
Publicly Traded Partnerships

Notice 98-3

This notice provides the method for grandfathered publicly traded partnerships to elect to remain exempt from § 7704 of the Internal Revenue Code pursuant to § 7704(g). This notice also provides the procedures for revoking the election. In addition, this notice informs grandfathered publicly traded partnerships that do not elect the application of § 7704(g) that the rules contained in proposed regulation § 1.743-2 regarding special § 743(b) basis accounts may be followed for purposes of a conversion from a partnership to a corporation. The references in this notice to § 7704(g) reflect the amendments made by the Taxpayer Relief Act of 1997 (1997 TRA), Pub. L. No. 105-34, 111 Stat. 788 (1997).

BACKGROUND

Section 7704(a) provides that a publicly traded partnership is treated as a corporation.

Section 7704(b) defines a partnership as a “publicly traded partnership” if interests in the partnership are traded on an established securities market or are readily tradable on a secondary market (or the substantial equivalent thereof).

Section 7704(c) provides that a publicly traded partnership will not be treated as a corporation if, for the current taxable year and each preceding taxable year beginning after December 31, 1987 during which the partnership (or any predecessor) was in existence, (1) at least 90 percent of the gross income of the partnership consisted of certain “qualifying income” (as defined in § 7704(d)), and (2) the partnership would not be described in § 851(a) if the partnership were a domestic corporation.

Section 7704 applies to taxable years beginning after December 31, 1987. However, for any existing partnership (as

defined in § 10211(c)(2) of the Revenue Reconciliation Act of 1987 (1987 Act), 1987-3 C.B. 125), § 7704 applies to taxable years beginning after December 31, 1997. The term “existing partnership” means any partnership that was a publicly traded partnership on December 17, 1987. If a substantial new line of business is added with respect to an existing partnership anytime after December 17, 1987, the grandfather status of the partnership terminates.

Section 7704(g) was enacted as part of the 1997 TRA. Under § 7704(g), an existing 1987 partnership may elect to remain exempt from § 7704(a) by agreeing to pay each taxable year a 3.5 percent tax on gross income from the active conduct of all trades and businesses of the partnership. A publicly traded partnership may make the election under § 7704(g) if: (1) the partnership is an existing partnership (as defined in § 10211(c)(2) of the 1987 Act), (2) § 7704(a) has not applied (and without regard to § 7704(c)(1) would not have applied) to the partnership for all taxable years beginning after December 31, 1987, and before January 1, 1998, and (3) the partnership elects the application of § 7704(g) for its first taxable year beginning after December 31, 1997, and consents to the application of the 3.5 percent tax imposed for each taxable year on gross income from the active conduct of all trades or businesses of the partnership.

PROCEDURAL REQUIREMENTS

To make an election under § 7704(g), a partnership must file with the Memphis Service Center a statement that provides the following: (1) a notification at the top of the statement that an election is being made (that is, “ELECTION UNDER SECTION 7704(g) FILED PURSUANT TO NOTICE 98-3”); (2) the name of the partnership; (3) the federal tax identification number of the partnership; (4) the mailing address of the partnership; (5) the taxable year of the partnership; and (6) a declaration that, pursuant to § 7704(g), the partnership consents to the imposition of a 3.5 percent tax on gross income from the active conduct of all trades and businesses by the partnership.

The statement must be signed by the tax matters partner of the partnership (as defined under § 6231(a)(7)) and must be filed at any time on or before the 75th day

of the first taxable year of the partnership beginning after December 31, 1997. The mailing address for the Memphis Service Center is Internal Revenue Service, Stop 1, 5333 Getwell Road, Memphis, TN 38118.

TAX ON GROSS INCOME

An electing partnership must pay each taxable year a tax of 3.5 percent of the gross income from all active trades and businesses conducted by the partnership. The tax is not deductible by the partnership. Pursuant to § 705(a)(2)(B), a partner of an electing partnership must reduce the adjusted basis of the partner's partnership interest by a proportionate share of the 3.5 percent tax paid by the partnership.

TERMINATION OF ELECTION

If a partnership that elects special treatment under § 7704(g) adds a substantial new line of business after December 31, 1997, the election under § 7704(g) will terminate. The rules concerning a new line of business and the timing of a resulting termination that are set forth in § 1.7704-2 of the regulations will be applied to electing partnerships.

In addition, a partnership may voluntarily terminate its election at any time by filing a notice of revocation. The revocation will be effective as of the date designated in the notice, but not earlier than the date that the notice is filed with the Internal Revenue Service. Once a partnership revokes or otherwise terminates its election under § 7704(g), the election may not be reinstated. If the partnership remains a publicly traded partnership on the date of the termination and does not meet the exception for partnerships with passive-type income contained in § 7704(c), then absent an actual transaction that eliminates the partnership, the conversion from a partnership to a corporation will be determined under § 7704(f).

PROCEDURAL REQUIREMENTS FOR REVOCATION

To make a revocation under § 7704(g), a partnership must file with the Memphis Service Center a statement that provides the following: (1) a notification at the top of the statement that a revocation is being made (that is, “REVOCATION UNDER

SECTION 7704(g) FILED PURSUANT TO NOTICE 98-3"; (2) the name of the partnership; (3) the federal tax identification number of the partnership; (4) the mailing address of the partnership; (5) the taxable year of the partnership; (6) a declaration that, pursuant to § 7704(g), the partnership revokes its election to pay a 3.5 percent tax on gross income from the active conduct of all trades and businesses by the partnership; and (7) the effective date of the revocation. The statement must be signed by the tax matters partner of the partnership (as defined under § 6231(a)(7)).

PARTNERSHIPS THAT DO NOT ELECT

If an existing partnership does not elect the special treatment of § 7704(g), then the partnership will become taxable as a corporation if it (1) remains a publicly traded partnership on the first day of its first taxable year beginning after December 31, 1997, and (2) does not meet the exception for partnerships with passive-type income contained in § 7704(c). Absent an actual transaction that eliminates the partnership, the conversion from a partnership to a corporation will be treated under § 7704(f) as an asset transfer from the partnership to the corporation followed by a liquidation of the partnership.

On October 28, 1997, proposed regulations under § 743 were issued that provide that upon the contribution of assets by a partnership to a corporation, the special § 743 basis accounts are reflected in the basis of the assets in the hands of the corporation. 62 Fed. Reg. 55768, 1997-48 I.R.B. 13. Although these rules are in proposed form, the Service will not challenge a taxpayer's § 7704(f) conversion, or any actual transaction applying the conversion method of § 7704(f) that follows the rules in proposed regulation § 1.743-2, so long as the conversion or transaction occurs prior to the issuance of further guidance on this issue.

DRAFTING INFORMATION

The principal author of this notice is Christopher Kelley of the Office of the Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact