which case this section applies to taxable years beginning on or after the addition of the new line of business. Partnerships that qualify for this transition period may continue to rely on the provisions of Notice 88–75 (1988–2 C.B. 386) (see § 601.601(d)(2) of this chapter) for guidance regarding the definition of readily tradable on a secondary market or the substantial equivalent thereof for purposes of section 7704(b).

(3) *Substantial new line of business.* For purposes of paragraph (l)(2) of this section—

(i) Substantial is defined in § 1.7704–2(c); and

(ii) A new line of business is defined in § 1.7704–2(d), except that the applicable date is ''December 4, 1995'' instead of ''December 17, 1987''.

(4) *Termination under section 708(b)(1)(B).* The termination of a partnership under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in partnership capital and profits is disregarded in determining whether a partnership qualifies for the transition period provided in paragraph (l)(2) of this section.

[T.D. 8629, 60 FR 62029, Dec. 4, 1995]

§ 1.7704–2 Transition provisions.

(a) *Transition rule*—(1) *Statutory dates.* Section 7704 generally applies to taxable years beginning after December 31, 1987. In the case of an existing partnership, however, section 7704 and the regulations thereunder apply to taxable years beginning after December 31, 1997.

(2) *Effective date of regulations.* These regulations are effective for taxable years beginning after December 31, 1991.

(b) *Existing partnership*—(1) *In general.* For purposes of § 1.7704–2, the term ''existing partnership'' means any partnership if—

(i) The partnership was a publicly traded partnership (within the meaning of section 7704(b)) on December 17, 1987;

(ii) A registration statement indicating that the partnership was to be a publicly traded partnership was filed with the Securities and Exchange Commission (SEC) with respect to the partnership on or before December 17, 1987; or

(iii) With respect to the partnership, an application was filed with a state regulatory commission on or before December 17, 1987, seeking permission to restructure a portion of a corporation as a publicly traded partnership.

(2) *Changed status of an existing partnership.* A partnership will not qualify as an existing partnership after a new line of business is substantial.

(c) *Substantial*—(1) *In general.* A new line of business is substantial as of the earlier of—

(i) The taxable year in which the partnership derives more than 15 percent of its gross income from that line of business; or

(ii) The taxable year in which the partnership directly uses in that line of business more than 15 percent (by value) of its total assets.

(2) *Timing rule.* If a substantial new line of business is added during the taxable year (e.g., by acquisition), the line of business is treated as substantial as of the date it is added; otherwise a substantial new line of business is treated as substantial as of the first day of the taxable year in which it becomes substantial.

(d) *New line of business*—(1) *In general.* A new line of business is any business activity of the partnership not closely related to a pre-existing business of the partnership to the extent that the activity generates income other than ''qualifying income'' within the meaning of section 7704 and the regulations thereunder.

(2) *Pre-existing business.* A business activity is a pre-existing business of the partnership if—

(i) The partnership was actively engaged in the activity on or before December 17, 1987; or

(ii) The partnership is actively engaged in the business activity that was specifically described as a proposed business activity of the partnership in a registration statement or amendment thereto filed on behalf of the partnership with the SEC on or before December 17, 1987. For this purpose, a specific description does not include a general grant of authority to conduct any business.

(3) *Closely related.* All of the facts and circumstances will determine whether

a new business activity is closely related to a pre-existing business of the partnership. The following factors, among others, will help to establish that a new business activity is closely related to a pre-existing business of the partnership and therefore is not a new line of business:

(i) The activity provides products or services very similar to the products or services provided by the pre-existing business.

(ii) The activity markets products and services to the same class of customers as that of the pre-existing business.

(iii) The activity is of a type that is normally conducted in the same business location as the pre-existing business.

(iv) The activity requires the use of similar operating assets as those used in the pre-existing business.

(v) The activity's economic success depends on the success of the pre-existing business.

(vi) The activity is of a type that would normally be treated as a unit with the pre-existing business in the business' accounting records.

(vii) If the activity and the pre-existing business are regulated or licensed, they are regulated or licensed by the same or similar governmental authority.

(viii) The United States Bureau of the Census assigns the activity the same four-digit Industry Number Standard Identification Code (Industry SIC Code) as the pre-existing business. Such codes are set forth in the Executive Office of the President, Office of Management and Budget, Standard Industrial Classification Manual, prepared, and from time to time revised, by the Statistical Policy Division of the United States Office of Management and Budget. For example, if a partnership's pre-existing business is manufacturing steam turbines and then the partnership begins an activity manufacturing hydraulic turbines, both activities would be assigned the same Industry SIC Code, 3511—Steam, Gas, and Hydraulic Turbines, and Turbine Generator Set Units. In the case of a pre-existing business or activity that is listed under the Industry SIC Code, 9999—Nonclassifiable Establishments—or under a miscellaneous category (e.g., most Industry SIC Codes ending in a ''9'' are miscellaneous categories), the similarity of the SIC Codes is ignored as a factor in determining whether the activity is closely related to the pre-existing business. The dissimilarity of the SIC Codes is considered in determining whether the business activity is closely related to the pre-existing line of business.

(e) *Activities conducted through controlled corporations*—(1) *In general.* An activity conducted by a corporation controlled by an existing partnership may be treated as an activity of the existing partnership if the effect of the arrangement is to permit the partnership to engage in an activity the income from which is not subject to a corporate-level tax and which would be a new line of business if conducted directly by the partnership. This determination is based upon all facts and circumstances.

(2) *Safe harbor*—(i) *In general.* This paragraph (e)(2) provides a safe harbor for activities of a corporation controlled by an existing partnership. An activity conducted by a corporation controlled by an existing partnership is not deemed to be an activity of the partnership for purposes of determining whether an existing partnership has added a new line of business if no more than 10% of the gross income that the partnership derives from the corporation during the taxable year is section 7704(d) qualifying income that is recharacterized as nonqualifying income under paragraphs (e)(2) (ii) and (iii) of this section. The Internal Revenue Service will not presume that an activity conducted through a corporation controlled by an existing partnership is an activity of the partnership solely because the partnership fails to satisfy the requirements of this paragraph (e)(2)(i).

(ii) *Recharacterization of qualifying income.* Gross income received by a partnership from a controlled corporation that would be qualifying income under section 7704(d) is subject to recharacterization as nonqualifying income if the amount is deductible in computing the income of the controlled corporation.

(iii) *Extent of recharacterization.* The amount of income described in paragraph (e)(2)(ii) of this section that is recharacterized as nonqualifying income is—

(A) The amount described in paragraph (e)(2)(ii) of this section; multiplied by

(B) The controlled corporation's taxable income (determined without regard to deductions for amounts paid to the partnership) that would not be qualifying income within the meaning of section 7704(d) if earned directly by the partnership; divided by

(C) The controlled corporation's taxable income (determined without regard to deductions for amounts paid to the partnership).

(3) *Control.* For purposes of paragraphs (e) (1) and (2) of this section, control of a corporation is determined generally under the rules of section 304(c). However, the application of section 304(c) is modified to apply only to partners who own five percent or more by value (directly or indirectly) of the existing partnership unless a principal purpose of the arrangement is to avoid tax at the corporate level.

(4) *Example.* The following example illustrates the application of the this paragraph (e):

Example. (i) PTP, an existing partnership, acquired all the stock of X corporation on January 1, 1993. During PTP's 1993 taxable year it received $185,000 of dividends and $15,000 of interest from X. Determined without regard to interest paid to PTP, X's taxable income during that period was $500,000 none of which was "qualifying income" within the meaning of section 7704 and the regulations thereunder. In computing the income of X, the $15,000 of interest paid to PTP is deductible.

(ii) Under paragraph (e)(2)(ii) of section, all $15,000 of PTP's interest income was nonqualifying income ($15,000×500,000/500,000). Under paragraph (e)(2) of this section, however, the activities of X will not be considered to be activities of PTP for the 1993 taxable year because no more than 10 percent of the gross income that PTP derived from X would be treated as other than qualifying income (15,000/200,000=7.5%).

(f) *Activities conducted through tiered partnerships.* An activity conducted by a partnership in which an existing partnership holds an interest (directly or through another partnership) will be considered an activity of the existing partnership.

(g) *Exceptions*—(1) *Coordination with gross income requirements of section 7704(c)(2).* A partnership that is either an existing partnership as of December 31, 1997, or an existing partnership that ceases to qualify as an existing partnership is subject to section 7704 and the regulations thereunder. Section 7704(a) does not apply to these partnerships, however, if these partnerships meet the gross income requirements of paragraphs (c) (1) and (2) of section 7704. For purposes of applying section 7704(c) (1) and (2) to these partnerships, the only taxable years that must be tested are those beginning on and after the earlier of—

(i) January 1, 1998; or

(ii) The day on which the partnership ceases to qualify as an existing partnership because of the addition of a new line of business; or

(iii) The first day of the first taxable year in which a new line of business becomes substantial (if the new line of business becomes substantial after the year in which it is added).

(2) *Specific exceptions.* In determining whether a partnership is an existing partnership for purposes of section 7704, the following events do not in themselves terminate the status of existing partnerships—

(i) Termination of the partnership under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in partnership capital and profits;

(ii) Issuance of additional partnership units; and

(iii) Dropping a line of business. This event, however, could affect an existing partnership's status indirectly. For example, dropping one line of business could change the composition of the partnership's gross income. The change in composition could make a new line of business "substantial," under paragraph (c) of this section, and terminate the partnership's status. See paragraph (b)(2) of this section.

(h) *Examples.* The following examples illustrate the application of this section:

Example 1. (i) On December 17, 1987, PTP, a calendar-year publicly traded partnership, owned and operated citrus groves. On March

1, 1993, PTP purchased a processing business involving frozen citrus products. In the partnership's 1993 taxable year, the partnership directly used in the processing business more than 15 percent (by value) of its total assets.

(ii) The citrus grove activities provide different products from the processing activities, are marketed to customers different from the customers of the processing activities, require different types of operating assets, are not commonly conducted at the same location, are not commonly treated as a unit in accounting records, do not depend upon one another for economic success, and do not have the same Industry SIC Code. Under the facts and circumstances, the processing business is not closely related to the citrus grove operation and is a new line of business under paragraph (d)(1) of this section.

(iii) The assets of the partnership used in the new line of business are substantial under paragraph (c)(2) of this section. Because PTP added a substantial new line of business after December 17, 1987, paragraph (b)(2) of this section terminates PTP's status as an existing partnership on March 1, 1993.

Example 2. (i) On December 17, 1987, PTP, a calendar-year publicly traded partnership, owned and operated retirement centers that serve the elderly. Each center contains three sections—

(A) A residential section, which includes suites of rooms, dining facilities, lounges, and gamerooms;

(B) An assisted-living section, which provides laundry and housekeeping services, health monitoring, and emergency care; and

(C) A nursing section, which provides private and semiprivate rooms, dining facilities, examination and treatment rooms, drugs, medical equipment, and physical, speech, and occupational therapy.

(ii) The business activities of each section constitute pre-existing businesses of PTP under paragraph (d)(2) of this section, because PTP was actively engaged in the activities on or before December 17, 1987.

(iii) The nursing sections primarily furnish health care. They employ nurses and therapists, are subject to federal, state, and local licensing requirements, and may change certain costs to government programs like Medicare and Medicaid.

(iv) In 1993, PTP acquired new nursing homes that treat inpatient adults of all ages. The nursing homes provide private and semiprivate rooms, dining facilities, examination and treatment rooms, drugs, medical equipment, and physical, speech, and occupational therapy. The nursing homes primarily furnish health care. They employ nurses and therapists, are subject to federal, state, and local licensing requirements, and may charge certain costs to government programs like Medicare and Medicaid.

(v) PTP's new nursing homes and old nursing sections provide very similar services, market to very similar customers, use similar types of property and personnel, and are licensed by the same regulatory agencies. The nursing homes and old nursing sections have the same Industry SIC Code. Under these facts and circumstances, the new nursing homes are closely related to a pre-existing business of the partnership. Accordingly, under paragraph (d)(1) of this section, the acquisition of the new nursing homes is not the addition of a new line of business.

(vi) PTP was a publicly traded partnership on December 17, 1987, and was an existing partnership under paragraph (b)(1)(i) of this section. Because PTP has added no substantial new line of business after December 17, 1987, paragraph (b)(2) of this section does not terminate PTP's status as an existing partnership.

Example 3. (i) On December 17, 1987, PTP, a calendar-year publicly traded partnership, owned and operated cable television systems in the northeastern United States. PTP's registration statement described as its proposed business activities the ownership and operation of cable television systems, any ancillary operations, and any business permitted by the laws of the state in which PTP was formed.

(ii) PTP's cable systems include cables strung along telephone lines, converter boxes in subscribers' homes, other types of cable equipment, satellite dishes that receive programs broadcast by various television networks, and channels that carry public service announcements of local interest. Subscribers pay the systems a fee for the right to receive both the local announcements and the network signals relayed through the cables. Those fees constitute PTP's primary revenue. The systems operate under franchise agreements negotiated with each municipality in which they do business.

(iii) On September 1, 1993, PTP purchased a television station in the northwestern United States. The station owns broadcasting facilities, satellite dishes that receive programs broadcast by the station's network, and a studio that produces programs of interest to the area that receives the station's broadcasts. Fees from advertisers constitute the station's primary revenue. The station operates under a license from the Federal Communications Commission.

(iv) In the partnership's 1993 taxable year, the station generated less than 15 percent of PTP's gross income and constituted less than 15 percent of its total assets (by value). In PTP's 1994 taxable year, the station generated more than 15 percent of PTP's gross income.

(v) The cable systems relay signals through cables to subscribers and earn revenue from subscriber fees; the station broadcasts signals to the general public and earns revenue by selling air time for commercials. Despite certain similarities, the two types of activities generally require different operating assets and earn income from different sources. They are regulated by different agencies. They are not commonly conducted at the same location and do not generally depend upon one another for their economic success. They have different Industry SIC Codes. Under the facts and circumstances, the television station activities are not closely related to PTP's pre-existing business, the cable system activities.

(vi) As of December 17, 1987, PTP did not own and operate any television station. PTP's registration statement specifically described as its proposed business activities only the ownership and operation of cable television systems and any ancillary operations. For purposes of paragraph (d)(2) of this section, a specific description does not include PTP's general authority to carry on any business permitted by the state of its formation. Therefore, the television station line of business was not specifically described as a proposed business activity of PTP in its registration statement. PTP's acquisition of the television station business activity constitutes a new line of business under paragraph (d)(1) of this section.

(vii) PTP was a publicly traded partnership on December 17, 1987, and was an existing partnership under paragraph (b)(1)(i) of this section. PTP added a new line of business in 1993, but that line of business was not substantial under paragraph (c) of this section, and thus PTP remained an existing partnership for its 1993 taxable year. In 1994, the new line of business became substantial because it generated more than 15 percent of PTP's gross income. Paragraph (b)(2) of this section therefore terminates PTP's existing partnership status as of January 1, 1994, the first day of the first taxable year beginning after December 31, 1987, in which PTP's new line of business became substantial.

[T.D. 8450, 57 FR 58708, Dec. 11, 1992]

§ 1.7704–3 Qualifying income.

(a) *Certain investment income*—(1) *In general*. For purposes of section 7704(d)(1), qualifying income includes capital gain from the sale of stock, income from holding annuities, income from notional principal contracts (as defined in § 1.446–3), and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner. Income from a notional principal contract is included in qualifying income only if the property, income, or cash flow that measures the amounts to which the partnership is entitled under the contract would give rise to qualifying income if held or received directly by the partnership.

(2) *Limitations*. Qualifying income described in paragraph (a)(1) of this section does not include income derived in the ordinary course of a trade or business. For purposes of the preceding sentence, income derived from an asset with respect to which the partnership is a broker, market maker, or dealer is income derived in the ordinary course of a trade or business; income derived from an asset with respect to which the taxpayer is a trader or investor is not income derived in the ordinary course of a trade or business.

(b) *Calculation of gross income and qualifying income*—(1) *Treatment of losses*. Except as otherwise provided in this section, in computing the gross income and qualifying income of a partnership for purposes of section 7704(c)(2) and this section, losses do not enter into the computation.

(2) *Certain positions that are marked to market*. Gain recognized with respect to a position that is marked to market (for example, under section 475(f), 1256, 1259, or 1296) shall not fail to be qualifying income solely because there is no sale or disposition of the position.

(3) *Certain items of ordinary income*. Gain recognized with respect to a capital asset shall not fail to be qualifying income solely because it is characterized as ordinary income under section 475(f), 988, 1258, or 1296.

(4) *Straddles*. In computing the gross income and qualifying income of a partnership for purposes of section 7704(c)(2) and this section, a straddle (as defined in section 1092(c)) shall be treated as set forth in this paragraph (b)(4). For purposes of the preceding sentence, two or more straddles that are part of a larger straddle shall be treated as a single straddle. The amount of the gain from any straddle to be taken into account shall be computed as follows:

(i) *Straddles other than mixed straddle accounts*. With respect to each straddle (whether or not a straddle during the