

## Form 1065 Reporting and Calculations for Partnership Terminations and Transfers of Interest

THURSDAY, FEBRUARY 20, 2014, 1:00-2:50 pm Eastern

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# Form 1065 Reporting and Calculations for Partnership Terminations and Transfers of Interest

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Feb. 20, 2014

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Robert A.N. Cudd, Polsinelli  
[rcudd@polsinelli.com](mailto:rcudd@polsinelli.com)

Joseph K. Fletcher, III, Glaser Weil Fink  
Jacobs Howard Avchen & Shapiro  
[jcolvin@c-hlaw.com](mailto:jcolvin@c-hlaw.com)

Amanda Wilson, Lowndes Drosdick Doster  
Kantor & Reed  
[amanda.wilson@lowndes-law.com](mailto:amanda.wilson@lowndes-law.com)

# Today's Program

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*[Amanda Wilson]*

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Lowndes  
Drosdick  
Doster &  
Kantor  
Reed, P.A.

A T T O R N E Y S  
A T L A W

Orlando, Florida

[www.lowndes-law.com](http://www.lowndes-law.com)

(407) 418-6220

Amanda.Wilson@lowndes-law.com

# Termination of a Partner's Interest, and Termination by Death or Abandonment

**Amanda Wilson**

February 20, 2014

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# I. Termination of a Partner's Interest

## Liquidating Distributions

- The termination of a partnership interest can be structured as one or more distributions in exchange for the liquidation of a partner's interest in the partnership (i.e., a redemption).
- General rule is found under Section 731. The tax consequences will depend on the items distributed and the partner's basis in his partnership interest.
  - Distributions of money can result in gain or loss.
  - Distributions of property do not result in gain or loss. Instead, terminating partner takes a basis in the distributed property equal to his basis in his partnership interest.

## Basis in Partnership Interest

- Increased by
  - cash and basis (not FMV) of property contributed to partnership
  - partner's distributable share of income and gain (including tax exempt income)
- Note: Increase in allocation of liabilities is treated as a deemed contribution of cash.

## Basis in Partnership Interest

- Decreased (but not below zero) by
  - cash and basis (not FMV) of property distributed by partnership
  - partner's distributable share of deductions and losses
  - partner's distributable share of partnership expenditures not deductible and not properly chargeable to capital account
- Note: Decrease in allocation of liabilities is treated as a deemed distribution of cash.
- Note: Basis cannot be negative.

## Example

- A contributes \$50 cash and property with basis of \$50 and FMV of \$100 to ABCD in exchange for a 25% partnership interest.
  - Basis is \$100 [\$50 (cash) + \$50 (basis of property)]
- In year 1, ABCD has \$200 of losses, 25% allocated to A.
  - Basis is \$50 [\$100 (initial basis) - \$50 (losses)]
- In year 2, ABCD has \$100 of income, 25% allocated to A, and distributes \$25 of cash to A.
  - Basis is \$50 [\$50 (year 1 basis) + \$25 (profits) - \$25 (distribution)]

## Example

- In year 3, ABCD incurs \$500 of debt to buy a building. 25% allocated to A under Section 752. No profits or losses.
  - Basis is \$175 [ $\$50$  (year 2 basis) +  $\$125$  (debt allocation)]
- In year 4, ABCD pays off the debt. No profits or losses.
  - Basis is \$50 [ $\$175$  (year 3 basis) -  $\$125$  (debt relief)]

## Gain Recognition

- Terminating partner recognizes gain to the extent that distributions of money exceed the partner's basis in his partnership interest.
  - Be sure to consider deemed distributions of cash as a result of debt relief under Section 752.

## What is Money?

- For purposes of Section 731, money is
  - Cash
  - Relief of a partner's allocable share of partnership debt (under Section 752)
  - Marketable securities that are actively traded
    - Financial instruments (including stock, debt, options, forward contracts, etc.)
    - Foreign currencies

## Loss Recognition

- Terminating partner may recognize loss but only if the liquidating distributions consist solely of money or Section 751 hot assets (unrealized receivables and inventory).
  - Loss in this situation recognized to extent partner's basis in partnership interest exceeds the sum of (1) money distributed, and (2) basis to terminating partner of any unrealized receivables and inventory received (because partner's carryover basis is capped by the partnership's basis for these assets).
  - If non-Section 751 property is received, then loss not recognized but is instead reflected in the partner's basis in the distributed property.

## Unrealized Receivables

- Unrealized receivables
  - Receivables for goods delivered or to be delivered to the extent the partnership would have had ordinary income
  - Receivables for services rendered or to be rendered
  - Exception: does not include amounts previously included in income under partnership's method of accounting.
  - Recapture property (e.g., under Section 1245 and 1250) to the extent of amount that would be treated as ordinary income if partnership sold property for FMV.

# Inventory

- Inventory
  - property held for sale to customers in the ordinary course of business (Section 1221(a)(1) property)
  - any other property that, on the sale or exchange by the partnership, would be considered property other than a capital asset or Section 1231 property; and
  - any other property that, if held by the terminating partner, would be described under the first two bullets.

## Examples

- ABCD distributes \$100 to A in liquidation of A's interest.
  - A's basis is \$50. A has \$50 of gain, and recognizes it because cash distributed exceeds basis.
  - A's basis is \$125. A has \$25 loss, and can recognize it because only cash was received.

## Examples

- ABCD distributes property with a FMV and basis of \$100 to A in liquidation of A's interest. Property is not unrealized receivable or inventory.
  - A's basis is \$50. A does not recognize any gain because no cash was distributed. A takes a basis in the property of \$50.
  - A's basis is \$125. A cannot recognize the loss because assets other than cash and Section 751 hot assets were received. A takes a basis in the property of \$125.

## Examples

- ABCD distributes property with a FMV and basis of \$100 to A in liquidation of A's interest. Property is unrealized receivable and ABCD's basis in the property is \$80.
  - A's basis is \$50. A does not recognize any gain because no cash was distributed. A takes a basis in the property of \$50.
  - A's basis is \$125. Because distributed asset is a hot asset, A can only take a basis in the property equal to ABCD's basis (\$80), not A's \$125 basis in his partnership interest. A recognizes a loss of \$45 and takes a basis in the property of \$80.

## Examples

- ABCD distributes \$100 of cash and property with a FMV and basis of \$100 to A in liquidation of A's interest. The property is not a Section 751 hot asset.
  - A's basis is \$50. A recognizes \$50 of gain because cash distributed exceeds basis. A takes a basis in the property of \$0.
  - A's basis is \$225. A recognizes no gain because cash distributed does not exceed basis. A recognizes no loss because assets other than cash and hot assets were received. A takes a basis in the property of \$125 (\$100 of A's \$225 basis is allocated to the cash).

## Exceptions

- While Section 731 sets forth the general rule for the treatment of liquidating distributions, there are exceptions:
  - Section 737 (Built-in gain or loss property)
  - Section 751(b) (Hot Assets)
  - Section 736 (Retirement Payments)

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## Section 737

- Section 704(c) provides special rules to address property that has a built-in gain or built-in loss at the time the property is contributed to the partnership. These rules are in place since the gain or loss will not be recognized at the time of contribution.
  - One of these rules is that the partner must recognize the gain or loss if the property is distributed to another partner within 7 years of the contribution.
- Section 737 is a corollary rule and provides that a partner must recognize gain if he receives a distribution of property other than the built-in gain property that he contributed within 7 years of the contribution of the built-in gain property.

## Section 737

- Gain recognized is lesser of
  - Excess distribution - Excess (if any) of FMV of property other than money received in distribution over the partner's adjusted basis in his partnership interest immediately before the distribution (reduced by the amount of any money distributed), or
  - Net precontribution gain – the gain, if any, that the partner would have recognized under Section 704(c) if the partnership had instead distributed any remaining Section 704(c) property contributed by that partner to another partner.

## Example

- A contributes Property 1 with FMV of \$500 and basis of \$300 to ABCD. Two years later, A receives Property 2 with FMV and basis of \$500 in liquidation of his interest. ABCD has taken \$50 of depreciation for Property 1, reducing partnership's basis in Property 1 to \$250. A's partnership basis at liquidation is \$300.
- Excess distribution is \$200 [\$500 FMV - \$300 basis].
- Net precontribution gain \$150 [\$200 built-in gain less \$50 depreciation].
- A recognizes \$150 of gain under Section 737.

## Section 737 Basis Adjustment

- Section 737 provides a basis adjustment rule, which in the case of a liquidating distribution, will increase the terminating partner's basis in the property distributed by the amount of gain recognized under Section 737.
- A's basis in Property 2 in prior example would be \$450 [ $\$300 + \$150$  of gain recognized].

## Section 737 Character of Gain

- Character of gain recognized is based on the proportionate character of the net precontribution gain.
- Gain and losses in the same category (e.g., capital, ordinary) are netted, and any category that has a net loss is ignored.

## Example

- A contributes Property 1 (FMV of \$500 and basis of \$350), Property 2 (FMV of \$450 and basis of \$500) and Property 3 (FMV of \$300 and basis of \$250). Property 1 and 2 are long-term capital assets and Property 3 is an ordinary income asset.
- Pre-contribution gain is \$150 [ $\$150$  (P1) -  $\$50$  (P2) +  $\$50$  (P3)]
  - Long-term capital portion is \$100 [ $\$150$  (P1) -  $\$50$  (P2)]
  - Ordinary income portion is \$50 [P3]
- So any gain recognized under Section 737 would be 2/3 long-term capital gain and 1/3 ordinary income.

## Section 751(b)

- Section 751(b) is an exception to Section 731 treatment of distributions.
- Section 751(b) can result in ordinary income (for the terminating partner or the partnership) where the partnership has unrealized receivables and substantially appreciated property.
  - Section 751(b) only applies to substantially appreciated inventory (FMV is more than 120% of partnership's adjusted basis).

## Section 751(b)

- Only applies to the extent a terminating partner receives
  - Section 751(b) property in exchange for all or a part of his interest in other partnership property (including money), or
  - partnership property (including money) other than Section 751(b) property in exchange for all or a part of his interest in the Section 751(b) property.
- To the extent the terminating partner gets an excess of one of these categories of property, there is a deemed taxable exchange of the surrendered interest in the one category in exchange for the excess interest in the other category.

## Section 751(b)

- If terminating partner gets excess non-Section 751(b) property, the terminating partner is treated as having acquired the excess non-Section 751(b) property in exchange for giving up a portion of his Section 751(b) property.
- There is a deemed distribution by the partnership of partner's proportionate interest in the Section 751(b) and non-Section 751(b) property, and then the partner is treated as exchanging his decreased share of Section 751(b) property for the excess share of the non-Section 751(b) property.

## Section 751(b)

- If terminating partner gets excess Section 751(b) property, the terminating partner is treated as having acquired the excess property in exchange for giving up a portion of his non-Section 751(b) property.
- There is a deemed distribution by the partnership of partner's proportionate interest in the Section 751(b) and non-Section 751(b) property, and then the partner is treated as exchanging his surrendered share of non-Section 751(b) property for the excess share of Section 751(b) property.

## Example

- ABCD partnership has cash of \$100,000 and Section 751(b) assets with FMV of \$100,000 and basis of \$50,000. A has a 25% interest.
- A receives \$50,000 in cash in liquidation of his interest. A's basis is \$37,500.
- A's share, pre-termination, of Section 751(b) property is \$25,000 and non-Section 751(b) property (the cash) is \$25,000.
- A's share, post-termination, of Section 751(b) property is \$0 and non-Section 751(b) property is \$50,000.

## Example

- A is treated as having received a distribution of (i) \$25,000 of cash with a basis of \$25,000 and (ii) \$25,000 of Section 751(b) assets with basis of \$12,500. A recognizes no gain or loss on this distribution.
- A then is treated as selling the Section 751(b) assets to ABCD for the remaining \$25,000 of cash. A recognizes \$12,500 of ordinary income, and ABCD takes a basis in the acquired Section 751(b) property of \$25,000.

## Example

- ABCD partnership has cash of \$100,000 and Section 751(b) assets with FMV of \$100,000 and basis of \$50,000.
- A receives \$50,000 in Section 751(b) assets in liquidation of his interest. A's basis is \$37,500.
- A's share, pre-termination, of Section 751(b) property is \$25,000 and non-Section 751(b) property (the cash) is \$25,000.
- A's share, post-termination, of Section 751(b) property is \$50,000 and non-Section 751(b) property is \$0.

## Example

- A is treated as having received a distribution of (i) \$25,000 cash with basis of \$25,000, and (ii) \$25,000 of Section 751(b) property with basis of \$12,500.
- A is then treated as paying \$25,000 cash to acquire the remaining \$25,000 of Section 751(b) property from ABCD. ABCD's basis in the property is \$12,500, so it recognizes \$12,500 ordinary income. A gets a basis in the acquired property of \$25,000.
- A's total basis in the Section 751(b) property is \$37,500.

## Section 751(b)

- Does not apply if partnership
  - Only has non-Section 751(b) property,
  - Only has Section 751(b) property, or
  - Distributes to terminating partner his proportionate share of Section 751(b) property and non-Section 751(b) property.
    - Using the prior examples, if A received \$25,000 of cash and \$25,000 of Section 751(b) property, Section 751(b) would not apply.

## Section 736 Retirement Payments

- Section 736 provides special rules in the case of retirement payments (discussed later in the presentation).

## Allocations of Income

- The termination of a partner's interest closes the partnership's tax year with respect to that partner.
- Allocation of income must take into account the partner's varying interest in the partnership throughout the tax year.
- Two primary methods:
  - Interim closing of the books method.
  - Pro rata method.

## II. Termination by Death or Abandonment

## Death

- The death of a partner does not automatically terminate a partner's interest in the partnership.
- Rather, the decedent partner's successor in interest is generally recognized as taking over the decedent's interest until it is sold or liquidated.
- The later sale of the decedent's interest by the successor in interest will be governed by Section 736 (discussed later).

## Closing of Tax Year at Death

- Under Section 706, the tax year of the partnership closes with respect to the deceased partner. This results in the deceased partner's distributive share of the partnership income or loss from the short tax year being included in the deceased partner's final income tax return.

## Example

- A is a 25% partner in ABCD when he dies.
- ABCD has \$500 of income for the tax year, \$300 of which is from the period up to August 1, the date of A's death.
- The partnership tax year closes with respect to A on August 1 and uses the interim closing of the books method to allocate income.
- A is allocated \$75 of income (25% of \$300).
- A's successor in interest is allocated \$50 (25% of \$200).

## Basis

- Decedent's successor generally takes a basis in the partnership interest equal to the FMV of the interest at the time of death.
  - This includes the successor's allocable share of partnership liabilities under Section 752, which is important as the liabilities will have been taken out when determining FMV.
- Consideration should be given to making a Section 754 election for the partnership to allow for a basis adjustment of the partnership's assets.

## Section 743(b) Adjustment

- Under Section 743(b), the basis of the partnership assets is adjusted with respect to the successor partner upon the death of a partner.
- Section 743(b) only applies if the partnership has made a Section 754 election or if there is a substantial built-in loss (>\$250,000).
- Adjustment is only with respect to the successor partner, not the partnership.
- The adjustment is equal to the difference between the successor partner's basis in his partnership interest and his “proportionate share of the adjusted basis of the partnership property.”

## Example

- ABC partnership has assets with FMV of \$3000 and basis of \$300. X inherits A's 33% interest with FMV of \$1000.
- X's proportionate share of the partnership's basis is \$100.
- X's basis in his partnership interest is \$1000.
- Section 743(b) adjustment would be \$900.
- If ABC sold the assets for \$3000, X would be allocated no gain from the sale because of the adjustment.
- Section 743(b) adjustment is only with respect to X.

## Section 743(b) Adjustment

- Once made, a Section 754 election cannot be revoked except with IRS consent.
- Applies to any subsequent sales or exchanges or transfers upon death, as well as distributions that trigger Section 734(b) adjustments.
- As a result, it can be an administrative headache and existing partners may resist making the election.

## Section 755 Allocation of Adjustment

- Determine the FMV of all partnership assets.
- Determine the amount of income, gain or loss that would be allocated to the successor partner with respect to each partnership asset if all of the assets were sold for FMV.
- Classify the assets into ordinary income property and capital gain property.
- Allocate Section 743 adjustment to ordinary income classes to the extent that the total income, gain, and loss that would be allocated to the successor partner with respect to the sale of ordinary income property in the hypothetical transaction.

## Section 755 Allocation of Adjustment

- Allocate Section 743 adjustment to capital gain classes to the partnership to the extent that the total income, gain, and loss that would be allocated to the successor partner with respect to the sale of capital gain property in the hypothetical transaction.
- Limitation: Basis of capital gain property cannot be reduced below zero. The additional reduction must go to ordinary income property.
- Adjustments within classes are allocated first to properties with unrealized appreciation or depreciation to the extent of the purchasing partner's share. Remainder allocated in proportion to the successor partner's share of the amount that would be realized upon the hypothetical sale of each asset in the class.

## Abandonment

- A partner that abandons a partnership interest for no consideration can take an ordinary loss in an amount equal to his basis in the partnership interest.
  - No consideration means that there is no sale or exchange under Section 1221, allowing ordinary income treatment.
  - However, if partner is relieved of liabilities under Section 752, the partner is treated as having received consideration. The result is the abandonment is treated as a sale of a partnership interest (a capital asset), and the entire loss is capital unless Section 751 provides otherwise.

## Example

- Partner A has an outside basis in his 33.3% ABC partnership interest of \$100. The assets of ABC have a basis of \$300 and a FMV to \$60. A is allocated no liabilities under Section 752.
- If A successfully abandons his interest in ABC, he would recognize \$100 ordinary loss.
- Assume instead that ABC sells the property for \$240 loss and liquidates. A would receive \$20 cash and would be allocated a loss of \$80 (1/3 of \$240). This would generally be a capital loss.
- If even \$1 of liability was allocated to A under Section 752, the entire \$100 loss would be capital.

## How to Abandon

- Abandonment of a partnership interest requires (1) an intention to abandon the asset, and (2) an affirmative act of abandonment.
- No specific steps are required.
- A written letter to the partnership stating that the partner is abandoning his interest has been approved by the IRS as a manner of establishing abandonment. Revenue Ruling 93-80.
- The terms of the partnership agreement may preclude abandoning a partnership interest.

## Worthlessness

- The IRS has also held that a partner is entitled to an ordinary loss on the worthlessness of a partnership interest. Revenue Ruling 93-80.
- May be a viable alternative if the partnership agreement prohibits abandonment.
- Worthlessness can be difficult to establish. The partner must show that the partnership interest has become worthless in the year that the loss is claimed.

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# Abandonment of Partnership Interests

Robert A.N. Cudd  
February 20, 2014

# Abandonment of Partnership Interest

- The abandonment of a partnership interest for no consideration is not generally treated as a sale or exchange so that it results in an ordinary loss under § 165(a). See Rev. Rul. 93-80 and Rev. Rul. 76-189.
- The abandonment of a partnership interest in which the partner's share of recourse or nonrecourse liabilities are reduced may result in capital rather than an ordinary loss under § 752(b) and § 731. Rev. Rul. 93-80 – Situation 1.

# Abandonment of Partnership Interest

- Under § 752(b) a reduction in a share of liabilities is treated as a distribution of cash to which § 731(a) applies.
- Note that the deemed distribution of money under § 731(a) could result in a capital gain.
- The rules under §§ 752(b) and 731(a) apply and characterize the loss as a capital loss if any amount of any partnership liability is allocated to the abandoning partners. Rev. Rul. 93-80.
- The Tax Court has ruled that the sale or exchange rule on abandonment of a partnership applies in the case of nonrecourse liabilities as well as recourse liabilities.

# Example

- Partner A has an outside basis in his 33.3% ABC partnership interest of \$100. The assets of ABC have a basis of \$300 and a FMV to \$60. A is allocated no liabilities under Section 752.
- If A successfully abandons his interest in ABC, he would recognize \$100 ordinary loss.
- Assume instead that ABC sells the property for \$240 loss and liquidates. A would receive \$20 cash and would be allocated a loss of \$80 (1/3 of \$240). This would generally be a capital loss.
- If even \$1 of liability was allocated to A under § 752, the entire \$100 loss would be capital.

# How to Abandon

- Abandonment of a partnership interest requires (1) an intention to abandon the asset, and (2) an affirmative act of abandonment.
- No specific steps are required.
- A written letter to the partnership stating that the partner is abandoning his interest has been approved by the IRS as a manner of establishing abandonment. Rev. Rul. 93-80.
- The terms of the partnership agreement may preclude abandoning a partnership interest.

# Bankruptcy – Insolvency – Foreclosure

- Cancellation of debt income (“COD” income) will be excluded from gross income under § 108(a)(1)(A) and (B) of the Code in the case of bankruptcy under Title 11 and to the extent the taxpayer is insolvent.
- Discharge from qualified real property business indebtedness (QRPBI) can be excluded by an individual.
- Under § 108(d)(6), the § 108(a)(1) exceptions for COD, insolvency and QRPBI are all applied at the partner level.

# Bankruptcy – Insolvency – Foreclosure

- Since the COD exclusions apply at the partner level, the COD income will increase the partner's basis in its partnership interest under § 705.
- The increase in the partner's basis may be reduced by a decreased distribution under § 752(b). A reduction in basis may also be required under § 108(b).
- To avoid the application of decreased distributions under § 752(b) the partner may want to require that the property be distributed in kind and the partner would then deal directly with the lender.

# Bankruptcy – Insolvency – Foreclosure Corporate Partner

- Discharge of secured nonrecourse debt is treated as a sale or exchange of the property for the principal amount of the debt regardless of the fair market value of the property. Treas. Reg. § 1.1001-2(a)(4)(i) and 2(b), Ex. 2 of Treas. Reg. § 1.1001-2(c).
- Under Treas. Reg 1.1001-2 the rules with respect to recourse and nonrecourse debt will apply directly.
- The corporate partners in a Title 11 case could be in a better position if the income is treated as COD income.

# Bankruptcy – Insolvency – Foreclosure Corporate Partner

- Discharge of a secured recourse debt is treated as a sale of this property to the extent of the fair market value of the property securing the debt and the cancellation of indebtedness income for the excess. Treas. Reg. § 1.1001-2(a)(2), Ex. 1 of Treas. Reg. Treas. Reg. § 1.1001-2(c).
- If a partner abandons its partnership interest and its share of debt is therefore reduced, all of the loss would be capital even if the partnership liability was recourse. Rev. Rul. 93-80.

# Bankruptcy – Insolvency – Foreclosure Corporate Partner

- It might be preferable for the partnership to sell the property in foreclosure to the lender if the partnership liability is a recourse debt. In that case, a portion of the income would be characterized as COD recourse and excludable from its gross income. This result occurs because the partner recognizes its income from the sale of the property under § 702(b) of the Code as the partner sold the property directly to the lender.

# Bankruptcy – Insolvency – Foreclosure Individual Partner

- When an individual files for bankruptcy, a new entity is created as the bankruptcy estate of the debtor - Section 1398.
- The bankruptcy estate succeeds to the tax attributes of the debtor such as NOL's, capital loss carryovers, etc., as well as the basis, holding period and character of the individual's assets. Section 1398(g).
- Transfers between the bankruptcy estate and the individual debtor are not treated as dispositions. Thus, transfers of property, including abandonment of partnership property by the trustee to the debtor would not be a taxable event and the tax attributes of the property would carryover. This rule applies to abandonment under § 534 of Title 11.

# Abandonment Issues in Bankruptcy of Individuals

- The individual debtor will want the bankruptcy estate to incur the taxable event in a foreclosure or abandonment especially since the bankruptcy estate will have succeeded to the individual debtor's tax attributes such as NOL's, capital losses, and passive activity losses, etc.
- Unsecured creditors will not want the bankruptcy estate to incur any tax liabilities which will be a priority claim to theirs.

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# **Termination of a Partnership By Sale Or Exchange**

**Joseph K. Fletcher, III**

Glaser Weil Fink Jacobs Howard Avchen & Shapiro LLP  
Los Angeles

# Types of Terminations

- Types of Termination
  - Actual Termination 708(b)(1)(A)
  - Technical Termination 708(b)(1)(B)
- Causes of an Actual Termination
  - One Partner/Member acquires all interests in the Partnership or LLC that is taxed as a Partnership, or
  - Partnership Winds Up

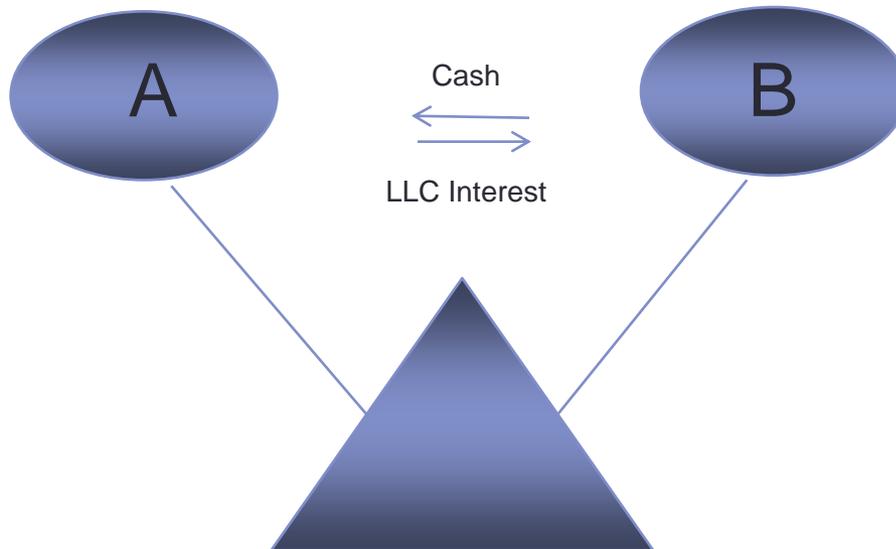
# Types of Terminations

- **Contrasting Actual Termination and Technical Termination**
  - Actual Termination – Assets Distributed or Deemed Distributed to Partners
  - Technical Termination – Assets Deemed Contributed to “New” Partnership with “New” Partnership Deemed to Distribute Interests to Partners

# Actual Termination: Acquisition of 100% of Interests by Existing Partner

- **Actual Termination: Rev. Rul. 99-6**

- **“Situation 1”**

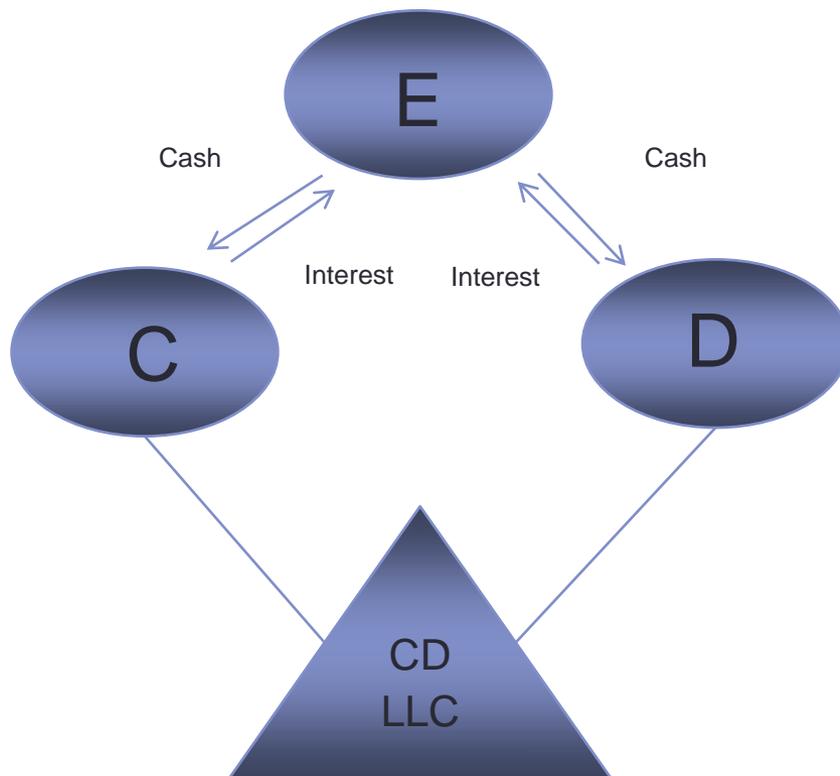


- A and B are 50 percent partners.
- B buys A's interest for cash.
- A is treated as if:
  - AB distributed all of its assets to A and B in liquidation of AB; and
  - B purchased from A the assets deemed to have been distributed to A.

# Actual Termination: Acquisition of 100% of Interests by New Partner

- **Actual Termination: Rev. Rul. 99-6**

- **“Situation 2”**



- C and D are equal partners
- C and D sell their interest to E, a third-Party purchaser, for cash.
- C and D are treated as if:
  - C and D sold their partnership interests to E.
  - E purchases the distributed assets from C and D.

# Actual Termination: What Causes It?

- Events that Do Not Cause a An Actual Termination

- Death of a Partner (Estate Becomes Partner)

- Treas. Reg. Section 1.708-1(b)(1)(i), *Estate of Skaggs v. Commissioner*, 672 F.2d 756 (9<sup>th</sup> Cir. 1982) aff'g per curiam, 75 T.C. 191 (1980).

- Retirement of Partner

- Section 736; Treas. Reg. Section 1.708-1(b)(1)(i); Treas. Reg. Section 1.736-1(a)(6). Where a Note is issued, the retired partner's interest is considered to remain outstanding until the Note is paid. PLR 8304059.

Note, however, that in a two partner partnership, if the remaining partner acquires the interest of a deceased or retired partner, there will be an “actual” termination under Section 708(b)(1)(A).

# Avoiding Actual Termination

- **Avoiding Actual Termination**

- Deemed distribution of assets can result in taxable gain .
- Deemed distribution of assets can result in lost inside bass.
- Potential for “disguised sale” issue.

- **Acquire Less Than 100%**

- As long as there are two or more partners, partnership will not terminate.
- What is the smallest percentage that is respected?

- **Have Separate Entity Acquire an Amount That Will Be Respected.**

# Technical Terminations

- Technical Termination:
  - A “sale or exchange”
  - of 50% or of the total interest in partnership capital or profits

# Technical Terminations: Tax Consequences

- The deemed steps in a “technical termination” are generally less likely to result in negative tax consequences than actual termination, because rather than distributing assets out of the partnership, assets are deemed contributed “down” to a new partnership and the interest in that new partnership is deemed distributed to existing partners.
- There are, however, issues that arise on a “technical termination”
  - Elections: Elections are not binding on the new partnership and must be made again.
  - Allocation of Income: The tax year of the old partnership closes and the old partnership files its “final” tax return. The new partnership begins its tax year, this could result in income being accelerated.
  - EIN: The new partnership has a different EIN (this may be significant for payroll purposes).
  - Even a “technical termination” may have reassessment consequences in California.

# Technical Terminations

- Is it a “sale or exchange?”

- Death is not a sale or exchange
- A gift is generally not a sale or exchange. Treas. Reg. Section 1.708-1(b)(2)
  - But, if liabilities are transferred with interest, this may constitute a sale or exchange.
- Abandonment is not a sale or exchange. Rev. Rul. 93-80, situation 2.
  - But, if the transferor is relieved of liabilities, an abandonment is a “sale or exchange.” Rev. Rul. 93-80, situation 1.
- Admission of a new Partner is not a “sale or exchange”
  - Treas. Reg. Section 1.708-1(b)(2); Rev. Rul. 75-423
  - Note, however, that if a new partner is admitted and a former partner exits, the “step transaction doctrine” may apply and may recast the transaction as a “sale or exchange.”
  - Complicated “disguised sale” rules may apply (new regulations were recently issued on disguised sales).

# Technical Terminations

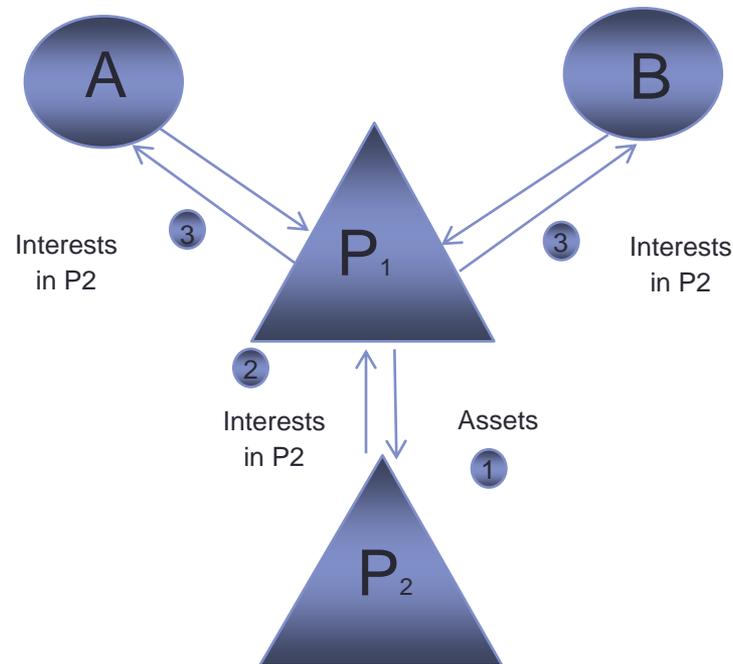
- Certain non-taxable transactions may be treated as a “sale or exchange” for purposes of determining whether there has been a transfer of 50% or more of the total interests in profits or capital.
  - Section 351 transactions constitute a sale or exchange. Rev. Rul. 81-38, *Evans v. Commissioner*, 447 F.2d 547 (7<sup>th</sup> Cir. 1971), aff’g. 54 T.C. 40 (1970).
  - Most tax-free exchanges are treated as a “sale or exchange” (whether they are or not depends upon whether the assets of the corporation, which include the partnership interest, are deemed transferred). Reorganizations under Sections 368(a)(1)(A), 368(a)(1)(B), 368(a)(2)(D), 368(a)(1)(C), 368(a)(1)(D), and potentially 368(a)(1)(F) reorganizations are treated as a sale or exchange.
  - The distribution of a partnership interest by a corporation is likely a sale or exchange, at least if Section 311(b) applies.
  - The transfer of an interest to another partnership is generally a sale or exchange.
  - The distribution of a partnership interest by a partnership is treated as a sale or exchange for purposes of “technical terminations” except for the distribution of an interest in a new partnership deemed created on an old partnership’s termination (as in the deemed steps of under Treas. Reg. Section. 1.708-1(b)(4).
  - This is a non-exclusive list. The moral is: don’t assume because a partnership interest is transferred in an otherwise tax-free exchange, that it doesn’t constitute a “sale or exchange” for purposes of determining whether there has been a “technical termination.”

# Technical Terminations

- Has 50% or more of the total interest in partnership capital or profits been transferred in a 12-month period?
  - Transfers within 12 months are aggregated.
  - Transfers of the same interest within the 12-month period are counted only once.

# Technical Terminations: Deemed Steps

- The deemed steps of a “technical termination” are found in Treas. Reg. Section 1.708-1(b)(4).
  - The partnership is treated as contributing all its assets to a new partnership in exchange for interest in the new partnership, and
  - The terminated partnership is treated as immediately distributing interests in the new partnership to the purchasing partner(s) and the remaining partner(s) in proportion to their interests in the terminated partnership.



# Avoiding Technical Terminations

- Avoiding “Technical Termination”

While the consequences of a “technical termination” are less likely to be severe than the consequences of an “actual termination,” there are instances in which a partnership would wish to avoid a technical termination.

- Transfer less than 50%. In one instance 49.9% was transferred within the 12-month period, 0.1% was transferred immediately after the 12-month period ended. PLR 7952057.
- Various instances have been respected with similarly small amounts although there is no guarantee that a particular transaction will be respected, step transaction must be considered.

# Retirement of a Partner

- Issue re Termination in Two Person Partnership
- Otherwise, Issue of Character of Income to Retiring Partner and Partnership
  - Section 736(b) Payment for withdrawing partner's interest in property
    - Agreement should generally separately state this amount, or default rules apply for allocating between Sections 736(a) and 736(b)
  - Section 736(a) Payment as a distributive share of guaranteed payment
    - Distributive share if payment is determined with regard to the income of the partnership. Section 736(a)(1)
      - Income passes through to partner and maintains character. Treas. Reg. Section 1.736-1(a)(4), Section 702.
    - Guaranteed payment if fixed in amount or determined by gross income or gross receipts. Section 736(a)(2).
      - Ordinary income to partner. Treas. Reg. Section 1.736-1(a)(4).
      - Deductible by partnership. Treas. Reg. Section 1.736-1(a)(5).
- Section 751 issues

# Windup of Partnership

- Windup of Partnership
  - Payment of Creditors
  - Deficit Restoration by GP
  - Negative Capital Accounts
  - Distribution to Partners
  - Basis Issue – the \$1 million paperclip.