Redemptions of Partnership Interests and Divisions of Partnerships

Andrea M. Whiteway
awhiteway@mwe.com
REDEMPTIONS OF PARTNERSHIP INTERESTS AND DIVISIONS OF PARTNERSHIPS

By:

Andrea M. Whiteway
Arnold & Porter LLP
Washington, DC

November 17, 2006
# Redemptions of Partnership Interests and Divisions of Partnerships

## Table of Contents

I. **Redemptions of Partnership Interests** ................................................................. 1  
   A. General Non-recognition Rule - Section 731 ..................................................... 1  
   B. Nonrecognition treatment applies to Current and Liquidating Distributions .......... 1  
   C. Exceptions to General Nonrecognition Rule ..................................................... 2  
   D. Distribution of Encumbered Property ............................................................... 6  
   E. Possible Exceptions to Nonrecognition - Unrealized receivables and inventory ...... 11  
   F. Possible Exceptions to Nonrecognition - Sections 704(c)(1)(B) and Section 737 .... 15  
   G. Possible Exceptions to Nonrecognition - Distribution of Corporate Partner Stock ... 15  

II. **Adjustments to Basis of Partnership Property** ..................................................... 16  
    A. Section 743 In General ....................................................................................... 16  
    B. Mandatory Application of Section 743(b) post Jobs Act .................................... 18  
    C. Section 734(b) - In General ............................................................................. 19  
    D. Mandatory Application of Section 734(b) post Jobs Act .................................... 20  
    E. Jobs Act - Targeted Abuse under Section 734(b) ............................................. 20  
    F. Jobs Act - Targeted Abuse under Section 743(b) ............................................. 22  
    G. Problematic Application of Mandatory Section 734(b) Adjustments ................. 22  
    H. Loss Duplication after the Mandatory Section 743(b) Basis Adjustment .............. 23  
    I. DeMinimis $250,000 Threshold – May still require very small basis adjustments ..... 23  
    J. Section 743(b) Mandatory Upward Basis Adjustment in Certain Cases .......... 24  

III. **Partnership Terminations Under Section 708(b)(1)(A)** .................................. 25
A. In General........................................................................................................................................ 25
B. Cessation of Partnership Business................................................................................................. 25
C. Reduction in Number of Partners.................................................................................................. 29
D. Consequences of Partnership Termination under Section 708(b)(1)(A)................................. 34

IV. DIVISIONS................................................................................................................................... 35
   A. Partnership Divisions Prior to the Regulations......................................................................... 35
   B. Division Regulations................................................................................................................... 36
   C. Planning under the Division Regulations.................................................................................. 40
I. REDEMPTIONS OF PARTNERSHIP INTERESTS

A. General Non-recognition Rule - Section 731

1. Section 731 provides in general for nonrecognition of gain or loss on the distribution of property from a partnership. However, a partner receiving a distribution does recognize gain to the extent that the partner receives an amount of money that exceeds the adjusted basis of the partner’s interest in the partnership.

2. Section 731(a)(1) provides that gain is recognized to the extent that any money distributed exceeds the adjusted basis of the partner’s interest in the partnership immediately before the distribution.

3. Section 731(a)(2) provides that loss is only recognized in the event of a liquidating distribution (or series of distributions) and only if the distribution consists solely of money, unrealized receivables and inventory. The amount of any loss recognized is the difference between the adjusted basis of the partner’s interest and the sum of the money received and the basis of any unrealized receivables and inventory received.

4. Section 731(b) provides that distributions of partnership property, including cash, will not result in gain or loss to the partnership.

B. Nonrecognition treatment applies to Current and Liquidating Distributions.


   a. In a current distribution, the partner’s basis is reduced first by the amount of any cash or marketable securities received in the distribution and then any property distributed takes a basis equal to the partnership’s basis in the property immediately before the distribution, limited to the partner’s adjusted basis in the partnership (after being reduced by any distributions of money).

   Section 732(a).
b. Under Section 733, the partner's basis in the partnership interest following the non-liquidating distribution must be reduced by the amount of money distributed to the partner and the amount of the basis to the partner of any property other than money received as a distribution, as determined under Section 732.

c. The partner's basis may not be reduced below zero.

2. Liquidating Distribution.

a. In a liquidating distribution, the partner will take a basis in the distributed property equal to the partner's adjusted basis in the partnership, as adjusted for any money distributions. Section 732(b).

3. Holding Period.

a. The holding period of the distributed property tacks the holding period of the partnership for capital gain and loss purposes.

4. Basis in Distributed Property.

a. Where the partner's basis in distributed property is determined by reference to the partner's basis in his partnership interest, the basis must be allocated among the distributed properties, if property of more than one type is received.

b. Section 732(c) provides that basis is first allocated to any unrealized receivables and inventory items in an amount equal to the adjusted basis of each such property to the partnership and the remaining basis is generally allocated to properties based on the unrealized appreciation or depreciation of the distributed properties, after allocated to each such property basis to the extent of the partnership's basis in such properties.

C. Exceptions to General Nonrecognition Rule

1. Money Distributions.

a. A partner will recognize gain to the extent that the amount distributed to the partner exceed the partner's basis in the partnership immediately before the distribution.

b. A principle of partnership taxation is that partnership income is taxable to the partners when it is earned regardless of whether it is distributed.
c. However, a distribution of cash to a partner will reduce a partner’s basis in the partnership interest, but not below zero. Section 733. If the amount distributed exceeds the partner’s basis, the partner will recognize gain as a result of the distribution in addition to recognizing his distributive share of partnership income. Section 731(a); Treas. Reg. §1.731-1(a)(1).

d. To the extent that the distribution exceeds basis and results in gain, such gain is capital gain. The gain has the same character as the gain realized when a partner sells or exchanges his partnership interest. Treas. Reg. §1.731-1(a)(3).

e. In addition to actual cash distributions, there can be a deemed distribution to a partner when the partner’s share of partnership liabilities is reduced. See discussion below on Section 752.


a. In General.

(i) Distributions of marketable securities will be treated as money for purposes of Section 731(c) to the extent that the partner receives more than his share of the partnership’s total appreciation in marketable securities. Section 731(c).

(ii) The amount of gain recognized as a result of a distribution of marketable securities is limited to appreciation that exceeds the partner’s share of appreciation in the partnership’s overall portfolio of marketable securities (i.e. treat as money gain from those securities that were effectively received in exchange for the partner’s interest in appreciated partnership property, applying a hypothetical sale analysis). Section 731(c)(3)(B).

(iii) Thus, in general, a partner receiving a distribution consisting of actively traded financial instruments (stocks, bonds, etc.), Section 731(c)(2)(A), will recognize gain if the value of these securities as of the date of the distribution exceeds the partner’s basis in the partnership. Section 731(a)(1).

---

2 Under this approach one hypothetical sale occurs immediately before the distribution, and one hypothetical sale occurs immediately after the distribution and the difference between the partner’s distributive shares resulting from these two sales is the amount by which the partner’s gain is reduced.
(iv) The gain recognized as a result of a distribution of a marketable security is treated as ordinary income if the distributed security is either an unrealized receivable or an inventory item (each as defined in Section 751). Section 731(c)(6).

(v) The partner takes a basis in the marketable securities which is increased by the amount of the recognized gain. Section 732. The basis increase is allocated to the marketable securities in proportion to their respective amounts of unrealized appreciation before the increase. Section 731(c)(4).

b. Marketable Securities defined

(i) The term "marketable securities" generally means actively traded financial instruments and foreign currencies. Section 731(c)(2)(A).

(ii) Financial instruments include stock or other equity interests, evidences of indebtedness, options, forward or future contracts, notional principal contracts, and derivatives. Section 731(c)(2)(C).

(iii) A financial instrument or foreign currency is actively traded if, as of the date of distribution, it is actively traded within the meaning of the straddle rules under Section 1092(d)(1). Section 731(c)(2)(A).

(iv) Looking to the straddle rules, personal property is considered "actively traded" if there is an established financial market for the property. Treas. Reg. §1.1092(d)-1(a).

(v) An established financial market can be a national securities exchange registered under the Securities Exchange Act; an interdealer quotation system sponsored by a national securities association registered under the Securities Exchange Act; a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission; or one of several other financial markets identified in Treas. Reg. §1.1092(d)-1(b).

(vi) Under Section 731(c)(2)(B), in addition to actively traded financial instruments and foreign securities, marketable securities also include the following property: (1) any interest in a common trust fund, or in a regulated investment company which has issued any redeemable
security which it is offering for sale or has outstanding; (2) any financial instrument which is readily convertible into or exchangeable for money or marketable securities; (3) any financial instrument the value of which is determined substantially by reference to marketable securities; (4) any interest in a precious metal which is actively traded unless the metal was produced, used, or held in the active conduct of a trade or business by the partnership; (5) any interest in any entity if substantially all of the assets of the entity consist, directly or indirectly, of marketable securities, money, or both; and (6) any interest in any entity to the extent that the value of the interest is attributable to marketable securities, money, or both.

(vii) Where substantially all of the assets of an entity consist of marketable securities, money, or both the interest in such entity is a marketable security. Section 731(c)(2)(B)(v).

For this purpose substantially all means 90 percent or more of the entity's assets by value as of the date of distribution, consist of marketable securities. Even if an entity does not meet the 90% test, the interest in the entity may still constitute a marketable security, if more than 20% of its assets consist of marketable securities, money or both, then the interest in the entity is a marketable security, but only to the extent that its value is attributable to marketable securities or money. Treas. Reg. §1.731-2(c)(3)(ii).

c. Exceptions to treatment of marketable-security as cash. Section 731(c)(3).

(i) Securities contributed to the partnership by the partner receiving the distribution.

(a) A marketable security is not treated as money if it was originally contributed by the partner receiving it in the distribution. Section 731(c)(3)(A).

(b) However, if any portion of the value of the distributed security is attributable to direct or indirect contributions of marketable securities or money to the entity to which the distributed security relates, that portion of the security's value is treated as money received from the partnership.

(ii) Securities that were not marketable when acquired by the partnership
(a) A marketable security is not treated as money if it was not actively traded when the partnership obtained it (e.g. stock acquired by a partnership in a private placement and distributed to a partner after the corporation went public and the stock was listed on a public exchange) and all of the following conditions are met: (1) the entity that issued the security had no outstanding marketable securities at the time the partnership acquired the security; (2) the partnership held the security for at least six months before it became marketable, and (3) the partnership distributed the security within five years of the date it became marketable. Treas. Reg. §1.731-2(d)(1)(iii).

(iii) Distributions by investment partnerships

(a) Investment partnerships, formed for the purpose of holding marketable securities for investment or for sale to customers, are not generally subject to Section 731(c).

(b) A distribution of marketable securities to a partner who did not contribute any property to the partnership other than money or securities will not generally be treated as a distribution of money.

d. Anti-Abuse Rule.

(i) A transaction with a principal purpose to achieve a tax result that is inconsistent with the purpose of Section 731(c) can be recast as appropriate to achieve consistent results. Treas. Reg. §1.731-2(h)

D. Distribution of Encumbered Property

1. Section 752 - In General.

a. A distribution of encumbered property can result in gain to the partner receiving the distribution, or to any other partner whose share of partnership liabilities is reduced as a result of the distribution, if the net reduction in the partner’s liabilities as a result of the transaction exceeds the partner’s basis in the partnership immediately before the distribution. If there is a reduction in a partner’s share of liabilities that is treated as a deemed distribution in excess of the partner’s basis in the partnership immediately before the deemed distribution, the partner will recognize gain under section 731(a)(1).
b. Section 752(a) treats any increase in liabilities experienced by a partner as a deemed contribution of money by that partner to the partnership.

(i) Section 752(a) provides: “Any increase in a partner’s share of the liabilities of a partnership, or any increase in a partner’s individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.”

c. Section 752(b) treats any decrease in liabilities experienced by a partner as a deemed distribution of money to that partner.

(i) Section 752(b) provides: “[A]ny decrease in a partner’s share of the liabilities of a partnership, or any decrease in a partner’s individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.”

d. Increases and decreases in liabilities are netted for purposes of making this determination.

(i) Treas. Reg. § 1.752-1(f) provides: “If, as a result of a single transaction, a partner incurs both an increase in the partner’s share of the partnership liabilities (or the partner’s individual liabilities) and a decrease in the partner’s share of the partnership liabilities (or the partner’s individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership.”


a. Treas. Reg. § 1.752-1(a) defines “recourse liability” as a liability for which any partner or related person bears the economic risk of loss under Treas. Reg. § 1.752-2. Treas. Reg. § 1.752-2(b)(1) states:

“[A] partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to
reimbursement from another partner or person that is a related person to another partner . . ."

b. The regulation provides that a liability is "recourse" to the extent that at least one partner bears the economic risk of loss with respect to the liability. In order to determine who bears the economic risk of loss, the regulation applies a "constructive liquidation" analysis.

c. Treas. Reg. § 1.752-2(b)(1) provides:

Upon a constructive liquidation, all of the following events are deemed to occur simultaneously: (i) All of the partnership’s liabilities become payable in full; (ii) With the exception of property contributed to secure a partnership liability (see § 1.752-2(h)(2)), all of the partnership’s assets, including cash, have a value of zero; (iii) The partnership disposes of all its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor’s right to repayment is limited solely to one or more assets of the partnership); (iv) All items of income, gain, loss, or deduction are allocated among the partners; and (v) The partnership liquidates.

d. A partner bears the economic risk of loss for a liability to the extent that if the partnership constructively liquidated, the partner would be obligated to either pay a creditor or make a contribution to the partnership because the liability would be due and the partner would not be entitled to reimbursement. Treas. Reg. § 1.752-2(b).

(i) In circumstances where a partner is entitled to reimbursement, the economic risk of loss is shifted to the obligor under such reimbursement arrangement. Treas. Reg. § 1.752-2(b)(3) provides in pertinent part:

". . . All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying this section, including: (i) Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership; (ii) Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and (iii) Payment obligations (whether in the form of direct remittances to another partner or a
contribution to the partnership) imposed by state law, including the governing state partnership statute. To the extent that the obligation of a partner to make a payment with respect to a partnership liability is not recognized under this paragraph (b)(3), paragraph (b) of this section is applied as if the obligation did not exist.”

(ii) Therefore, a contractual obligation to pay a liability that runs either to the creditor or another partner would shift the economic risk of loss with respect to such liability to the obligor under such contractual arrangement.

e. Treas. Reg. § 1.752-2(i) addresses the treatment of recourse liabilities in a tiered partnership structure. Treas. Reg. § 1.752-2(i) provides:

“If a partnership (the “upper-tier partnership”) owns (directly or indirectly through one or more partnerships) an interest in another partnership (the “lower-tier partnership”), the liabilities of the lower-tier partnership are allocated to the upper-tier partnership in an amount equal to the sum of the following—(1) The amount of the economic risk of loss that the upper-tier partnership bears with respect to the liabilities; and (2) Any other amount of the liabilities with respect to which partners of the upper-tier partnership bear the economic risk of loss.”

f. Pursuant to this provision, an upper-tier partnership is allocated liabilities of a lower-tier partnership for which the upper-tier partnership or its partners bear the economic risk of loss.3 Once an upper-tier partnership’s allocable share of a lower-tier partnership’s liabilities is determined, it is necessary to allocate such liabilities at the upper-tier partnership. Treas. Reg. § 1.752-4(a) provides that:

“An upper-tier partnership’s share of the liabilities of a lower-tier

---

3 Treas. Reg. 1.752-4(c) provides:

The amount of an indebtedness is taken into account only once, even though a partner (in addition to the partner’s liability for the indebtedness as a partner) may be separately liable therefore in a capacity other than as a partner.

The author believes that a similar limitation should apply with respect to liabilities allocable to a partner as a result of the partner’s direct ownership interest in a lower-tier partnership, where the partner owns interests in an upper-tier partnership that also owns an interest in the lower-tier partnership.
partnership (other than any liability of the lower-tier partnership that is owed to the upper-tier partnership) is treated as a liability of the upper-tier partnership for purposes of applying section 752 and the regulations thereunder to the partners of the upper-tier partnership.

(i) Therefore, to the extent that a partner of an upper-tier partnership bears the ultimate economic risk of loss for a liability of a lower-tier partnership, the recourse liability would be allocable to the upper-tier partnership by the lower-tier partnership as if the upper-tier partnership bore the economic risk of loss. Moreover, when such liability is allocated to the upper-tier partnership, such upper-tier partnership would allocate the recourse liability among its partners who bear the ultimate economic risk of loss for such liability pursuant to Section 752.

3. Allocation of Partnership Nonrecourse Liabilities

a. Treas. Reg. § 1.752-3 sets forth the rules for determining a partner's share of the nonrecourse liabilities of a partnership. Those rules state that a partner's share of the nonrecourse liabilities of a partnership equals the sum of the following:

(i) The partner’s share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder [the “First Tier”];

(ii) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration [the “Second Tier”]; and

(iii) The partner’s share of the excess nonrecourse liabilities (those not allocated under [the above paragraphs]) of the partnership as determined in accordance with the partner’s share of partnership profits. The partner’s interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners’ interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent.
with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain. Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property, or property for which reverse section 704(c) allocations are applicable, where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in the Second Tier with respect to such property. Excess nonrecourse liabilities are not required to be allocated under the same method each year [the "Third Tier"].

E. Possible Exceptions to Nonrecognition - Unrealized receivables and inventory.

1. A partner who receives more than his proportionate share of certain ordinary income items will be treated as having sold those items to the partnership, producing ordinary gain to the partner receiving the distribution. Section 751(b) and Section 731(d).4

2. Section 751 property includes unrealized receivables of the partnership that have not yet been included in income and inventory items of the partnership. The term "unrealized receivables" includes rights to income for property or services that have not yet been included in income under the method of accounting used by the partnership, as well as section 1245 and section 1250 property, as well as numerous other items expected to generate ordinary income for the partnership. Section 751(c).

3. Thus, a disproportionate distribution of depreciated property which would require recapture under Section 1245 or Section 1250 may trigger ordinary income to the partner.

4. Unrecaptured Section 1250 Gain under Treas. Reg. § 1.1(1H)-1(B)(3)

---

4 For a comprehensive discussion of Section 751, see Monte A. Jackel, "Blissful Ignorance: Section 751(b) Uncharted Territory", PLI Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures, & Other Strategic Alliances 2005.
a. Sections 1250(a) and (b) generally provide that a taxpayer recognizes an amount of ordinary income upon the disposition of real property held for more than one year equal to the amount of depreciation in respect of such property that is in excess of the amount that would have resulted if the property had been depreciated under the straight-line method of depreciation.

(i) Section 1(h)(6)(A) provides that "unrecaptured section 1250 gain" is determined by reference to "the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent." Unrecaptured section 1250 gain is taxable at a 25% Federal income tax rate. Section 1(h)(1)(D).

(ii) Treas. Reg. § 1.1(h)-1(b)(3)(ii) provides that "[w]hen an interest in a partnership held for more than one year is sold or exchanged in a transaction in which all realized gain is recognized, there shall be taken into account under section 1(h)(7)(A)(i) in determining the partner's unrecaptured section 1250 gain the amount of section 1250 capital gain that would be allocated... to that partner... if the partnership transferred all of its section 1250 property in a fully taxable transaction immediately before the transfer of the interest in the partnership."\(^5\)

(iii) Thus, in general a selling partner must take into account an amount equal to his share of the section 1250 gain that the partnership would have realized on a hypothetical sale of all of its assets occurring immediately prior to the actual sale of the partnership interest. The selling partner's share of the partnership's hypothetical depreciation recapture (determined as if section 1250(b)(1) included all depreciation) is treated as unrecaptured section 1250 gain subject to the 25% tax rate. Treas. Reg. § 1.1(h)-1(b)(3)(i).

(iv) The result required by Treas. Reg. § 1.1(h)-1(b)(3)(i) is consistent with the governing provisions of the Code.

(v) Section 751(a) provides that the portion of the gain on a sale of a partnership interest that is attributable to unrealized receivables is treated as ordinary income.

\(^5\) Section 1(h)(7) was redesignated as section 1(h)(6) by the Jobs and Growth Tax Relief Reconciliation Act of 2003, P.L. 108-27.
Section 751(c) (flush language) provides that the term "unrealized receivables" includes section 1250 property, to the extent of the gain which would be subject to section 1250(a) recapture had such property been sold by the partnership.

(vi) The interplay between sections 751(a) and 751(c) (flush language) makes clear that upon a sale or exchange of a partnership interest, the selling partner must recognize ordinary income to the extent of his share of the ordinary income from section 1250(a) depreciation recapture that would be recognized by the partnership upon a sale of its section 1250 property (i.e., depreciable real estate).

(vii) Applying the modifications to section 1250 contained in section 1(h)(6)(A), upon a sale of the partnership's section 1250 property, gain equal to all depreciation previously claimed would be treated as ordinary income.

(viii) Moreover, upon a sale or exchange of an interest in the partnership, the selling partner would recognize ordinary income equal to his share of the amount of depreciation previously claimed on the partnership's section 1250 property.

(ix) Therefore, upon the sale or exchange of a partnership interest, this is an "amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary" if section 1250 contained the modifications set forth in section 1(h)(6)(A). Accordingly, this amount is subject to the 25% tax rate upon the sale or exchange of an interest in a partnership.

b. Exception for Partnership Redemptions

(i) Treas. Reg. § 1.1(h)-1(b)(3)(ii) provides that "[t]his paragraph (b)(3) does not apply to a transaction that is treated, for Federal income tax purposes, as a redemption of a partnership interest."

(ii) Accordingly, a redemption of a partner's interest in a partnership would not be subject to the "look-through" rule of Treas. Reg. § 1.1(h)-1(b)(3)(ii).

(iii) Thus, the partner would not be deemed to recognize unreaptured section 1250 gain upon a redemption of its interests in the partnership.
(iv) As noted above, section 1(h)(6)(A) provides that unrecaptured section 1250 gain is determined by reference to "the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent."

(v) In the case of a redemption of a partnership interest, no amount of long-term capital gain would be treated as ordinary income if section 1250 contained the modifications set forth in section 1(h)(6)(A). Section 751(b), not section 751(a), applies to redemption transactions and does not cause any amount of capital gain to be ordinary income. Rather, section 751(b) constructs a deemed pro rata distribution of ordinary income and capital gain property followed by deemed exchanges of one category back to the partnership for the other. Moreover, because "unrecaptured section 1250 gain" maintains its character as capital gain (rather than ordinary income), the application of section 751(b) should not be triggered solely by the ownership of real estate subject to the 25% tax rate.

c. The Importance of Form

(i) In Foxman v. Commissioner, 41 T.C. 535 (1964), aff'd 352 F.2d 466 (3d Cir. 1965), the Tax Court analyzed whether a partner's receipt of consideration for a partnership interest constituted a sale or a redemption of such interest for Federal income tax purposes.

(ii) In holding that the transaction at issue constituted a sale of the partner's interest to the other partners, the Tax Court noted that, although the economic consequences of a sale or a redemption of a partnership interest may be indistinguishable under certain circumstances, there may be a significant difference in tax consequences.

(a) The Tax Court stated: "Where the practical differences between a 'sale' and a 'liquidation' are, at most slight, if they exist at all, and where the tax consequences to the partners can vary greatly, it is in accord with the purpose of the statutory provisions to allow the partners themselves, through arm's-length negotiations, to determine whether to take the 'sale' route or the 'liquidation' route,"
thereby allocating the burden among themselves.”

Foxman, 41 T.C. at 551-552.

F. Possible Exceptions to Nonrecognition - Sections 704(c)(1)(B) and Section 737

1. Section 704(c)(1)(B) provides that if a partnership either directly or indirectly distributes “section 704(c) property” to any partner other than the contributing partner within seven years of the property’s contribution, then the contributing partner must recognize gain or loss as if the property had been sold for its fair market value at the time of the distribution.

   a. The character of the gain or loss is determined as if the property had been sold to the distributee.

   b. Adjustments to the partner’s adjusted basis in its partnership interest and to the adjusted basis of the distributed property shall be made to reflect any gain or loss recognized.

2. Section 737 provides that if a partner who contributed section 704(c) property receives a distribution of other property (other than money) from a partnership within seven years of the contribution, such partner will recognize gain equal to the lesser of the “excess distribution” or the partner’s “net precontribution gain.”

   a. Any gain required to be recognized under section 737 is in addition to any gain recognized under section 731.

   b. The character of the gain is determined by reference to the proportionate character of the net precontribution gain.

G. Possible Exceptions to Nonrecognition - Distribution of Corporate Partner Stock

1. The general nonrecognition treatment of Section 731(a) does not apply when a corporate partner receives a partnership distribution of its own stock. Notice 89-37, 1989-1 CB 679.

2. A distribution to a corporate partner of its own stock (or stock of an affiliate) is treated as a redemption of the partner’s stock in exchange for all or a portion of the partner’s partnership interest. The transaction is taxed as a corporate distribution of appreciated property to the other partners under Section 311(b) with the corporation recognizing gain equal

---

6 In addition to anti-mixing bowl concerns under Sections 704(c)(1)(B) and 737, the partnership and the partner should analyze each distribution under the disguised sale rules which are more fully discussed in Andrea M. Whiteway, “Property and Liability Transfers to Partnerships: Built in Gain or Loss, Boot and Disguised Sales”, William & Mary 52nd Tax Conference (2006) Section VII.
to the difference between the partner’s basis in the portion of the partnership interest deemed transferred and the fair market value of that interest.

3. The IRS was specifically authorized under Section 337(d) to issue regulations designed to thwart efforts to circumvent the repeal of the General Utilities doctrine and in 1992 issued Prop. Reg. §1.337(d)-2. The proposed regulations include a de minimis provision to exempt corporations from the distribution rule if the corporation has only a small investment in the partnership.

II. ADJUSTMENTS TO BASIS OF PARTNERSHIP PROPERTY

A. Section 743 - In General

1. Section 743 provides that, if a section 754 election is in effect, upon the transfer of an interest in a partnership by sale or exchange or on the death of a partner, the basis of the partnership’s property with respect to the transferee partner is (1) increased by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or (2) decreased by the excess of the transferee partner’s proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership.

a. Treas. Reg. § 1.743-1(d) provides that, generally, a transferee partner’s share of the adjusted basis to the partnership of partnership property is equal to the sum of the transferee’s interest as a partner in the partnership’s previously taxed capital (which is generally the amount of cash the transferee would receive upon a hypothetical sale of the partnership’s assets for fair market value, minus any taxable gain that would be allocated to the transferee upon such a sale), plus the transferee’s share of partnership liabilities.

2. Section 761(e) provides in relevant part that, for purposes of section 743, any distribution of an interest in a partnership is treated as an exchange of such interest. Thus, if the property distributed out by a partnership to its partner constitutes an interest in a lower-tier partnership then that distribution constitutes an exchange of such lower-tier interest for purposes of section 743.

3. Section 743(c) provides that the adjustment in basis shall be allocated among the assets owned by the partnership in accordance with the rules provided in section 755.

   a. In general, Treas. Reg. § 1.755-1 requires that the amount of the decrease be divided between two classes of property: (1) capital assets and property described in section 1231(b) and (2) ordinary income property.

   b. Section 1221(a) provides that the term “capital asset” means property held by a taxpayer other than property specifically excluded by section 1221(a), including property used in the taxpayer’s trade or business of a character which is subject to the allowance for depreciation provided in section 167, or real property used in the taxpayer’s trade or business. Property described in section 1231(b) generally includes property used in the taxpayer’s trade or business which is subject to the allowance for depreciation provided in section 167 and held for more than one year, and real property used in the taxpayer’s trade or business and held for more than one year, which is not (A) inventory, (B) property held by the taxpayer primarily for sale to customers in the ordinary course of business, (C) a copyright, a literary, musical or artistic composition or similar item, or (D) a publication of the U.S. Government.

4. In the case of a section 743(b) adjustment that results from an exchange pursuant to which the transferee’s basis in the partnership is not determined in whole or in part by the transferor’s basis in the partnership, the amount of the basis adjustment allocated to the class of ordinary income property is equal to the total amount of income, gain, or loss (including any remedial allocations under Treas. Reg. § 1.704-3(d)) that would be allocated to the transferee from the sale of all ordinary income property pursuant to a hypothetical disposition of all of the partnership’s property in a taxable transaction immediately after the transfer of the partnership interest. Treas. Reg. § 1.755-1(b). The amount of the basis adjustment allocated to capital gain property is equal to the total amount of the section 743(b) adjustment reduced by the amount of the basis adjustment allocated to ordinary income property under the preceding sentence, but only to the extent of the partnership’s basis in its capital gain property. Treas. Reg. § 1.755-1(b)(2). Any remaining section 743(b) basis adjustment must be applied to reduce the basis of the partnership’s ordinary income property.

   a. Treas. Reg. § 1.755-1(b)(3)(i) provides that the amount of the basis adjustment to each item of ordinary income property is equal to:

      (A) the amount of income, gain, or loss (including any remedial allocations under Treas. Reg. § 1.704-3(d)) that would be allocated
to the transferee from the hypothetical sale of the item, reduced by (B) the product of (1) any decrease to the amount of the basis adjustment to ordinary income property required by the last sentence of Treas. Reg. § 1.755-1(b)(2)(i); multiplied by (2) a fraction, the numerator of which is the fair market value of the item of property to the partnership and the denominator of which is the total fair market value of all of the partnership’s items of ordinary income property.

B. Mandatory Application of Section 743(b) post Jobs Act.

1. The Jobs Act amended section 743(a)\(^8\) to provide that the basis adjustment under section 743(b) is mandatory upon the sale or exchange of an interest in a partnership or upon the death of a partner where, immediately after such transfer, the partnership has a “substantial built-in loss.” A partnership has a “substantial built-in loss” if the partnership’s adjusted basis in its property exceeds the fair market value of the partnership’s property by more than $250,000.\(^9\)

2. Section 743(b), as amended by the Jobs Act, makes a section 743(b) basis adjustment mandatory in the case of a transfer of an interest in a partnership where immediately after such transfer the partnership has a substantial built-in loss (more than $250,000). The basis adjustment applies whether or not a section 754 election is in effect and includes transfers upon the death of a partner.

a. Substantial Built-In Loss. A partnership has a substantial built-in loss with respect to a transfer of an interest if the partnership’s adjusted basis in its property exceeds the fair market value of the property by more than $250,000. Section 743(d)(1).

b. Regulations. The Service has the authority to prescribe regulations to carry out the purposes of section 743(d)(1), including regulations aggregating related partnerships and disregarding property acquired in an attempt to avoid the loss threshold. Section 743(d)(2).

c. Electing Investment Partnerships. The Jobs Act amendment includes an alternative basis adjustment rule for electing investment partnerships. An electing investment partnership is not treated as having a substantial built-in loss, and thus is not required to make basis adjustments to partnership property in the case of a transfer of a partnership interest. Section 743(e)(1). Instead, the

\(^8\) Jobs Act, § 833(b)(1).

\(^9\) Section 743(d)(1).
partnership must apply a partner-level loss limitation rule that disallows the transferee partner's distributive share of losses from the sale except to the extent it can be established that the loss has not been duplicated. Section 743(e)(2).

d. Securitization Exception. The mandatory section 743(b) basis adjustment provisions contain an exception for securitization partnerships. Section 743(f). A securitization partnership is not treated as having a substantial built-in loss with respect to any transfer and, therefore, is not required to make basis adjustments to partnership property.

3. Effective Date. The mandatory section 743(b) basis adjustment provision applies to transfers of interests in partnerships made after October 22, 2004.

C. Section 734(b) - In General.

1. Section 734(b) provides that upon a distribution of property to a partner, a partnership that has a section 754 election in effect shall,

(1) increase the adjusted basis of partnership property by –

(A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1), and

(B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)) over the basis of the distributed property to the distributee, as determined under section 732, or

(2) decrease the adjusted basis of partnership property by –

(A) the amount of any loss recognized to the distributee partner with respect to such distribution under section 731(a)(2), and

(B) in the case of distributed property to which section 732(b) applies, the excess of the basis of the distributed property to the distributee, as determined under section 732, over the adjusted basis of the distributed property to the partnership immediately
before such distribution (as adjusted by section 732(d)).

2. However, if the distributed property is an interest in another partnership, paragraph (1)(B) only applies if both the distributing partnership and the partnership whose interests are distributed have elections under section 754 in effect. Section 734.

D. Mandatory Application of Section 734(b) post Jobs Act.

1. Section 734(b) and (d), as added by the Jobs Act, require a partnership to make a section 734(b) downward basis adjustment to the basis of partnership assets in the case of any distribution of partnership property that would result in a "substantial basis reduction" if a section 754 election were in effect. The requirement applies whether or not the partnership has a section 754 election in effect.

   a. Substantial Basis Reduction. A substantial basis reduction means a downward adjustment of more than $250,000 that would be made to the basis of a distributing partnership’s assets if a section 754 election were in effect. Section 734(d).

   b. Regulations. The Service has the authority to prescribe regulations to carry out the purposes of section 734(d), including regulations aggregating related partnerships and disregarding property acquired in an attempt to avoid the application of the new rules. Section 734(d)(2).

   c. Securitization Exception. There is an exception for securitization partnerships as defined in section 743(o). Section 734(e). A securitization partnership is not treated as having a substantial basis reduction with respect to any distribution of property to a partner, and, therefore, is not required to make basis adjustments to partnership property.

2. Effective Date. The mandatory section 734(b) adjustment provisions apply to transfers of assets by a partnership that occur after October 22, 2004.

E. Jobs Act - Targeted Abuse under Section 734(b)

1. The Section 734(b) abuse was set forth in an Example outlined in the Jobs Act House Committee Report (the "House Report").

---

a. The ABC partnership has the following balance sheet:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>Value</th>
<th>Partner</th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>LMN Stock</td>
<td>3,000,000</td>
<td>1,000,000</td>
<td>A</td>
<td>2,500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>XYZ Stock</td>
<td>7,000,000</td>
<td>1,000,000</td>
<td>B</td>
<td>2,500,000</td>
<td>500,000</td>
</tr>
<tr>
<td></td>
<td>C</td>
<td>5,000,000</td>
<td></td>
<td>1,000,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>10,000,000</td>
<td>2,000,000</td>
<td>Total</td>
<td>10,000,000</td>
<td>2,000,000</td>
</tr>
</tbody>
</table>

2. A and B are each 25 percent partners and C is a 50 percent partner. The LMN stock is distributed to C in complete redemption of its interest. C takes a basis of $5,000,000 in the LMN stock. If C thereafter sold the LMN stock for $1,000,000, the fair market value of the LMN stock at the time of the redemption, C would recognize a $4,000,000 loss.

3. Absent a section 734(b) adjustment, and subject to a section 704(d) basis limitation, A and B would each recognize a $3,000,000 loss upon sale of the XYZ stock for $1,000,000, its fair market value at the time of the redemption. Accordingly, in the aggregate, A, B and C would recognize $10,000,000 of loss even though, had partnership ABC simply sold the LMN stock and XYZ stock, A, B and C would have recognized only $8,000,000 of loss.

4. If partnership ABC had a section 754 election in effect, upon the distribution of the LMN stock to C, partnership ABC’s basis in the XYZ stock would have been reduced by $2,000,000, which equals the difference between the basis of the LMN stock in the hands of partnership ABC and the basis of the LMN stock in the hands of C. In that case, upon the sale of the XYZ stock, A and B would each recognize only a $2,000,000 loss.

5. The stated purpose of the mandatory section 734(b) adjustment (and the mandatory section 743(b) adjustment, discussed below) is to prevent loss duplication and partnership loss transfers. It is important to note, however, that the loss duplication that would occur under the facts of the Example is only temporary. Upon the liquidation of partnership ABC, A and B would each recognize $1,000,000 of gain, resulting in an aggregate net loss of $8,000,000 from the transactions described above.

---

11 Section 732(b).
12 Under section 704(d), A and B would be permitted to deduct their distributive share of this loss only to the extent of their respective adjusted bases in their partnership interest. If A and B made capital contributions to the partnership or the partnership incurred indebtedness, their adjusted bases in their interests would be increased accordingly. The analysis in Example 6 assumes that the loss would be deductible by A and B.
F. Jobs Act - Targeted Abuse under Section 743(b)

1. Example. The facts are the same as in the House Report, except that instead of being redeemed, C sells its interest in partnership ABC to D for $1,000,000, recognizing a $4,000,000 loss. Absent a section 743(b) adjustment, and subject to a section 704(d) basis limitation, a sale by the partnership of all of its assets would allow D to recognize a $4,000,000 loss. Accordingly, in the aggregate, the partners of partnership ABC would recognize $12,000,000 of loss as a result of the transactions described above even though, had the ABC partnership simply sold the LMN stock and XYZ stock for their fair market values, the partners of ABC would have recognized only $8,000,000 of loss.

2. As noted above, upon liquidation of partnership ABC for cash, D would recognize an offsetting $4,000,000 gain resulting in a net $8,000,000 loss to the partners of partnership ABC. Nevertheless, a $4,000,000 loss has (at least temporarily) been transferred from C to D and duplicated.

G. Problematic Application of Mandatory Section 734(b) Adjustments.

1. In addition, as illustrated in the following Example, the mandatory section 734(b) adjustment can apply when no loss property is involved and there is no potential for loss transfer or duplication. The DEF partnership has the following balance sheet:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>Value</th>
<th>Partner</th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prop. 1</td>
<td>500,000</td>
<td>3,000,000</td>
<td>A</td>
<td>1,000,000</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Prop. 2</td>
<td>1,500,000</td>
<td>3,000,000</td>
<td>B</td>
<td>500,000</td>
<td>1,500,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>C</td>
<td>500,000</td>
<td>1,500,000</td>
</tr>
<tr>
<td>Total</td>
<td>2,000,000</td>
<td>6,000,000</td>
<td>Total</td>
<td>2,000,000</td>
<td>6,000,000</td>
</tr>
</tbody>
</table>

2. Property 1 is distributed to A in complete redemption of A's partnership interest. A's basis in distributed Property 1 equals $1,000,000. Accordingly, because the basis of Property 1 in A's hands is $500,000 more than the basis of Property 1 in the partnership's hands, new section 734(d) requires partnership DEF to make a downward $500,000 basis adjustment in its remaining property regardless of whether partnership DEF has a section 754 election in effect. However, partnership DEF owns no loss property and, accordingly, no loss duplication or transfer could

---

14 Under section 704(d), D would be permitted to deduct its distributive share of this loss only to the extent of its adjusted basis in its partnership interest. If D made a capital contribution to the partnership or the partnership incurred indebtedness, D's adjusted basis in its interest would be increased accordingly. The analysis in Example 8 assumes that the loss would be deductible by A and B.

15 Section 732(b).
result from the absence of a step-down in inside basis. Nevertheless, new section 734(b) would require the downward basis adjustment. Thus, as seems so often the case when Congress enacts "anti-abuse" tax rules, the rule sweeps more broadly than intended.

H. Loss Duplication after the Mandatory Section 743(b) Basis Adjustment

1. As illustrated by the following Example, due to the way the $250,000 de minimis threshold is computed, some loss transfers and duplication may persist even with the mandatory section 743(b) basis adjustment provision. A, B and C form the equal ABC Partnership. A and B each contribute $10,000,000 of cash to the partnership. C contributes Property 1 with a basis of $5,000,000 and a fair market value of $10,000,000. The partnership buys Property 2 for $10,000,000 and holds the balance of the cash. Property 2 subsequently declines in value to $7,000,000. As a result, the partnership's balance sheet is as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>Value</th>
<th>Partner</th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prop. 1</td>
<td>5,000,000</td>
<td>10,000,000</td>
<td>A</td>
<td>10,000,000</td>
<td>9,000,000</td>
</tr>
<tr>
<td>Prop. 2</td>
<td>10,000,000</td>
<td>7,000,000</td>
<td>B</td>
<td>10,000,000</td>
<td>9,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>10,000,000</td>
<td>10,000,000</td>
<td>C</td>
<td>5,000,000</td>
<td>9,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>25,000,000</td>
<td>27,000,000</td>
<td>Total</td>
<td>25,000,000</td>
<td>27,000,000</td>
</tr>
</tbody>
</table>

2. A then sells its interest in the partnership to D for $9,000,000 and recognizes a $1,000,000 loss. No mandatory section 743(b) basis adjustment applies because the partnership's total basis in its property does not exceed the fair market value of such property by more than $250,000. Upon a sale of Property 2 by the partnership, D would be allocated a $1,000,000 loss.

3. Accordingly, the loss is transferred and duplicated to the same extent as under prior law, and the new rule misses its mark. In contrast, if A had been redeemed for a $9,000,000 cash distribution, a mandatory section 734(b) adjustment would have been required, equal to the $1,000,000 loss A would have recognized as a result of the redemption.

I. DeMinimis $250,000 Threshold – May still require very small basis adjustments

1. The purpose of the $250,000 threshold is, presumably, to exempt transactions that by some measure are so de minimis that the complexity resulting from the mandatory basis adjustment is unwarranted. As illustrated by the following Example, however, because the $250,000 threshold is computed based on the total excess of partnership basis over value, very small basis adjustments become mandatory.

2. The facts are the same as the facts in immediately preceding Example, except that the value of Property 2 declines to $4,000,000. As a result, the partnership's balance sheet is as follows:
<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>Value</th>
<th>Partner</th>
<th>Basis</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prop. 1</td>
<td>5,000,000</td>
<td>10,000,000</td>
<td>A</td>
<td>10,000,000</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Prop. 2</td>
<td>10,000,000</td>
<td>4,000,000</td>
<td>B</td>
<td>10,000,000</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>10,000,000</td>
<td>10,000,000</td>
<td>C</td>
<td>5,000,000</td>
<td>8,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>25,000,000</td>
<td>24,000,000</td>
<td>Total</td>
<td>25,000,000</td>
<td>24,000,000</td>
</tr>
</tbody>
</table>

3. A sells a 0.1 percent interest in the partnership to D for $24,000. Because total partnership basis exceeds total value by more than $250,000, the de minimis threshold is met. A recognizes a $1,000 loss on the sale, and a $1,000 downward section 743(b) adjustment will be required for D. In light of the $250,000 threshold, it is hard to imagine that Congress (or Congressional staffers involved in developing the legislation) intended that a $1,000 (or even smaller) basis adjustment would be made mandatory, but that is how the statute is drafted.

J. Section 743(b) Mandatory Upward Basis Adjustment in Certain Cases.

1. The facts are the same as in the immediately preceding Example, except that C sells its interest to D for $8,000,000, recognizing a $3,000,000 gain. Because the partnership's total basis in its property exceeds its value by more than $250,000, a section 743(b) adjustment is mandatory. D will receive a $3,000,000 net positive adjustment ($5,000,000 positive with respect to Property 1 and $2,000,000 negative with respect to Property 2).  

a. Thus, the partnership will not need to make a section 754 election in order for D to obtain the benefit of a step-up in inside basis. Rather, the new mandatory adjustment rule will require the step-up in inside basis. A section 754 election is revocable only with the consent of the district director for the internal revenue district in which the partnership return is required to be filed. Moreover, as discussed above, mandatory adjustments are not required in every case in which they would result in a step-down. In contrast, if a section 754 election is in effect, even if a step-down is not required by the mandatory rule, it will be required by the section 754 election. Thus, well-advised taxpayers in this situation will not make a section 754 election but instead will simply rely on the application of the mandatory rule.

17 Treas. Reg. § 1.754-1(c)(1).
III. PARTNERSHIP TERMINATIONS UNDER SECTION 708(b)(1)(A)

A. In General.

1. Section 708 provides “a partnership shall be considered as terminated only if-- 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 . . . .”

2. A partnership terminates when the operations of the partnership are discontinued.

3. There is a difference between a partnership dissolution for state law purposes (which may lead to the liquidation of that partnership) and a partnership termination under section 708. For state law purposes, certain events (e.g. death or bankruptcy of a partner) give rise to a “dissolution” of a partnership. If the dissolved partnership is not continued, but instead liquidates, the following occurs: (i) a winding-up period in which any remaining business is completed, assets are sold and expenses of the partnership are paid, followed by (ii) the distribution of remaining assets first to pay creditors and thereafter to the partners. Neither the dissolution nor the liquidation of a partnership pursuant to state law necessarily results in the termination of the partnership for Federal income tax purposes.

B. Cessation of Partnership Business.

1. In General.
   a. As noted above, a partnership terminates under section 708(b)(1)(A) when there is a complete cessation of its business. Thus, it is necessary to determine when a “complete cessation” has occurred.
   b. The determination of whether the business of a partnership has ceased is based on all relevant facts.

   a. A partnership is not considered to have terminated during the winding-up period. Consequently, a partnership is not terminated

---

19 Treas. Reg. §1.708-1(b)(1).
20 See Revised Uniform Partnership Act §801.
21 Treas. Reg. §1.708-1(b)(1)
under section 708(b)(1)(A) until all assets are distributed to the partners, rather than some earlier date, such as when business activities are terminated and merely administrative activities remain to be carried out.

b. For example, where partners agree on April 1 to dissolve their partnership, but carry on the business through a winding-up period ending on September 30, when all remaining assets, consisting only of cash, are distributed to the partners, the partnership does not terminate because of cessation of business until September 30.²²

c. In *Austin v. U.S.*,²³ the Court of Appeals for the Tenth Circuit affirmed the district court finding that even though the taxpayer took no part in the partnership after his divorce from the other partner, the partnership did not terminate until its affairs could be wound up and an accounting made.

3. Level of Business Activity.

a. A partnership is not considered to have terminated if there is some level of business activity. Thus, a partnership that has abandoned its primary business purpose but continues some level of business activity has not terminated.

b. In *Goulder Est. v. U.S.*, the Court of Appeals for the Sixth Circuit stated that "[t]here is no per se rule that the mere retention of certain assets or management of particular activities in anticipation of liabilities amounts to a continuation of a partnership."²⁴

c. Depending on the facts, a nominal amount of activity, such as holding property, may be sufficient to prevent a termination.

(i) In *Foxman v. Comm'r*,²⁵ the Tax Court held that a partnership had not terminated under section 708(b)(1)(A) where it transferred all of its business assets to a wholly-owned corporation and distributed the corporation's stock

---

²² Id.
²³ 461 F.2d 733 (10th Cir. 1972).
²⁴ 95-2 U.S.T.C. ¶ 50,464 (6th Cir. 1995), rev'g and rem'g, 93-2 U.S.T.C. ¶ 50,421 (N.D. Ohio 1993), citing Barran v. Comm'r, 334 F.2d 58 (5th Cir. 1964) (partnership terminated, although it retained a piece of land, and sold a half interest for $17,500); La Rue v. Comm'r, 90 T.C. 465 (1988) (defense of ongoing litigation does not constitute business activity that would result in continuation of partnership); Sargent v. Comm'r, 29 T.C.M. 941 (1970).
²⁵ 41 T.C. 535 (1964), aff'd, 352 F.2d 466 (3d Cir. 1965).
to its partners because it continued to hold two promissory notes realized from the disposition.

(ii) In *Baker Commodities Inc. v. Comm'r*,\(^{26}\) the Court of Appeals for the Ninth Circuit held that a partnership had not terminated under section 708(b)(1)(A) where it sold its only asset in exchange for a promissory note and its only remaining activity consisted of the collection of interest on the note and distribution of the payments to the partners.

(iii) In *Ginsburg v. U.S.*,\(^{27}\) the Court of Claims concluded that a partnership, which was originally formed to develop and sell land, but that had ceased such plans and continued to participate in the barley growing business, had not terminated.

(iv) In *Hoagland v. Comm'r*,\(^{28}\) the Tax Court held that a partnership did not terminate as a result of cessation of business where the land development business for which it was originally formed was frustrated and the partnership's only function was holding land pending its sale.

(v) In *Harbor Cove Marina Partners Partnership, et al. v. Comm'r*,\(^{29}\) the Tax Court held that a partnership did not terminate during the tax year where the managing general partner notified the other partners of its intent to liquidate the partnership and filed returns to that effect, where the other partners filed suit seeking an accounting, and claiming breach of fiduciary duty and declaratory relief regarding disposition of the partnership assets. The Tax Court concluded that the lawsuit sought to compel the managing general partner to comply with the liquidation procedures set forth in the partnership agreement and that the resolution of the lawsuit could reasonably lead to the partnership reporting significant items of income, gain, loss or deduction in a subsequent year, thus precluding the conclusion that the entity had terminated.

d. Bankruptcy and Receiverships.

\(^{26}\) 415 F.2d 579 (9th Cir. 1969), cert. denied, 397 U.S. 988 (1970).

\(^{27}\) 396 F.2d 989 (Ct. Cl. 1968).

\(^{28}\) 30 T.C.M. 1326 (1971), appeal dism'd (9th Cir. 1972).

\(^{29}\) 123 T.C. 64 (2004).
(i) The bankruptcy of a partnership does not create a separate taxable entity under section 1399 (added by the Bankruptcy Tax Act of 1980). Prior to the enactment of section 1399, the Service took the position that a partnership terminated as a result of the creation of a bankruptcy estate.30

(ii) Similarly, the appointment of a receiver for an insolvent partnership should not result in the termination of that partnership under section 708(b)(1)(A). Instead, the partnership continues in existence for federal income tax purposes until the receiver has concluded its liquidation activities and a final accounting for the partnership has occurred.31

e. Level of Activity to Prevent Termination is Less than Required for Partnership Formation.

(i) Interestingly, it is not necessary for an existing partnership to continue to meet the qualifications for a new partnership under section 761 in order to be considered as continuing for purposes of section 708.

(ii) Section 761 defines a partnership as including “a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on.”

(iii) The Treasury regulations (“Regulations”) interpreting section 761 exclude from the definition of a “separate entity” an entity which merely holds passive investment property.32 Therefore, the mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity.33 Thus, if a newly formed entity’s only activity consists of the holding of debt


31 See Priv. Ltr. Ruls. 9436032 (Sept. 9, 1994) and 9440019 (Oct. 7, 1994) (a limited partnership in receivership continued to be a partnership for Federal tax purposes until its affairs were wound up, including the sale of assets, satisfaction of liabilities, and continuation and commencement of legal actions beneficial to the partnership’s liquidation, and was complete when a formal partnership accounting was made).


33 See Treas. Reg. §301.7701-1(a)(2).
instruments, collection of payments thereon and the
distribution of payments to its owners, it is unlikely that the
entity would qualify as a partnership under section 761.
However, if an existing entity which is engaged in other
business activities reduces its activities to the collection and
disbursement of debt payments, the entity would not
terminate for Federal income tax purposes.

f. Avoiding Termination due to Business Cessation.

(i) A prudent taxpayer desiring to avoid a termination by
virtue of a cessation of business activity may do so by
causing the partnership to retain and actively manage one
or more income producing assets.

C. Reduction in Number of Partners.

1. In General.

a. As noted above, a partnership terminates under
section 708(b)(1)(A) if the partners cease to carry on the business
through a partnership. Thus, the partnership ceases to exist when
there is only one partner remaining, either by virtue of the
withdrawal or death of a partner, redemption of a partner’s interest,
or through a transfer of partnership interests among partners.

b. For example, where partners A and B, each of whom own a 20
percent interest in partnership ABC, sell their interests to C, who
owns a 60 percent interest in ABC, ABC is terminated as of the
date of the sale since the business is no longer carried on by any of
its partners in a partnership.\[34\]

c. Unlike cessation of business activities, where the termination for
tax purposes does not occur until the winding up process is
complete, termination occurs immediately when only one partner
remains.

d. The Regulations set forth two exceptions to the rule that a
partnership terminates when only one partner remains. The first
exception applies in the context of the death of a partner.\[35\] The
second exception applies where continuing payments are made

\[34\] Treas. Reg. §1.708-1(b)(1).

\[35\] Treas. Reg. §1.708-1(b)(1)(i).
under section 736 to a retiring partner or deceased partner’s successor.\textsuperscript{36}

2. Death of Partner in a Two Member Partnership.
   a. Treas. Reg. §1.708-1(b)(1)(i) provides that upon the death of one partner in a two member partnership, the partnership is not considered 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.\textsuperscript{37}
   b. The estate need not be a state law partner in order for this provision to apply.

   a. Purchase of Interest.
      (i) In Rev. Rul. 99-6, 1999 C.B. 432, the Service ruled that when one member acquires the entire interest of the other member in a two-member limited liability company treated as a partnership for Federal income tax purposes, the partnership is deemed to terminate under section 708(b)(1)(A).
      (ii) The selling member’s tax consequences are determined by treating the selling member as selling its partnership interest, with the result that gain or loss, if any, is reported on such sale.
      (iii) The purchasing member’s tax consequences are determined by treating the partnership as if it made liquidating distributions of all of its assets to both members and, following such distributions, the purchasing member is treated as purchasing the assets deemed to have been distributed to the selling member in liquidation of its interest.\textsuperscript{38} The purchasing member is treated as receiving a

\textsuperscript{36} Treas. Reg. §1.708-1(b)(1)(ii).

\textsuperscript{37} See Haines v. U.S., 76-1 U.S.T.C. ¶ 9222 (N.D. N.J. 1976) (the court held that a partnership did not terminate upon the death of one of its two partners because the business was carried on by the remaining partner and the decedent’s estate continued to share in the partnership’s profits and losses). See also Skaggs Est., 75 T.C. 191 (a husband-wife partnership was found to continue after the husband’s death where the husband’s estate continued to bear responsibility for a portion of the partnership’s debts.)

\textsuperscript{38} See also McCauslen v. Comm’r, 45 T.C. 588 (1966).
distribution of those assets attributable to his former interest in the partnership and must recognize gain or loss, if any, on the deemed distribution of the assets to the extent required under section 731(a).

(iv) In order to avoid a termination of the partnership under section 708(b)(1)(A), the purchasing member could acquire the interest of the selling member through a related party, that is not itself a disregarded entity for tax purposes. This would avoid the recognition of gain or loss that would otherwise be required under section 731(a). The transaction may nevertheless trigger a constructive liquidation of the partnership under section 708(b)(1)(B).

b. Liquidation of Interest.

(i) Although not directly addressed in Rev. Rul. 99-6, the Federal income tax consequences of the liquidation of one member’s interest in a two-member partnership or LLC treated as a partnership for Federal income tax purposes is essentially the same for the remaining member with respect to his interest as they would be if he had purchased the interest from the liquidated member. The partnership is deemed to terminate under section 708(b)(1)(A) and is deemed to make liquidating distributions to both of the members of all the assets of the LLC. The remaining member must recognize gain or loss, if any, with respect to his interest on the liquidating distribution to the extent required by section 731(a).

(ii) A different approach applies where one of the partners’ interest is liquidated over time through a series of payments under section 736. A partnership is not terminated during the period during which payments are being made under section 736 to a retiring partner or deceased partner’s successor, even though only one partner remains.39 The former partner is considered to be a partner until its entire interest is liquidated. If, however, the partnership terminates due to the cessation of business activities, then payments to a retired partner under section 736 will not change this result.40 While the partnership’s conversion to a single owner entity results in the entity being treated as a

sole proprietorship rather than a partnership because the entity does not meet the definition of a partnership pursuant to state law (i.e. Section 101(6) of the Revised Uniform Partnership Act defines a partnership as “an association of two or more persons to carry on as co-owners of a business for profit”) the Federal income tax rules continue to treat the sole proprietorship as a partnership until all section 736 payments are made to the retired partner or the deceased partner’s successor or until the deceased partner’s successor no longer shares in partnership profits or losses.

c. Section 704(c)(1)(B) and Section 737.

(i) Section 704(c)(1)(B) or Section 737 could be implicated in the sale by one member of its interest to the other member in a transaction described in Rev. Rul. 99-6, in the event that there has been a contribution of “section 704(c) property” to the partnership during the seven year period prior to the liquidation of the entity for Federal income tax purposes. While the selling member is treated as selling its membership interest, the purchasing member’s tax consequences assume a liquidation of the LLC followed by a purchase of assets.

(ii) In the event that there is “section 704(c) property” in the LLC, under the construct of Rev. Rul. 99-6, the entity is first deemed to liquidate, with each member being distributed an interest in assets of the LLC attributable to the member’s membership interest. Thus, it is necessary to determine if the asset being distributed is “section 704(c) property” contributed to the LLC by the other member, or whether the member receiving the asset has contributed other “section 704(c) property” to the LLC during the prior seven year period.

(iii) From the purchasing member’s perspective, Section 704(c)(1)(B) could apply if the purchasing member contributed “section 704(c) property” to the LLC, and the assets of the LLC attributable to the non purchasing

---

41 Rev. Rul. 99-6 does not mandate what assets of the entity are treated as distributable to each member in the liquidation of the LLC. The ruling suggests the assets treated as distributed to each member are those attributable to the member’s interest in the LLC. Query whether this requires one to conclude that each member receives an undivided interest in each asset of the entity, or whether the members have some flexibility in determining which assets each member is deemed to receive in liquidation.
member’s membership interest include a portion of such “section 704(c) property”, in which case when such property is treated as having been distributed to a member other than the purchasing member in liquidation of the entity, Section 704(c)(1)(B) applies to trigger gain or loss to the purchasing member.

(iv) From the purchasing member’s perspective, Section 737 could apply if the purchasing member contributed “section 704(c) property” to the LLC, and is treated as receiving other property in liquidation of the entity.

(v) To the extent that there is a concern over the applicability of either Section 704(c)(1)(B) or Section 737 to the transaction, one could avoid a termination of the partnership under section 708(b)(1)(A) by structuring the transaction as a purchase of the selling member’s interest through a related party, that is not itself a disregarded entity for tax purposes. This would avoid the recognition of gain or loss that may otherwise be required under Sections 704(c)(1)(B) or 737. The transaction may nevertheless trigger a constructive liquidation of the partnership under section 708(b)(1)(B).

d. Purchase of Partnership Assets by Less than All of the Partners.

(i) The purchase of all of a partnership’s assets by less than all of the partners through a newly formed partnership may avoid a termination of the selling partnership. In Rev. Rul. 66-264, 1966-2 C.B. 248, the assets of a five-person partnership were purchased at a judicial sale by a partnership comprised of three of the original five partners. The Service concluded that the new three-person partnership was a continuation of the five-person partnership and that there was no termination because the partnership’s business was carried on by some of its partners in a partnership. 42

(ii) The mere formation of a new partnership by some of the same partners in an existing partnership does not mean the

42 See also Neubecker v. Comm’r, 65 T.C. 577(1975) (Tax Court held that that a partner in a three-person partnership was not entitled to a loss on liquidation of his interest where the taxpayer and another of his partners formed a new two-person partnership that was a continuation of the dissolved three-person partnership.)
new partnership will be considered a continuation of the old partnership.

D. Consequences of Partnership Termination under Section 708(b)(1)(A).

1. Closing of Taxable Year.
   a. For purposes of subchapter K, a partnership’s taxable year closes with respect to all of its partners on the date on which the partnership terminates.\textsuperscript{43}

2. Date of Termination.
   a. For purposes of section 708(b)(1)(A), the partnership terminates on the date on which the winding up of its affairs is completed.\textsuperscript{44}

3. Liquidating Distributions to Partners.
   a. A partnership that terminates under section 708(b)(1)(A) ceases to exist and its assets are deemed to be distributed to its partners in a liquidation to which sections 731 and 732 apply.

4. Holding Period.
   a. Under section 735, generally, the holding period of the partnership in the assets that are distributed is tacked to the partner’s holding period in such assets.
   b. The assets continue to be depreciable over their remaining depreciable lives.

5. Section 704(c)(1)(B) and Section 737.
   a. Upon a section 708(b)(1)(A) termination, if previously contributed section 704(c) property is distributed in liquidation to a partner other than the contributing partner within seven years of its contribution to the partnership, then the contributing partner must recognize gain or loss as if the property had been sold for its fair market value at the time of the distribution.
   b. Upon a section 708(b)(1)(A) termination, if a partner who contributed section 704(c) property receives a distribution of other property (other than money) from a partnership within seven years of the contribution, such partner will recognize gain equal to the

\textsuperscript{43}Treas. Reg. §1.708-1(b) (3). See also section 706(c)(1) and Treas. Reg. §1.706-1(c)(1).
\textsuperscript{44}Treas. Reg. §1.708-1(b)(3)(i).
lesser of the “excess distribution” or the partner’s “net precontribution gain.”

IV. DIVISIONS

A. Partnership Divisions Prior to the Regulations

1. Neither the Code, the prior regulations relating to partnership divisions nor the Division Regulations define a partnership “division.”

2. Nevertheless, partnership divisions are presumably analogous to corporate spin-offs in which, in the simplest case, one corporation divides into two by distributing the stock of another corporation to its shareholders. The tax consequences of corporate spin-offs are generally specified in Section 355, which as of this writing consists of 3,189 words contained in 172 sentences. In contrast, the Code provision governing partnership divisions consists of a single sentence, unchanged since its enactment in 1954.

3. Section 708(b)(2)(B) provides that, in the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) shall be considered a continuation of the prior partnership.

4. Prior to the issuance of the Division Regulations, regulations issued in 1956 elaborated on the statutory rule by providing that, if members of a resulting partnership had interests of 50 percent or less in the prior partnership, the resulting partnership was considered to be a new partnership. If none of the resulting partnerships had members with interests greater than 50 percent in the prior partnership, none of the resulting partnerships were considered continuations and the prior partnership was considered terminated. Finally, the prior regulations provided that where members of a partnership that has been divided do not become members of a resulting partnership that is considered a continuation of the prior partnership, such members' interests are considered liquidated as of the date of the division.

---


46 Reg. §1.708-1(b)(2)(ii), prior to amendment by the Division Regulations.

47 Id.

48 Id.
B. Division Regulations

1. Continuation of Prior Partnership

   a. Although the Division Regulations clarify in some respects the determination of which partnership in a division transaction is considered to be a continuation of the prior partnership, they do not make any fundamental changes in that determination. Indeed, they could not, because as discussed above Section 708(b)(2)(B) governs that determination and has not been changed since its enactment in 1954.

   b. Rather, the central function of the Division Regulations is to specify when the state-law form chosen for the division will be respected for Federal income tax purposes, and when it will be recast into a different form for Federal income tax purposes.

   c. As will be illustrated later, whether the state law form of the division is respected for Federal income tax purposes can have a critical effect on the subsequent application of certain other important rules of Subchapter K, such as the “anti-mixing bowl rules” of Code Secs. 704(c)(1)(B) and 737.49

2. Definition of Terms

   a. Like the prior regulations under Section 708(b)(2)(B), the Division Regulations provide that upon the division of a partnership, one or more resulting partnerships shall be treated as a continuation of the prior partnership if the members of the resulting partnership or partnerships had an interest of more than 50 percent in the capital and profits of the prior partnership.50

   b. For this purpose, the term “prior partnership” refers to “the partnership subject to division that exists under applicable jurisdictional law before the division” — i.e., the partnership that divides under state law.51 Likewise, the term “resulting partnership” refers to “a partnership resulting from the division that exists under applicable jurisdictional law after the division and

---

49 For a comprehensive discussion of the partnership “anti-mixing bowl” rules, see Rubin, Macintosh and Mallory, Working With the Partnership Disguised Sale and Anti-Mixing Bowl Rules, 58th N.Y.U. Institute on Federal Taxation, Ch. 10 (2000).

50 Reg. §1.708-1(d)(1).

51 Reg. §1.708-1(d)(4)(ii).
that has at least two partners who were partners in the prior partnership” – again a determination made under state law.  

(c) Where a prior partnership divides into two partnerships, both partnerships existing after the division are “resulting partnerships.” If a resulting partnership is treated as a continuation of a prior partnership, then the resulting partnership is bound by all pre-existing elections that were made by the prior partnership.

3. Form of Partnership Division

(a) The Division Regulations provide that the form of a partnership division accomplished under the laws of the applicable jurisdiction will be respected for Federal income tax purposes if the partnership undertakes the transaction in one of two prescribed forms. As indicated in the discussion of the Merger Regulations, the two forms are the “assets-over form” and the “assets-up form.”

(b) Assets-Over Form

(i) In the “assets-over form” of a partnership division where at least one resulting partnership is a continuation of the prior partnership, the divided partnership contributes certain assets and liabilities to one or more recipient partnerships in exchange for interests in the recipient partnership(s), and, immediately thereafter, the divided partnership distributes the interests in such recipient partnership(s) to some or all of its partners in partial or complete liquidation of the partners’ interests in the divided partnership.  

---

52 Reg. §1.708-1(d)(4)(iv).

53 Id.

54 Reg. §1.708-1(d)(2)(ii).

55 Reg. §1.708-1(d)(3)(i)(A). The Preamble to the proposed regulations noted that this construct involves the newly formed partnership having only one partner for a moment in time, but indicated that the entity should nevertheless be classified as a partnership from the time of its formation. The Preamble noted that the partnership termination regulations of Reg. §1.708-1(b)(1)(iv) also treat the deemed new partnership as a partnership from its inception notwithstanding that for a moment in time it has only one owner. The implications of this analysis for situations where a partnership owns for more than a moment in time all of the interests in an entity that is disregarded under Reg. §301.7701-3 and then distributes the interest to its partners are unclear. See Rev. Rul. 99-5, 1999-1 C.B. 434, which arguably implies that such a transfer should be treated as a transfer of an undivided interest in the assets of the disregarded entity followed by the formation of a partnership.
(ii) For this purpose, the term “divided partnership” refers to the continuing partnership that is treated, for Federal income tax purposes, as transferring the assets and liabilities to the recipient partnership or partnerships. Thus, whether a partnership is a “divided partnership” is determined under Federal income tax law (which, as discussed below, may or may not look to state law).

(iii) Likewise, the term “recipient partnership” refers to “a partnership that is treated as receiving, for Federal income tax purposes, assets and liabilities from a divided partnership” – also a determination made under Federal income tax law.

