 708(b)(1)(B). Finally, partnerships subject to transitional relief may continue to rely on Notice 88-75 for guidance.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information. The principal author of these regulations is Christopher T. Kelley, Office of Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.7704–1 is added to read as follows: