

# Partnership Terminations: Mastering Section 708

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# Partnership Terminations

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# Partnership Terminations Mastering Section 708(b)(1)

January 25, 2017

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# Overview

- Introduction to Section 708(b)
- Partnership Capital and Profits Interests
- Sales and Exchanges
- Deemed Transactions
- Effect on Tax Elections
- Book Value, Basis & Holding Period
- Effect on Depreciation & Amortization
- Effect on Built-in Gain under Section 704(c)
- Partnership Taxable Years
- IRS Communications
- Planning Techniques

# Introduction: Partnership Termination

- Section 708(a) provides that an existing partnership shall be considered as continuing if it is not terminated
- Under Section 708(b)(1), a partnership can terminate in 2 ways:
  - Actual termination: No part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. Section 708(b)(1)(A).
  - Technical termination: Within a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. Section 708(b)(1)(B).

## Introduction (cont'd): Section 708(b)(1)(A)

- *No part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership*
  - Termination occurs upon actual cessation of operations, not agreement to cease operations
- Pursuant to case law, a nominal amount of activity may prevent a termination under Section 708(b)(1)(A)
  - For example, merely holding a note received upon a sale of partnership assets has been held to constitute sufficient activity to not constitute a termination. *See, e.g., Baker Commodities, Inc. v. Comm'r (9th Cir. 1969)*

# Capital Interest and Profits Interest

- “50% or more of the total interest in partnership capital and profits” means 50% or more of the *total* interest in partnership capital *plus* 50% or more of the *total* interest in partnership profits. Section 708(b)(1)(B); Treas. Reg. § 1.708-1(b)(2).
- Neither the Code nor the Regulations defines “capital interest” or “profits interest”
- Administrative guidance suggests a capital interest is the amount received as a liquidating distribution if the partnership sold its assets at FMV, satisfied its liabilities, and distributed its remaining assets. Treas. Reg. § 1.704-1(e)(1)(v); Rev. Proc. 93-27.
- More difficult to determine “profits interest” where sharing ratios for allocations of profits and distributions diverge, are non-pro rata or vary with time

# Sale or Exchange

The following are treated as sales or exchanges for purposes of Section 708(b)(1)(B):

- Taxable sale to a new or existing partner
- Contribution of the partnership interest to another partnership.
- Contribution of the partnership interest to a corporation. Rev. Rul. 81-38.
- Asset-level corporate reorganizations involving a partner. See, e.g., Rev. Rul. 87-110.
- Distribution of partnership interest by a corporation or another partnership. Section 761(e)(1).
- Termination of an upper-tier partnership (upper-tier partnership treated as exchanging its entire interest in the capital and profits of the lower-tier partnership) (discussed below)

## Sale or Exchange (cont'd)

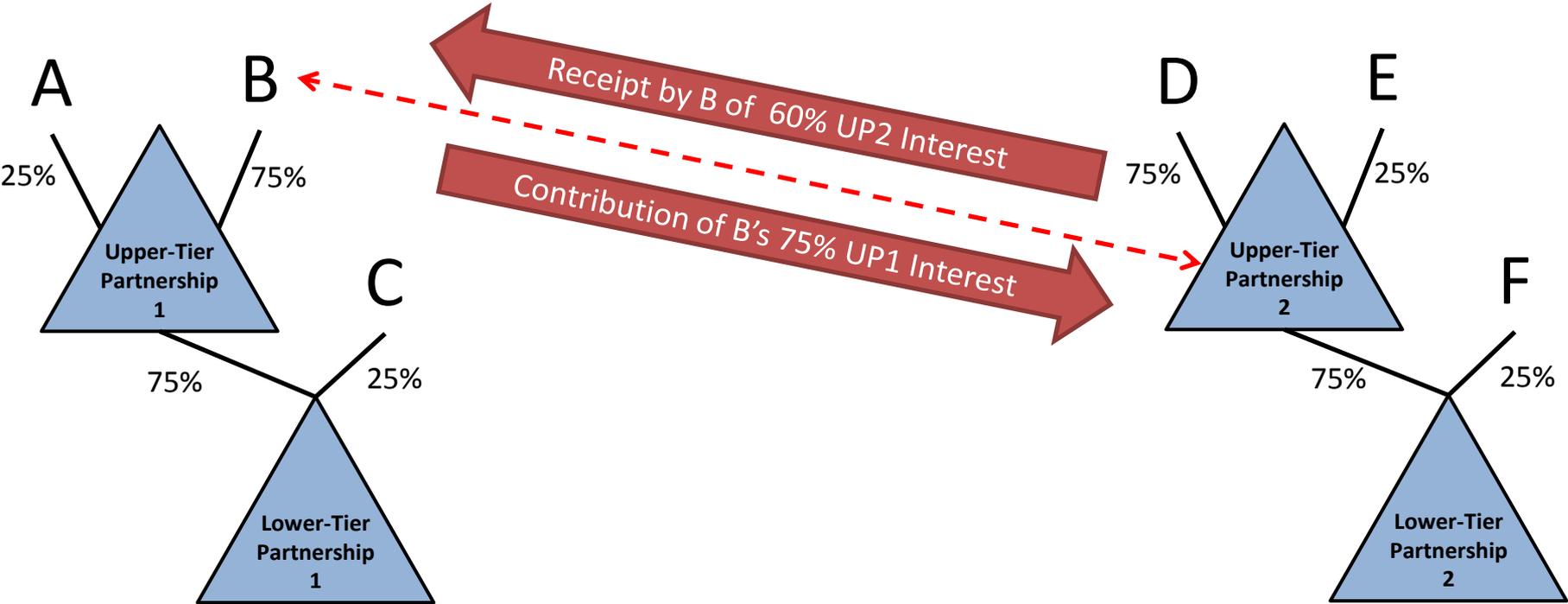
The following are NOT treated as sales or exchanges for purposes of Section 708(b)(1)(B):

- Contribution of property to the partnership in exchange for a partnership interest. Treas. Reg. § 1.708-1(b)(2).
- Liquidation of a partnership interest
- Disposition of a partnership interest by gift, bequest, or inheritance
- Change in the rights and privileges associated with a partnership interest (e.g., conversion of general partner interest into limited partner interest, or partnership interest into an LLC interest)

## Sale or Exchange (cont'd): Tiered Partnerships

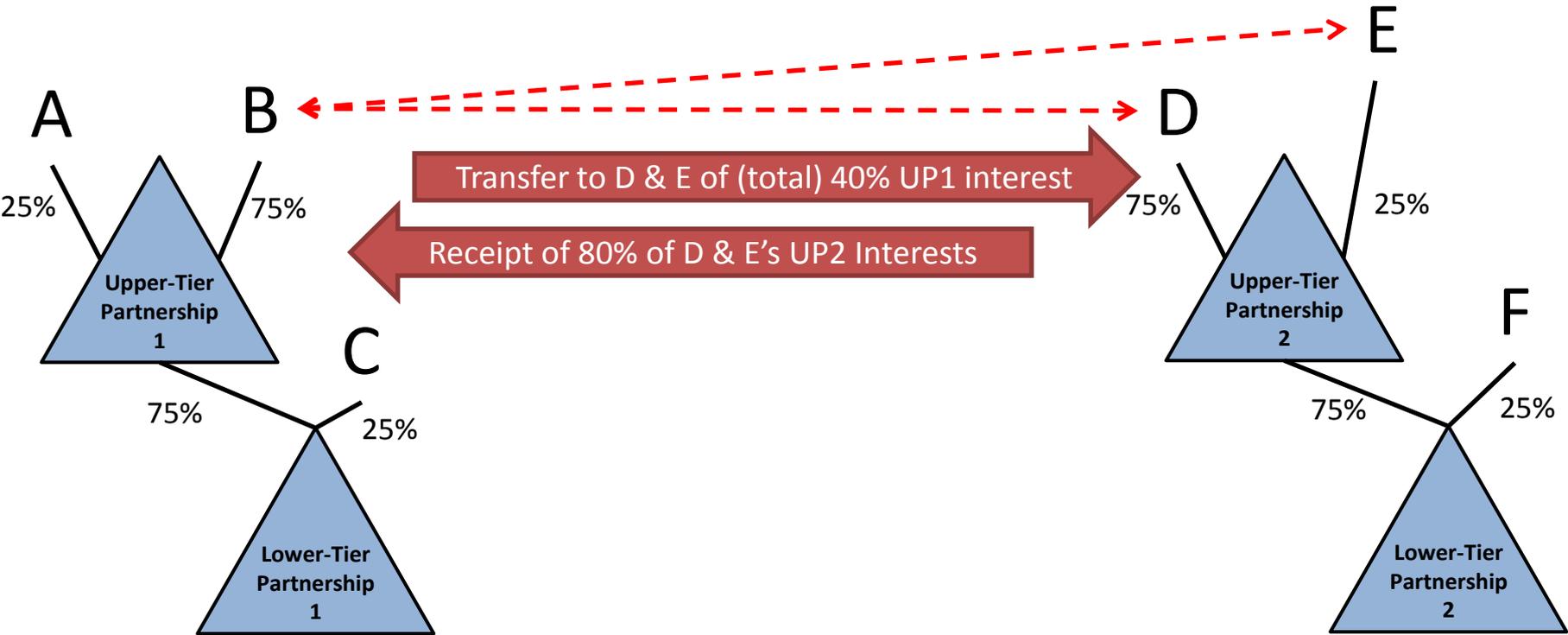
- “All or nothing” entity-type approach to sales or exchanges that terminate upper-tier partnerships
  - If the sale or exchange of an interest in a partnership (upper-tier partnership) that holds an interest in another partnership (lower-tier partnership) results in a termination of the upper-tier partnership, the upper-tier partnership is treated as exchanging its entire interest in the capital and profits of the lower-tier partnership.
  - If the sale or exchange of an interest in an upper-tier partnership does not terminate the upper-tier partnership, the sale or exchange of an interest in the upper-tier partnership is not treated as a sale or exchange of a proportionate share of the upper-tier partnership's interest in the capital and profits of the lower-tier partnership. Treas. Reg. § 1.708-1(b)(2).
  - Consider Rev. Rul. 87-50: A had owned a 60 percent interest in partnership PAB. PAB in turn was a parent partnership that owned an 80 percent partnership interest in the capital and profits of PRS, a subsidiary partnership. A sold to C A's entire 60 percent interest in PAB, terminating PAB & PRS.

# Sale or Exchange (cont'd): Examples



- Contribution by B to Upper-Tier Partnership 2 is a sale or exchange of interest in Upper-Tier Partnership 1 and therefore terminates Upper-Tier Partnership 1 and Lower-Tier Partnership 1
- Contribution by B to Upper-Tier Partnership 2 is not a sale or exchange of interest in Upper-Tier Partnership 2 and therefore does not terminate Upper-Tier Partnership 2 or Lower-Tier Partnership 2

# Sale or Exchange (cont'd): Examples



- B does not transfer more than 50% interest in Upper-Tier Partnership 1 and therefore neither Upper-Tier Partnership 1 nor Lower-Tier Partnership 1 terminates
- D & E's transfers are sales or exchanges of interests in Upper-Tier Partnership 2 and therefore terminate Upper-Tier Partnership 2 and Lower-Tier Partnership 2



## Sale or Exchange (cont'd): Aggregation of Sales

- If one or more partners sell or exchange interests aggregating 50 percent or more of the total interest in partnership capital and 50 percent or more of the total interest in partnership profits within a period of 12 consecutive months, such sale or exchange is considered as being within the provisions of Section 708(b)(1)(B)
  - When interests are sold or exchanged on different dates, the percentages to be added are determined as of the date of each sale
    - Implication from regulations that “12 months” is computed on a daily basis
  - If same partnership interest sold multiple times, only counted once
  - The example: The sale by A on May 12, 1956, of a 30-percent interest in capital and profits to D, and the sale by B on March 27, 1957, of a 30-percent interest in capital and profits to E, is a sale of 50-percent or more. Accordingly, the partnership is terminated as of March 27, 1957. However, if, on March 27, 1957, D instead of B, sold his 30-percent interest in capital and profits to E, there would be no termination since only one 30-percent interest would have been sold or exchanged within a 12-month period

# Sale or Exchange (cont'd): Non-Recognition Transactions

- Non-recognition transactions under subchapter C are nevertheless generally treated as sales or exchanges for purposes of Section 708(b)(1)(B)
- Rev. Rul. 81-38: The taxpayer owned a 50 percent interest in the capital and profits of PYZ partnership, which interest was transferred to S in a transaction qualifying under Section 351.
  - The transfer is an exchange under Section 708(b)(1)(B).
- Rev. Rul. 87-110: X corporation owned a 50 percent interest in the capital and profits of XZ partnership. Pursuant to a reorganization under Section 368(a)(1), X transferred its assets, including the 50 percent interest in XZ, to Z corporation solely for Y stock in a transaction qualifying under section 361(a).
  - Held: The transfer is an exchange for purposes of Section 708(b)(1)(B)
    - Exception: Reorganizations under Section 368(a)(1)(F)

# Deemed Transactions

When a partnership terminates under Section 708(b)(1)(B), the following transactions are deemed to occur:

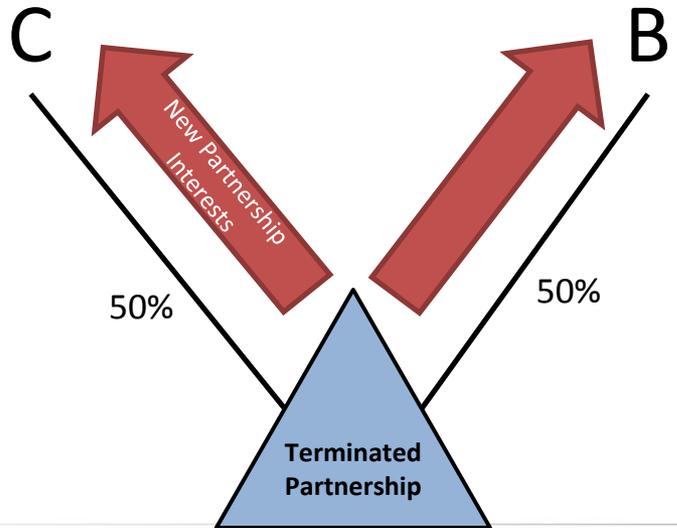
- The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and
- Immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up. Treas. Reg. § 1.708-1(b)(4)

# Deemed Transactions (cont'd)

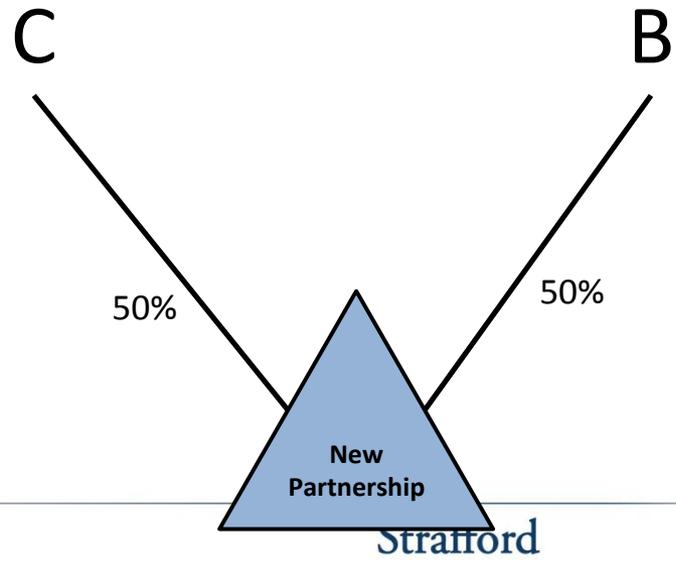
Step 1:



Step 2:



Result:



# Deemed Transactions (cont'd): Tax Treatment

The deemed transactions, by themselves, do not result in the recognition of gain or loss

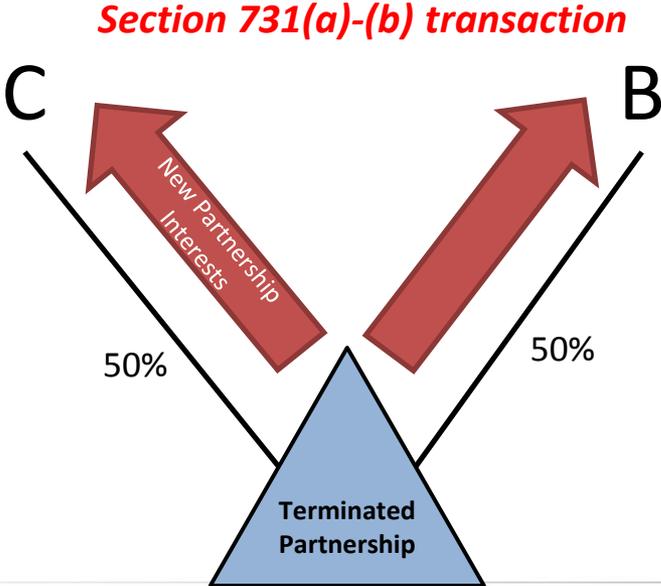
- No gain or loss is recognized upon the deemed contribution of assets by the terminated partnership. Section 721.
- Generally, any deemed distribution of money resulting from the assumption of the terminated partnership's liabilities by the new partnership is offset by the inclusion of those liabilities in the terminated partnership's basis in its interest in the new partnership. Treas. Reg. § 1.752-1(f)
- No gain or loss is recognized by the terminated partnership or the new or continuing partners in connection with the deemed distribution of new partnership interests. Section 731(a)-(b).
- The deemed distribution of interests in the new partnership are not treated as a distribution of money under §731(c). Treas. Reg. § 1.731-2(g)(2).
- Deemed transactions occur after the sale of the partnership interest

# Deemed Transactions (cont'd): Tax Treatment

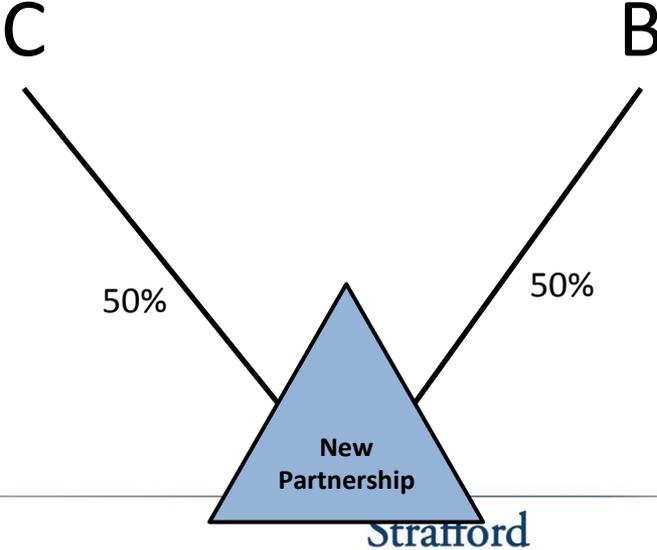
Step 1:



Step 2:



Result:



## Effect on Tax Elections

The following elections of the terminated partnership do NOT carry over to the new partnership

- Section 754 election to adjust the basis of partnership assets upon some distributions or upon the transfer of a partnership interest (discussed further below). See Treas. Reg. § 1.743-1(h)(1).
- Section 704(c) methods. Treas. Reg. § 1.704-3(a)(2).

## Effect on Tax Elections (cont'd)

The following elections of the terminated partnership DO carry over to the new partnership

- Section 108(i) election to defer recognition of certain COD income
- Election to be treated as a Section 743(e) electing investment partnership
- Section 1295 election (to treat a PFIC as a QEF with respect to the partnership).  
Treas. Reg. § 1.1295-1(b)(3)(iii).

If a partnership that has elected to amortize start-up expenditures under Section 195(b) or organizational expenses under Section 709(b)(1) terminates in a transaction (or a series of transactions) described in Section 708(b)(1)(B), the new partnership must continue to amortize those expenditures over the remaining portion of the amortization period adopted by the terminating partnership. Treas. Reg. § 1.708-1(b)(6).

## Effect on Tax Elections: Section 754

- The basis of assets deemed contributed to the new partnership carries over from the terminated partnership, so any inside/outside basis disparity carries over to the new partnership absent a Section 754 election
- The terminated partnership can make a Section 754 election on its final return to provide the new partner a Section 743(b) basis adjustment. Treas. Reg. § 1.708-1(b)(5).
- The technical termination provides an opportunity for the new partnership to make a Section 754 election on its tax return for the initial tax year
  - The deemed distribution of an interest in a new partnership by a partnership that terminates under Section 708(b)(1)(B) is treated as an exchange of the interest in the new partnership for purposes of Section 743. Treas. Reg. § 1.761-1(e).
  - A Section 754 election made by the new partnership provides the new partner a basis step-up with respect to the sale or exchange that triggered the technical termination.

# Capital Accounts, Book Value, Basis, & Holding Period

- The book values of the “new” partnership’s assets are the same as they were for the terminated partnership immediately before the technical termination
- The capital account balances of the new and continuing partners do not change as a result of the technical termination. Treas. Reg. § 1.708-1(b)(4), Example.
- A technical termination is disregarded for purposes of capital account maintenance. Treas. Reg. § 1.704-1(b)(2)(iv)(I).

# Capital Accounts, Book Value, Basis, & Holding Period (cont'd)

- The “new” partnership takes a carryover basis in the terminated partnership’s assets. Section 723.
- A partner’s basis and holding period in its new partnership interest is determined by the generally applicable basis and holding period rules
- The holding period of the assets deemed contributed by the terminated partnership to the new partnership appears to carry over with respect to those assets in the hands of the new partnership. Treas. Reg. § 1.723-1.



# Depreciation & Amortization

- The new partnership computes depreciation as if the property received from the terminated partnership were newly placed in service. Section 168(i)(7)(B).
  - Also effect on application of the applicable MACRS convention
- The terminated partnership computes depreciation for its short tax year as if the assets were disposed of on the date of termination.
- Section 197 intangibles: The new partnership depreciates intangibles over their remaining useful life (i.e., no reset). Treas. Reg. § 1.197-2(g)(2)(iv)(B).
- Bonus depreciation: If a partnership places in service property eligible for bonus depreciation and terminates under Section 708(b)(1)(B) in the same year, only the new partnership may claim bonus depreciation. Treas. Reg. § 1.168(k)-1(b)(5)(iii) and -1(f)(1)(ii).

# Depreciation & Amortization (cont'd): Section 743(b)

- A technical termination does not affect a partner's Section 743(b) special basis adjustment with respect to property held by the terminated partnership. Treas. Reg. § 1.743-1(h)(1).
  - The Section 743(b) basis adjustment carries over even if the new partnership does not make a Section 754 election

## Effect on Built-in Gain under Section 704(c)

- Section 704(c) provides that income, gain, loss, and deduction with respect to property contributed to the partnership by a partner must be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its FMV at the time of contribution
- Because neither the Section 704(b) book basis of the assets deemed contributed to the new partnership nor the partner's capital accounts are affected by the technical termination, the deemed contribution of assets to the new partnership does not create additional Section 704(c) layers. Treas. Reg. §§ 1.704-3(a)(3)(i) and 1.708-1(b)(4).
- To the extent assets deemed contributed to the new partnership constituted Section 704(c) property in the hands of the terminated partnership, those assets also constitute Section 704(c) property in the hands of the new partnership.

## Closing of Partnership Taxable Year

- Upon a technical termination, the partnership's taxable year closes with respect to all its partners. Treas. Reg. § 1.708-1(b)(3).
- The terminated partnership must file a final year partnership tax return on or before the 15th day of the third month after the technical termination. Section 6072(b).
  - The tax year of the new partnership is determined by reference to the tax years of its partners under Section 706(b)(1)(B)
- Can result in a bunching of income if partner/partnership have different taxable years
  - For example, if partnership with a taxable year ending January 31 terminates on July 31, a calendar year partner would report 18 months of partnership income for its taxable year that included the termination

## IRS Communications

- Because a PLR may be relied upon only by the taxpayer to whom it is issued, query whether the new partnership may rely on a PLR issued to the terminated partnership. See Section 6110(k)(3).
- The new partnership uses the same EIN as the terminated partnership. Treas. Reg. § 301.6109-1(d)(2)(iii).

## Other rules

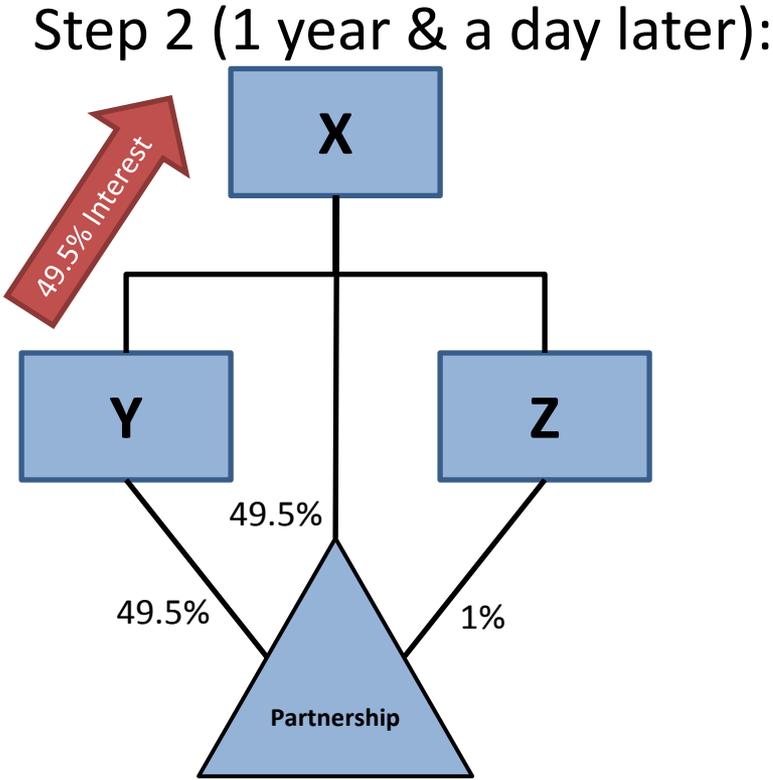
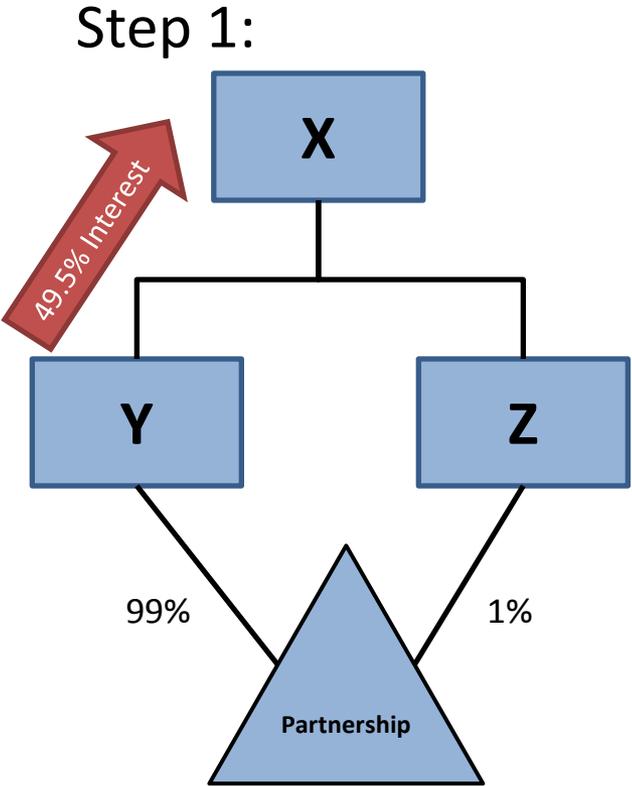
- In applying the partnership disguised sale rules, transfers resulting from a termination of a partnership under Section 708(b)(1)(B) are disregarded. Treas. Reg. § 1.707-3(a)(4).
- To the extent assets of the terminated partnership were subject to Sections 704(c)(1)(B) and 737, they continue to be subject to the same rules in the hands of the new partnership. Treas. Reg. §§ 1.737-2(a); 1.704-4(c)(3).
- Under Section 724(a), any gain or loss recognized by a partnership on the disposition of unrealized receivables contributed by a partner is treated as ordinary income or loss
  - Under Section 724(d), any Section 724 amount with respect to assets of the terminated partnership appears to carry over to the new partnership
- Section 751(b) appears to not be implicated in a technical termination because no partner receives a disproportionate share of hot assets in the deemed distribution. Treas. Reg. § 1.751-1(b)(1)(ii).
- No investment tax credit recapture solely as a result of deemed transactions in a Section 708(b)(1)(B) termination. T.D. 8717.

## Planning Techniques: Time-Staggered Transfers

- Section 708(b)(1)(B) requires that within a 12-month period there be a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.
- Therefore, Section 708(b)(1)(B) may not apply if a sale or exchange of 50 percent or more of a partnership is properly respected as staggered across a period of more than 12 months. See, e.g., PLR 8517022.

# Planning Techniques: Time-Staggered Transfer (cont'd)

Corporation X wholly owns Corporations Y and Z. Corporation Y owns a 99% interest in a partnership, and Corporation Z owns the other 1% interest. Corporation Y adopts a plan of complete liquidation that includes a distribution of a 49.5% interest in the partnership, followed by a distribution of its remaining 49.5% interest a year and a day later. The liquidation does not result in a technical termination of the partnership because the distributions are separated by more than 12 months, and neither exceeds the 50% threshold. See, e.g., PLR 9332026.



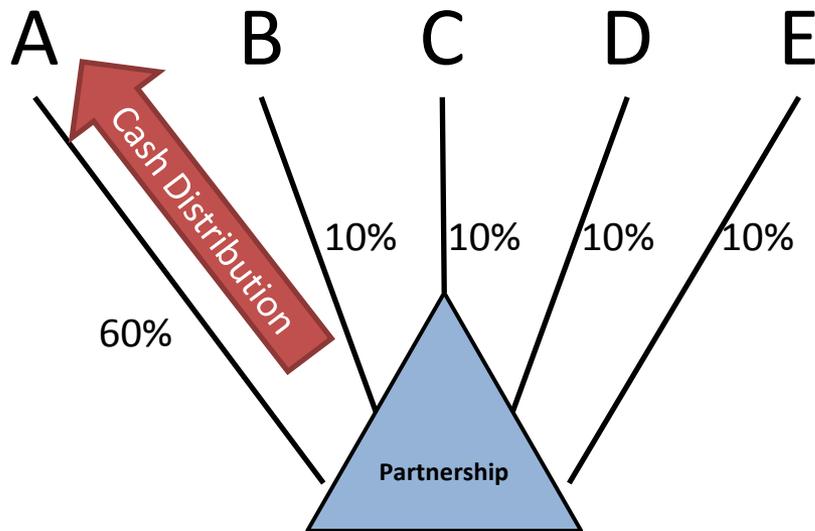
## Planning Technique: Liquidating Distribution

- If the continuing partners intend to acquire the interest of the terminating partner on a pro rata basis, the transaction can be structured as a liquidating distribution instead of a purchase
  - A distribution in liquidation of a partner's interest is not a sale or exchange of the interest for purposes of the technical termination rules. Treas. Reg. § 1.708-1(b)(2).
  - Consider whether the transaction is to be recast as a sale among the partners
- Structure can be combined with purchase of a less-than-50% interest

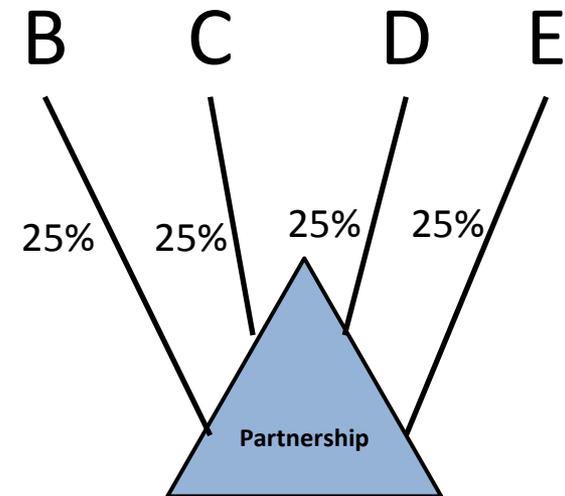
# Planning Technique: Liquidating Distribution (cont'd)

Example: A holds a 60% interest and B, C, D, and E each hold a 10% interest in the capital and profits of a partnership. B, C, D, and E want to buy A's interest. The partnership distributes cash to A in liquidation of his 60% interest. After A's redemption, the remaining partners each own a 25% interest of the capital and profits of the partnership.

Redemption of A's Interest:



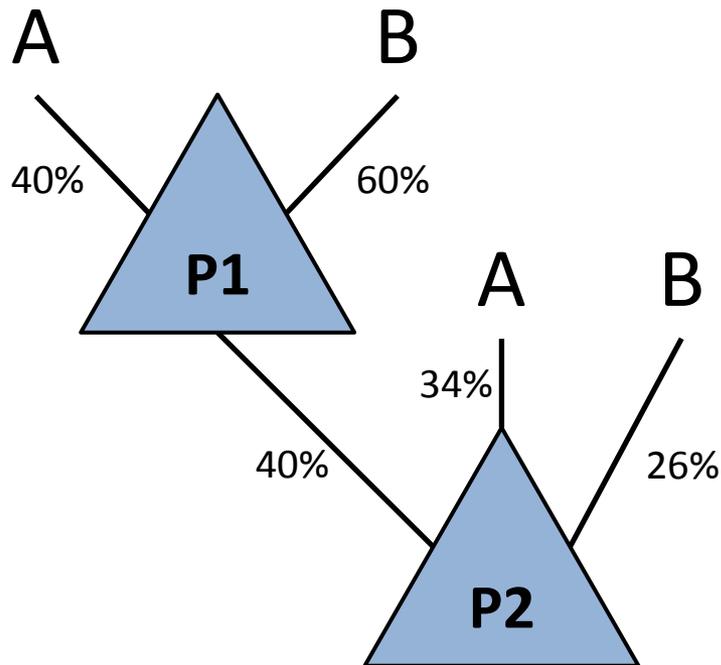
After A's Redemption:



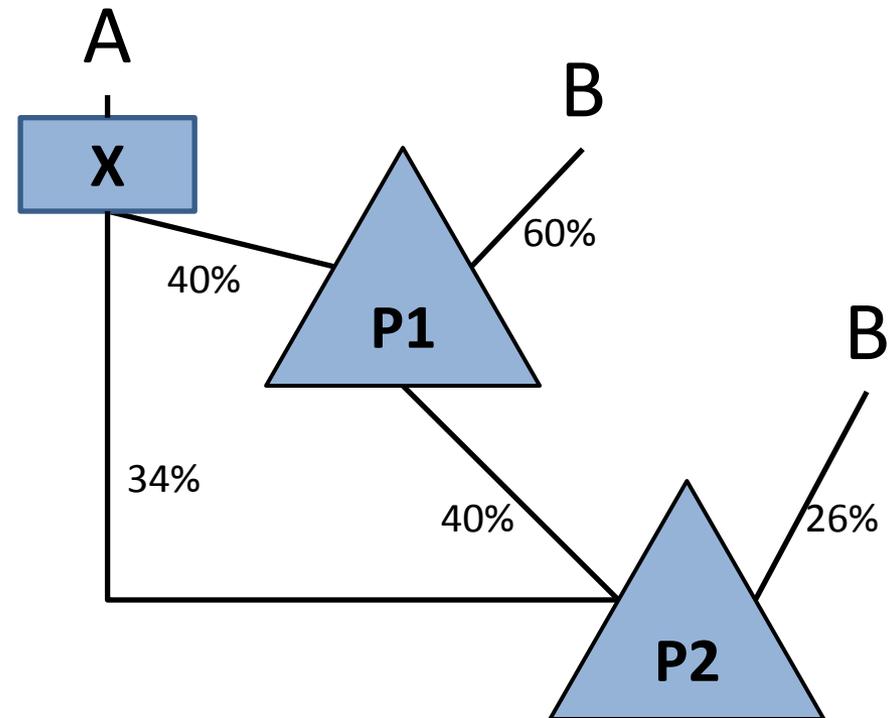
# Planning Technique: Tiered Partnership

Example: A owns a 40% interest in partnership P1 and B owns a 60% interest. A owns a 34% interest in partnership P2, B owns a 26% interest, and P1 owns a 40% interest. There might not be a technical termination if A contributes its interests in P1 and P2 to Corporation X, because neither interest exceeds the 50% threshold, even though together the transfer represents a 50% interest in P2 as economic matter.

## Partnership Formation:



## After A's Contribution:



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# Planning Technique: Capital and Profits Interests

- Section 708(b)(1)(B) requires a transfer of an interest in at least 50% of partnership capital
- Therefore, if the non-transferring partner(s) dilute the transferring partner's interest by contributing additional capital (to reduce the capital interest of the transferring partner below 50%), Section 708(b)(1)(B) might not apply
  - If the partnership distributed the contributed capital as part of a plan that included the transfer, the contribution could be disregarded as transitory or as part of a disguised sale of interests

# For More Information



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