BASIC PARTNERSHIP TAX II

SALES, DISGUISED SALES
& TERMINATIONS

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BASIC PARTNERSHIP TAX II

SALES, DISGUISED SALES & TERMINATION

PART I
SALES & EXCHANGES

I. SALES & EXCHANGES OF PARTNERSHIP INTERESTS

A. General Rules—Transferor/Selling Partner.

1. Amount Realized. In determining amount realized under §1001, the partner must include his or her share of partnership debt as a part of the amount realized. (§752.)

2. Adjusted Basis. In determining his or her adjusted basis, the selling partner must include his or her share of partnership income or loss up to and including the date of sale.

3. Closing the Tax Year of the Selling Partner. Although, under §705, outside basis for income and loss is not generally adjusted prior to the close of a tax year, §706(c) states that the sale or exchange of an entire interest closes the tax year of a partnership (only) with respect to the selling partner.

a. §706(c) does not authorize the closing of the partnership's tax year with respect to a partner who sells or exchanges less than his or her entire interest. In such a case, §706(d)(1) requires the partnership and the partners involved to appropriately account for the impact such a sale or change in interest has on basis, capital account, income sharing, etc.

4. Selling Partners - Installment Sales Treatment. Partnership interests, like other capital assets, may be sold, with gains thereon reported on the installment method under §453. Under the installment method of accounting, otherwise taxable capital gains are reported as and when principal payments are received on the basis of a gross profit ratio. However, per §453(i)(2), gain on the sale of an interest subject to §751(a) recapture items may not be subject to installment reporting. (See also, Rev. Rul. 89-108 (denying §453 treatment to the extent of §751(a) substantially appreciated inventory items).

a. "Hot Assets." To the extent the partnership holds inventory or "unrealized receivables" (collectively referred to as "Hot Assets"), a selling partner's capital gain

or loss may be recharacterized as ordinary income under §751(a). The rule (under §741) that a sale or exchange of a partnership interest results in capital gain is expressly overridden by §751.

B. General Rules—Buying Partner.

1. Adjusted Basis. The purchasing partner acquires a cost basis in the acquired partnership interest equal to (i) the cash and FMV of property paid to the seller in consideration of the interest; plus (ii) the new partner's allocable share of partnership debt.

2. §754 Considerations. An important consideration to a purchasing partner whose purchase price (outside basis) exceeds his or her underlying share of the basis of partnership assets (inside basis) is whether to demand or request that the partnership elect to adjust its inside basis under §754.

3. Interim Income/Loss Allocations. Just as the selling partner should be concerned with respect to the partnership's determination of interim income and loss for allocation and basis purposes, the incoming partner should also be interested in income and loss allocations for the 2 deemed short periods.

4. Capital Account. The buying partner generally takes the selling partner's capital account without adjustment.

C. The Partnership and Other Partners. Generally, the sale or exchange of a partner's interest to a new or existing partner does not trigger any issues or tax consequences for the partnership or its other partners unless if there is a (tax) termination.

D. Exchanges of Partnership Interests. While §1031(a)(2)(D) has clearly disallowed like-kind exchange treatment for swaps of partnership interests, conversions of a partner's interest in a single partnership (general to limited and vice-versa) may still be accomplished tax free. (See Rev. Rul. 84-52.) However, beware of liability allocation shifts which may trigger §752(b) deemed cash distributions resulting in §731(a)(1) gains.

1. A partnership may opt out of Subchapter K under IRC §761, in which case the partners are treated as cotenants whose interests in co-owned assets can be exchanged.

PART II
DISGUISED SALES

I. DISGUISED SALES

There are three (3) separate "disguised sale" rules in the Code:

A. §707(a)(2)(B), which generally treats a "contribution" of property followed by a "distribution" of other property to the same partner in a related transaction which occurs within 2 years (or maybe longer) as a disguised sale with gain or loss being recognized.

B. §704(c)(1)(B), which requires recognition of built-in gain to the contributing partner when a contributing partner contributes property with built-in gain and that same property is distributed to another partner within 7 years.

C. §737, which complements §704(c)(1)(B) by providing that, if a contributing partner contributes property which has built-in gain and the contributing partner receives a distribution of other property within 7 years, the built-in gain on the original transfer must be recognized by the contributing partner.

II. §707(a)(2)(B)

The Regs under §707(a)(2)(B) set forth rules as to when a contribution to the partnership followed (or preceded) by a partnership distribution will be deemed a sale requiring the selling partner to recognize gain or loss on the disguised sale.

A. Facts and Circumstances Test. In general, contributions of property (excluding money) to a partnership and distribution of money or other consideration (including the assumption of debt or taking property subject to a liability) by the partnership to the partner will constitute a sale if, based on all of the facts and circumstances: (i) the partner's receipt of money or other consideration would not occur but for the transfer of property; and (ii) if the transfers are not simultaneous, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

B. Factors.

1. The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer;

2. The transferor has a legally enforceable right to the subsequent transfer;

3. The partner's right to receive the transfer or money or other consideration is secured in any manner, taking into account the period during which it is secured;

4. Any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;

5. Any person has loaned or agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether such lending obligation is subject to contingencies related to the results of partnership operations;

6. The partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such facts as whether any person has agreed to guarantee or assume personal liability for that debt);

7. The partnership holds money or other liquid assets beyond the reasonable needs of the business that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);

8. Partnership distributions, allocations, or control of partnership operations are designed to effect an exchange of the burdens and benefits of ownership of property;

9. The transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits; and

10. The partner either has no obligation to return or repay the money or other consideration to the partnership or has such an obligation but the obligation is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

C. <u>2-Year Presumption</u>.

1. Unless the facts and circumstances clearly establish that the transfers do <u>not</u> constitute a sale, if a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner <u>within a 2-year period</u>, then <u>the transfers are presumed to be a sale of the property</u> to the partnership.

2. If the transfer of property by the partner to the partnership and the transfer of money or other consideration to the partner by the partnership takes place <u>more than 2 years</u>

apart, the transfers are presumed to not constitute a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers constitute a sale.

D. Exceptions to Sale Treatment. Certain "guaranteed payments," "preferred returns," "operating cash flow distributions," and "reimbursements of preformation expenditures" are not treated as part of a sale.

1. Reasonable Guaranteed Payments. "Reasonable" guaranteed payments for capital made to a partner are not treated as part of a sale of property.

a. A guaranteed payment for capital is any payment to a partner by a partnership that is determined without regard to the partnership income and that is for the use of that partner's capital. Payments are not treated as being made for the use of a partner's capital if the payments are designed to liquidate all or part of the partner's interest in property contributed to the partnership rather than to a provide the partner with a return on an investment in the partnership.

2. Reasonable Preferred Returns. "Reasonable" preferred returns presumptively do not constitute part of a sale of property to a partnership.

a. A preferred return is a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched by an allocation of income or gain. (Regs. §1.707-4(a)(2).)

3. Definition of "Reasonable" Preferred Returns and Guaranteed Payments. Preferred returns or guaranteed payments for capital are reasonable only to the extent that the transfer is made to the partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and only to the extent that the payment is made for the use of capital after the date on which that provision is added to the partnership agreement.

A preferred return or guaranteed payment for capital is presumed reasonable in amount if the sum of any preferred return and any guaranteed payment for capital that is payable for that year does not exceed the amount determined by multiplying either the partner's unreturned capital at the beginning of the year or, at the partner's option, the partner's weighted average capital balance for the year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid preferred return or guaranteed payment for capital that is payable to the partner) by the "safe harbor interest rate" for that year.

The "safe harbor interest rate" for a partnership's taxable year equals 150% of the highest applicable federal rate ("AFR"), at the appropriate compounding period or periods, in effect at any time from the time that the right to the preferred return or guaranteed payment for capital is first established pursuant to a binding, written agreement among the partners through the end of the taxable year.

A partner's unreturned capital equals the excess of the aggregate amount of money and the FMV of other consideration (net of liabilities) contributed by the partner to the partnership over the aggregate amount of money and the FMV of other consideration (net of liabilities) distributed by the partnership to the partner.

4. Operating Cash Flow Distributions. Certain operating cash flow distributions are presumed to not constitute part of a sale of property to a partnership unless the facts and circumstances clearly establish that the transfer is part of a sale. Operating cash flow distributions are one or more transfers of money by a partnership to a partner during a tax year of the partnership to the extent that the transfers (1) are not guaranteed payments; (2) are not reasonable preferred returns; (3) are not characterized as distributions to the partner acting in a capacity other than as a partner; and (4) do not exceed the product of the net cash flow of the partnership from operations for the year multiplied by the lesser of: (i) the partner's percentage interest in overall partnership profits for that year; or (ii) the partner's percentage interest in overall partnership profits for the life of the partnership.

5. Reimbursements of Preformation Expenditures. A transfer of money or other consideration by a partnership to a partner is not treated as part of the sale of property by the partner to the partnership under the facts and circumstances test to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, certain "preformation expenditures."

a. "Preformation expenditures" are those capital expenditures that (i) are incurred during the 2-year period preceding the transfer by the partner to the partnership and (ii) are incurred by the partner with respect to partnership organization and syndication costs or property contributed to the partnership, but only to the extent that the reimbursed capital expenditures do not exceed 20% of the property's FMV at the time of the contribution. The 20% limit does not apply if the contributed property's FMV does not exceed 120% of the partner's adjusted basis in the contributed property at the time of contribution.

E. Liabilities Assumed in Transfer. A transfer of property by a partner to a partnership may be treated as a disguised sale if the contributing partner incurs debt in anticipation of the transfer and the partnership assumes the debt or takes the contributed property subject to the debt.

1. "Qualified Liabilities." If a transfer of property by a partner to a partnership is not otherwise treated as a sale, the partnership's assumption of or taking subject to a "qualified liability" in connection with the transfer also is not treated as part of a sale.

2. Definition of "Qualified Liability." A "qualified liability" is a liability that:

a. was incurred by the partner more than 2 years prior to the earlier date that the partner agreed in writing to transfer the property or the date that the partner transferred the property to the partnership, and has encumbered the transferred property throughout the 2-year period; or

b. was not incurred in anticipation of the transfer of the property to the partnership; or

c. is allocable to capital expenditures with respect to the property; or

d. was incurred in the ordinary course of the trade or business in which property transferred to the partnership as used or held but only if all of the assets related to that trade or business are transferred other than assets that are not material to the continuation of the trade or business.

3. Nonqualified Liabilities. If a partnership assumes or takes property subject to a liability of the partner other than a "qualified liability," the partnership is treated as transferring consideration to the partner to the extent that the amount of the liability exceeds the partner's share of that liability immediately after the partnership assumes or takes subject to the liability.

F. Disclosure of Transfers Made Within 2 Years. Disclosure to the Internal Revenue Service[1] in accordance with Regs. §1.707-8 is required if -

1. A partner transfers property to a partnership; and

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[1] Form 8275 must be filed. The disclosure should include: (i) a caption identifying the statement as a disclosure under IRC §707; a description of the transferred property or money, including its value; *and* (iii) a description of any relevant facts in determining if the transfers are properly viewed as a disguised sale.

2. The partnership transfers money or other consideration to the partner within a 2-year period (without regard to the order of the transfers);

3. The partner treats the transfers other than as a sale for tax purposes; and

4. The transfer of money or other consideration to the partner is not presumed to be a guaranteed payment for capital, is not a reasonable preferred return, and is not an operating cash flow distribution.

G. Examples.

EXAMPLE

Treatment of Simultaneous Transfers as a Sale. A transfers property X to partnership AB on April 9, 1992, in exchange for an interest in a partnership. At the time of the transfer, property X has a FMV of $4,000,000 and an adjusted basis of $1,200,000. Immediately after the transfer, the partnership transfers $3,000,000 in cash to A. Assume that, under this section, the partnership's transfer of cash to A is treated as part of a sale of property X to the partnership. Because the amount of cash A receives on April 9, 1992, does not equal the FMV of the property, A is considered to have sold a portion of property X with a value of $3,000,000 to the partnership in exchange for the cash. Accordingly, A must recognize $2,100,000 of gain ($3,000,000 (amount realized) less $900,000 (adjusted basis=$1,200,000 x $3,000,000/$4,000,000)).

Assuming A receives no other transfers that are treated as consideration for the sale of the property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, $1,000,000 of the FMV of the property with an adjusted tax basis of $300,000.

EXAMPLE

Operation of Presumption for Transfers More Than 2 Years Apart.

(1) G transfers undeveloped land to the GH partnership in exchange for an interest in the partnership. At the time the land is transferred to the partnership, it is unencumbered and has an adjusted tax basis of $500,000 and a FMV of $1,000,000. H contributes $1,000,000 in cash in exchange for an interest in the partnership. Under the partnership agreement, the partnership is obligated to construct a building on the land. The projected construction cost is $5,000,000 which the partnership plans to fund with its $1,000,000 in cash and the proceeds of a construction loan secured by the land and improvements.

(2) Shortly before G's transfer of the land to the partnership, the partnership secures commitments from lending institutions for construction and permanent financing. To obtain the construction loan, H guarantees completion of the building for a cost of $5,000,000. The partnership is not obligated to reimburse or indemnify H if H must make payment on the completion guarantee. The

permanent loan will be funded upon completion of the building, which is expected to occur 2 years after G's transfer of the land. The amount of the permanent loan is to equal the lesser of $5,000,000 or 80 percent of the appraised value of the improved property at the time the permanent loan is closed. Under the partnership agreement, the partnership is obligated to apply the proceeds of the permanent loan to retire the construction loan and to hold any excess proceeds for transfer to G 25 months after G's transfer of the land to the partnership. The appraised value of the improved property at the time the permanent loan is closed is expected to exceed $5,000,000 only if the partnership is able to lease a substantial portion of the improvements by that time, and there is a significant risk that the partnership will not be able to achieve a satisfactory occupancy level. The partnership completes construction of the building for the projected costs of $5,000,000 approximately 2 years after G's transfer of the land. Shortly thereafter, the permanent loan is funded in the amount of $5,000,000. At the time of funding the land and building have an appraised value of $7,000,000. The partnership transfers the $1,000,000 excess permanent loan proceeds to G 25 months after G's transfer of the land to the partnership.

(3) G's transfer of the land to the partnership and the partnership's transfer of $1,000,000 to G occurred more than 2 years apart. Those transfers are presumed not to be a sale unless the facts and circumstances clearly establish that the transfers constitute a sale of the property, in whole or in part, to the partnership. The transfer of $1,000,000 to G would not have been made but for G's transfer of the land to the partnership. In addition, at the time G transferred the land to the partnership, G had a legally enforceable right to receive a transfer from the partnership at a specified time and amount that equals the excess of the permanent loan proceeds over $4,000,000. In this case, however, there was a significant risk that the appraised value of the property would be insufficient to support a permanent loan in excess of $4,000,000 because of the risk that the partnership would not be able to achieve a sufficient occupancy level. Therefore, the facts of this example indicate that at the time G transferred the land to the partnership the subsequent transfer of $1,000,000 to G depended on the entrepreneurial risks of partnership operations. Accordingly, G's transfer of the land to the partnership is not treated as part of a sale.

III. DISTRIBUTIONS OF CONTRIBUTED PROPERTY TO ANOTHER PARTNER

A. Prior Law. Under §704(c)(1)(A), a partner contributing property with a built-in gain or loss is generally allocated that gain or loss when the partnership subsequently disposes of the property. Prior to the enactment of §704(c)(1)(B), a contributing partner could avoid an allocation of precontribution gain or loss if the partnership distributed the contributed property to another partner rather than selling it.

B. §704(c)(1)(B) provides that, if property contributed by one partner has built in gain and that property is distributed to another partner within 7 years of its contribution, to the

contributing partner (or his or her successor) is treated as recognizing §704(c) gain or loss as if the partnership had sold the property for its FMV at the time of the distribution. The contributing partner's *outside* basis is increased or decreased by the amount of gain or loss so recognized. To avoid double recognition of that gain or loss, the partnership's *inside* basis in the property is increased or decreased prior to the distribution to reflect the gain or loss recognized by the contributing partner.

EXAMPLE

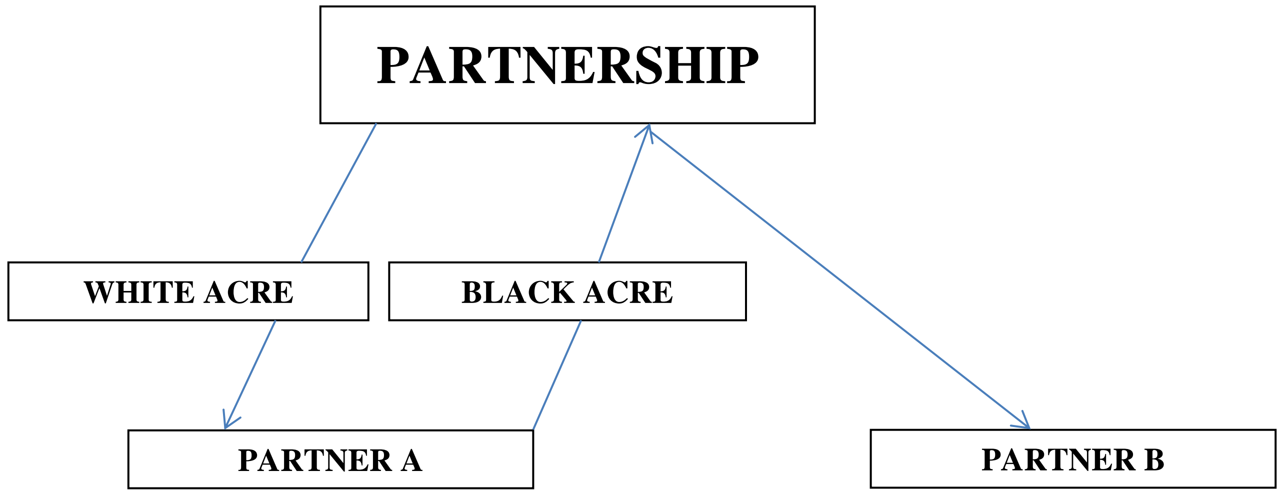
> A contributes Blackacre with an adjusted basis of $12,000 and a FMV of $20,000 and B contributes $20,000 cash to the equal AB partnership. Assume that three years later the partnership distributes Blackacre, then worth $23,000, to B. Under §704(c)(1)(B), A is allocated the $8,000 precontribution gain just as if the partnership had sold the property instead of distributing it, and A would increase his outside basis by $8,000. In addition, Blackacre's basis would be $20,000.

C. Exceptions.

1. §707(c)(1)(B) does not apply if the contributed property is (re)distributed back to the contributing partner.

2. §704(c)(2) provides relief to a contributing partner who receives a distribution of like-kind property (within the meaning of §1031) within 180 days after the contributed property is distributed to another partner. The policy here is that the contributing partner should not have to recognize gain under §704(c)(1)(B) if he or she would have qualified for nonrecognition if the transaction had taken place outside the partnership. (See "diagrams," below.)

§704(c)(2)



§1031

D. Anti-Abuse. The Regs under §704(c)(1)(B) also contain an anti-abuse provision under which the statute and Regs must be applied in a manner consistent with the purpose of the section and the Service can recast a transaction for federal tax purposes to achieve appropriate tax results. For example, the Regs apply §704(c)(1)(B) to a distribution that actually takes place after the statute's time limitation (i.e., more than 7 years after the contribution of property), but where the partners took steps that were the functional equivalent of a distribution before the end of that period.

IV. DISTRIBUTIONS TO CONTRIBUTING PARTNER - §737

A. Exception to Nonrecognition. Under §737, the general nonrecognition rule of §731 does not apply if the distributee partner contributed appreciated property to the partnership within 7 years of the date of distribution of other property of the same partner. §737 requires recognition of gain but does not allow for loss recognition.

B. Amount of Gain Recognized. §737 provides for gain recognition by a partner who contributed property with precontribution gain to the partnership upon distribution of other property to the same partner in any current or liquidating distribution to the extent of the lesser of:

1. the excess of the FMV of property (other than money) distributed to the contributing partner over the partner's adjusted basis in his or her partnership interest ("*outside* basis"), as reduced by any money distributed in the same transaction; or

2. the "net precontribution gain" of the partner. The term "net precontribution gain" means the amount of net gain (i.e., gain reduced by any loss) that the distributee partner would be required to recognize under §704(c)(1)(B) if all property owned by the partnership immediately before the distribution that had been contributed by the distributee within 7 years of the distribution was distributed to a partner other than the contributing partner.

EXAMPLE

A and B form partnership AB by each contributing property to AB on January 1, 1996. A contributes property Y, unimproved real estate having a basis of $10,000 and a FMV of $100,000. B contributes property Z, unimproved real estate having a basis and FMV of $100,000. A's basis in his partnership interest is initially $10,000 and B's basis is $100,000. On June 30, 1997, property Y is worth $150,000 and property Z is worth $110,000. On that date, when A's basis in his partnership interest is $10,000, the partnership distributes Property Z to A in a nonliquidating distribution. A's net precontribution gain as of June 30, 1997 is

$90,000 (the amount of gain A would be required to recognize under §704(c)(1)(B) if property Y were distributed to B). The excess of the FMV of property Z ($110,000) over A's adjusted basis in his partnership interest ($10,000) is $100,000. Thus, A is required to recognize $90,000, the amount of his precontribution gain, because it is less than the excess of the FMV of the distributed property over his basis.

Under §737(a), the character of the gain recognized by the distributee is determined in proportion to the distributee's net precontribution gain. In the preceding example, all of A's $90,000 of gain would be capital, assuming that Property Y is a capital asset in the partnership's hands.

C. Exception if Same Property is Distributed. No gain is recognized by a distributee partner under §737 if the property contributed by the distributee partner is distributed to him or her.

D. Basis Adjustments.

1. Under §737(c)(1), a distributee partner recognizing gain under §737(a) increases the basis of his or her partnership interest to the extent of the gain recognition.

2. Under §737(c)(2), the partnership's basis in the contributed property is also appropriately adjusted to reflect gain recognized under §737(a).

PART III

TERMINATIONS

I. TAX TERMINATIONS

A. §708. Code §708 sets forth the basic events which trigger a so-called termination for tax purposes. Under Subchapter K, absent a termination, a partnership is treated as continuing. This means that, despite partner changes or shifts in percentage interests in debt, cash flow, profits, losses and capital, absent a termination, the partnership will continue to be treated as the same tax entity. In this regard, §708(b)(1) provides that:

> "For purposes of subsection (a), "a partnership shall be considered as terminated only if--
>
> (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, or

(B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits." (Emphasis added.)

B. §708(b)(1)(a): No Further Business Carried on by the Partners in a Partnership.

1. Explanation of "(b)(1)(A)" Terminations. Prior to liquidation of the partnership, it's hard to trigger (b)(1)(A) terminations because, even if a modicum of business is carried on by the partnership, the partnership will not be deemed to have been terminated.[2]

a. A "(b)(1)(A)" termination can occur when there is only one partner left. For example, one person in a 2 person partnership sells to the other.

b. Upon the death of one partner in a 2-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business. (Regs. §1.708-1(b)(1)(i)(a)).

2. Dissolution Distinguished. Local law concepts of dissolution and windup, or liquidation, are not meaningful terms of art in determining whether a tax termination has or will occur. A dissolution may occur under local law without necessity of a tax termination occurring and, conversely, a tax termination may arise without a dissolution.

3. Liquidation. A partnership liquidation takes place when all of the assets are marshaled, all creditors paid and the assets are distributed to the partners in satisfaction of their equity interests.

C. §708(b)(1)(B): Sales or Exchanges of 50% or more of the Capital and Profits Interests Within 12 Months.

§708(b)(1)(B) terminating events are based upon the sales or exchanges of partnership interests. For a termination to occur, **there must be a sale or exchange of at least 50% of the total interests in partnership capital and profits during a 12 (consecutive) month period**. The same interest sold more than once during the 12 (consecutive) month period is only counted once, although the later sale rolls the 12 month period forward.

EXAMPLE

In partnership ABC, where A, B and C each hold an equal 1/3 interest in capital, profits and losses, if A sells her 1/3 capital and profits interest to X on June 1, 20X0, and X sells the same 1/3 interest to Y on September 15, 20X0, no

[2] Even mere collection of interest and principal on a note receivable held by the partnership upon sale of all of its assets will constitute sufficient business to avoid termination per (b)(1)(A).

termination arises, since only 33.3% has been sold, **but** the 12 month period will run forward to September 15 of the next year (20X1).

1. "12 Months" Means 12 Consecutive Months. The 12-month period is not a reference to a (taxable) year, but to any 12 consecutive month period.

2. Multiple Sales. Other than the same interest being sold twice, multiple interest sales are counted within the 12 month period for the 50% test and, so long as the aggregate total of capital and profits interests transferred equals 50% or more within the 12 month period, a termination occurs under §708(b)(1)(B).

EXAMPLE

In partnership ABC, where A, B and C each hold an equal 1/3 interest in capital, profits and losses, if A sells her 1/3 capital and profits interest to X on June 1, 20X0 and B sells her 1/3 capital and profits interest to Y on January 1, 20X1, a termination results. The termination occurs despite the fact that the second sale by B to Y occurred during the following taxable year.

EXAMPLE

Distributions. In partnership ABC, where A, B and C each hold an equal 1/3 interest in capital, profits and losses, if A and B each receive a current distribution from ABC, resulting in their overall interests reduced to 5% each, no termination occurs because there's no sale or exchange for §708 purposes. This result would be true under §708 even if A and B receive money distributions in excess of their adjusted basis resulting in §731 gains (treated as gains from the sale or exchange of an interest).

Contributions. The same result (i.e. no termination) would arise if C alone, contributed additional property/capital, resulting in a 50% or more shift in profits and capital interest.

D. Gifts and Bequests. The Regs further provide that other events are not deemed sales or exchanges for termination purposes, including gifts, bequests, and inheritances.

E. Closing the Tax Year for All Partners.

1. Date of Closing. For purposes of subchapter K, a partnership taxable year closes with respect to all partners on the date on which the partnership terminates. See §706(c)(1) and Regs. §1.706-1(c)(1). Regs. §1.706-1 states that the date of termination is:

a. For purposes of §708(b)(1)(A), the date on which the winding up of the partnership affairs is completed; and

b. For purposes of §708(b)(1)(B), the date of the sale or exchange of a partnership interest which, of itself or together with sales or exchanges in the preceding 12 months, transfers an interest of 50% or more in both partnership capital and profits.

2. Effects of Closing the Tax Year.

a. Creates a short year final return.

b. Requires income/loss for the short period to be determined, allocated and reported by the partners.

c. Under §705, outside basis adjustments are then required for the income/loss adjustments.

EXAMPLE

Assume that A, a partner in partnership ABC decides to sell her entire 1/3 overall interest in the partnership to D for $100,000 cash. At the time of sale, June 30, 20X0, the partnership has $30,000 of capital gains income and $30,000 of dividend income; however, assume that, within 12 months prior to June 30, 20X0, B acquired her 1/3 interest by purchasing it from X. At the time of sale to D, the partnership books reflect the following:

Partnership ABC	Tax Basis	Book Value
Cash	$110,000	$110,000
Stock	160,000	250,000
Total Assets:	270,000	360,000
Liabilities	60,000	60,000
A	70,000	100,000
B	70,000	100,000
C	70,000	100,000
Total Liabilities & Capital:	$270,000	$360,000

Questions:

Is there a tax termination triggered on A's sale of a 1/3 interest in ABC to D?

Yes, there has been a 50% or more capital and profits interest transfer when considering the earlier transfer of X's interest to B.

Does the partnership tax year close with respect to A?

Yes, and because it's a sale triggering a tax termination per §708(b)(1)(B), the Partnership tax year closes as regards all partners. Note, this would be true even if A sold less than her entire interest, so long as she sold at least 17% which, when added to X's 1/3 interest would total 50%, thereby triggering a termination. Since

there is a termination, the tax year of the partnership closes, and an interim adjustment for profits and losses would have to be made to compute gain or loss to A.

F. Deemed Contribution and Distribution (to New Partnership)—“Assets Over”.

If a tax termination occurs, the partnership is deemed to contribute all of its assets and liabilities to a new partnership in exchange for interests in the new partnership which, immediately thereafter, are distributed 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.

EXAMPLE

(i) A and B each contribute $10,000 cash to form AB, a general partnership, as equal partners. AB purchases depreciable Property X for $20,000. Property X increases in value to $30,000, at which time A sells its entire 50 percent interest to C for $15,000 in a transfer that terminates the partnership under §708(b)(1)(B). At the time of the sale, Property X had an adjusted tax basis of $16,000 and a book value of $16,000 (original $20,000 tax basis and book value reduced by $4,000 of depreciation). In addition, A and B each had a capital account balance of $8,000 (original $10,000 capital account reduced by $2,000 of depreciation allocations with respect to Property X).

(ii) Following the deemed contribution of assets and liabilities by the terminated AB partnership to a new partnership (new AB) and the liquidation of the terminated AB partnership, the adjusted tax basis of Property X in the hands of new AB is $16,000. See §723. The book value of Property X in the hands of new partnership AB is also $16,000 (the book value of Property X immediately before the termination) and B and C each have a capital account of $8,000 in new AB (the balance of their capital accounts in AB prior to the termination). See Regs. §1.704-1(b)(2)(iv)(l) (providing that the deemed contribution and liquidation with regard to the terminated partnership are disregarded in determining the capital accounts of the partners and the books of the new partnership). Additionally, new AB retains the taxpayer identification number of the terminated AB partnership.

(iii) Property X was not §704(c) property in the hands of terminated AB and is therefore not treated as §704(c) property in the hands of new AB, even though Property X is deemed contributed to new AB at a time when the FMV of Property X ($30,000) was different from its adjusted tax basis ($16,000). See Regs. §1.704-3(a)(3)(i) (providing that property contributed to a new partnership under Regs. §1.708-1(b)(1)(iv) is treated as §704(c) property only to the extent that the property was §704(c) property in the hands of the terminated partnership immediately prior to the termination).

(iv) If a partnership is terminated by a sale or exchange of an interest in the partnership, a §754 election (including a §754 election made by the terminated partnership on its final return) that is in effect for the taxable year of the terminated partnership in which the sale occurs, applies with respect to the incoming partner. Therefore, the bases of partnership assets are adjusted pursuant to §§743 and 755 prior to their deemed contribution to the new partnership.

G. What About §704(d) Suspended Losses if §708(b)(1)(B) Termination Occurs? Unclear. Under the old termination rules, the suspended losses were lost. Under the new rules, suspended losses should carry over to the new entity.

H. What About §704 (c)(1)(B) Gains and §737 Gains?

1. Recall that §704(c)(1)(B) requires gain to be recognized by contributing partner if built-in gain property is distributed to another partner within7 years of contribution. Will the §704(c)(1)(B) deemed distributions rule be triggered if §708(b)(1)(B) termination occurs? No, see Regs. §1.704-4(c)(3).

2. Recall that §737 requires net pre-contribution gain to be recognized by a contributing partner if built-in gain property is contributed and distributions are made to the contributing partner within 7 years of contribution. Will §737 be triggered if §708(b)(1)(B) termination occurs? No, see Regs. §1.737-2(a): no gain is triggered, but the §704(c) partner is still a §704(c) partner subject to §737 in the new partnership.

I. Are §731 Gains Possible in a Tax Termination Under §708(b)(1)(B)? Under the old rules, a terminated partnership was deemed to distribute all of its properties in a liquidating distribution to the (new and remaining) partners, who recontributed such assets (and liabilities) back to the partnership in exchange for their new interests in the new partnership. Therefore, theoretically, (actual or deemed) cash could have been distributed in excess of basis, triggering §731 gains. Now, the old partnership is deemed to contribute its assets and liabilities to the new partnership in exchange for the issuance of interests in the new partnership to the (new and continuing) partners. Since only partnership interests (in the new partnership) are distributed to the partners, there should not be any recognition of gain or loss on the deemed contributions and distributions. (See §§721 and 731, and Regs. §1.731-2(g)(2).)