(iv) In the “assets-over form” of a partnership division where no resulting partnership is a continuation of the prior partnership, the prior partnership will be treated as contributing all of its assets and liabilities to new resulting partnerships in exchange for interests in the resulting partnerships, and, immediately thereafter, the prior partnership will be treated as liquidating by distributing the interests in the new resulting partnerships to the prior partnership’s partners.

c. Assets-Up Form

(i) In the “assets-up form” in which the divided partnership is a continuing partnership, the divided partnership distributes certain of its assets and liabilities to some or all of its partners who then contribute such assets and liabilities to a recipient partnership in exchange for interests therein.

(ii) In the “assets-up form” in which no resulting partnership is a continuation of the prior partnership, the prior partnership distributes certain assets to some or all of its partners in partial or complete liquidation of the partners’ interests in the prior partnership, and immediately thereafter, such partners contribute the distributed assets to a resulting partnership.

---

56 Reg. §1.708-1(d)(4)(i).
57 Reg. §1.708-1(d)(4)(iii).
partnership or partnerships in exchange for interests in such resulting partnership or partnerships.\textsuperscript{60}

(iii) In order for the “assets-up form” to be respected for Federal income tax purposes, the transfer of assets from the prior partnership to its partners must be accomplished in a manner that causes the partners to be treated under state law as the owners of such assets – albeit only for a moment in time.\textsuperscript{61}

d. Formless Divisions and “Disrespected” Forms

(i) If no form for the division is undertaken, or if a form is undertaken that is not respected as the “assets-over form” or the “assets-up form,” then the division will be treated as occurring under the “asset-over form” for Federal income tax purposes.\textsuperscript{62}

(ii) Moreover, if the transaction is recharacterized into the “assets-over form,” then the “direction” of the transaction – i.e., which partnership is treated for Federal income tax purposes as the “divided” partnership that transfers assets and which partnership is treated as the “recipient” partnership that receives them – may not correspond to the state law form of the transactions.

(iii) As noted above, the “divided partnership” is the continuing partnership that is treated, for Federal income tax purposes, as transferring the assets and liabilities to the recipient partnership or partnerships, either directly (under the “assets-over form”) or indirectly (under the “assets-up form”).\textsuperscript{63}

(iv) Moreover, the regulations provide that if the resulting partnership that, in form, transferred the assets and liabilities in connection with the division is a continuation of the prior partnership, then such resulting partnership will be treated as the divided partnership.

\textsuperscript{60} Reg. §1.708-1(d)(3)(ii)(B).

\textsuperscript{61} Reg. §§1.708-1(d)(3)(ii)(A) and (B).

\textsuperscript{62} This might occur, for example, if applicable jurisdictional law permitted the division to be accomplished by filing “articles of division.” The authors are not aware of any state law that currently permits this. The scope of this rule is discussed in detail below.

\textsuperscript{63} Reg. §1.708-1(d)(4)(i).
(v) If a partnership divides into two or more partnerships and only one of the resulting partnerships is a continuation of the prior partnership, then the resulting partnership that is a continuation of the prior partnership will be treated as the divided partnership.

(vi) If a partnership divides into two or more partnerships without undertaking either the “assets-over” or “assets-up form” for the division or if the resulting partnership that, in form, transferred assets and liabilities is not considered a continuation of the prior partnership, and more than one resulting partnership is considered a continuation of the prior partnership, then the continuing resulting partnership with the assets having the greatest fair market value (net of liabilities) will be treated as the divided partnership.64

C. Planning under the Division Regulations

1. Fact Pattern - To illustrate the planning techniques that are possible under the Division Regulations, assume that A and B each own a 50 percent interest in AB Partnership, which owns an office building and undeveloped land that is not related to the office building. AB Partnership purchased the office building four years ago, and it now has a fair market value of $500x. AB Partnership purchased the land three years ago, and it now has a fair market value of $100x. Both of these values are substantially in excess of the adjusted tax basis of the properties. C is interested in entering into a joint venture with A and B with respect to the office, but does not want to own an interest in the undeveloped land. In general, the business plan calls for C to make capital contributions of $1000x into a partnership that owns the office building (but not the undeveloped land) in exchange for a 66.67 percent interest. Ultimately, A and B may wish to exit the joint venture partnership by having their partnership interest redeemed in exchange for a distribution of property other than money. Because of state law liability concerns, C would prefer to acquire an interest in a newly formed entity, rather than in the AB Partnership that has existed for many years and may have unknown or contingent liabilities. A and B would also like to minimize any real property transfer taxes incurred in connection with the transaction.

2. Alternative Structures - The following discussion analyzes the consequences under the Division Regulations and other relevant provisions of Subchapter K of several alternative structures that might be considered in an attempt to accommodate the parties’ business and tax objectives.

64 Reg. §1.708-1(d)(4)(i).
a. Alternative 1: AB Partnership Transfers Wanted Assets to AB LLC, Distributes AB LLC Interests to A and B, then Admits C into AB LLC

(i) Under Alternative 1, AB Partnership would transfer the office building to a newly formed limited liability company ("AB LLC") in exchange for all of the interests in AB LLC, and then distribute 50 percent of the interests in AB LLC to each of A and B. Thereafter, C would be admitted as a 66.67 percent member in AB LLC (transforming it into ABC LLC) in exchange for a capital contribution of $1,000.

(ii) As noted above, neither the Code, the prior regulations relating to partnership divisions nor the Division Regulations actually define what constitutes a partnership "division." A threshold question, therefore, is whether the admission of C into AB LLC pursuant to a plan negates the applicability of the Division Regulations.

(iii) None of the seven examples in the Division Regulations involve a fact pattern in which a person who was not a partner in the prior partnership ends up owning an interest in a resulting partnership. Nor do any of the private letter rulings applying the old division regulations involve such a fact pattern. Nevertheless, the Preamble to the final Division Regulations at least suggests that the Division Regulations apply in such a case, and in our analysis of this and other alternatives we will assume that they do.

---

65 This and all subsequent limited liability companies discussed in this outline are assumed not to elect to be treated as an association taxable as a corporation under Reg. §301.7701-3.

66 See PLR 199944016; PLR 199908043; PLR 9437007; PLR 9437008; PLR 9350035; PLR 9108015; PLR 9029019; PLR 9015016; PLR 8852004; PLR 8605047; PLR 8406045; PLR 8244124; PLR 8108091.

67 The Preamble notes that the IRS and Treasury had declined to define what constitutes a partnership "division." The Preamble then states that:

In addition to requesting guidance as to the general definitions of a partnership merger and division, some commentators have asked more narrowly whether a partnership division can occur when only one partner from the prior partnership is a partner in a resulting partnership. Consider the following example: ABC partnership owns X business and Y business. A and B each own a 20-percent interest, and C owns a 60-percent interest in the ABC partnership. C does not want to continue in the partnership with A and B and would like to operate X business with D. Accordingly, ABC partnership distributes X business to C in liquidation of C's interest in partnership ABC. Subsequently, C forms a partnership with D and contributes X business to the CD
(iv) Under the Division Regulations, AB Partnership would be considered the “prior partnership.” Both AB Partnership (as it exists after the division) and ABC LLC would be “resulting partnerships.”

(v) Both resulting partnerships would be considered continuations of the prior partnership because the members of each resulting partnership had an interest of more than 50 percent in the capital and profits of the prior partnership. Moreover, because AB Partnership (as it exists after the division) is a continuation of the prior partnership and actually transferred the assets and liabilities, AB Partnership is treated as the divided partnership. Thus, the Federal income tax characterization of the transaction corresponds precisely to its state law form.

(vi) Goals Achieved

(a) Alternative 1 achieves some of the business and tax goals of the parties. It separates ownership of AB Partnership’s assets and gives C an ownership interest in the office building but not the undeveloped land.

(b) From C’s perspective, the fact that ABC LLC is a new state law entity that is the transferee of only specified assets and liabilities associated with the office building reduces concerns about unknown or contingent liabilities in AB Partnership.

Footnote continued from previous page

partnership. After the distribution and contribution of X business, AB partnership owns Y business and CD partnership owns X business.

The IRS and Treasury believe that the above transaction does not constitute a division. To have a division, at least two members of the prior partnership must be members of each resulting partnership that exists after the transaction. In the above example, C is the only member of the ABC partnership in the CD partnership. Accordingly, this transaction would not be treated as a division for Federal income tax purposes. The final regulations modify the proposed regulations to clarify this result.

Presumably, if two members of the ABC partnership had joined the new partnership with D, the transaction would have constituted a division notwithstanding D’s admission. At least arguably, the same result should apply if the ABC partnership first transferred the X business to a new partnership with D and then transferred the partnership interest to at least two of A, B and C.

Note that the fact that A and B own only 33.33 percent of ABC LLC after the division is irrelevant.

68 Note that the fact that A and B own only 33.33 percent of ABC LLC after the division is irrelevant.
However, from the perspective of A and B, the contribution of the office building into a new partnership invokes the application of the partnership anti-mixing bowl rules, inhibiting their ability to exit ABC LLC later in a tax-deferred manner. If, for example, A or B were to receive a distribution of property other than the office building from ABC LLC within seven years after the division, gain could be triggered pursuant to Section 737. In addition, Alternative 1 may subject the $500x value of the office building to local real property transfer tax.

b. Alternative 2: AB Partnership Transfers Unwanted Assets to AB LLC, Distributes AB LLC Interests to A and B, then Admits C Into AB Partnership

(i) Under Alternative 2, AB Partnership would transfer the undeveloped land to a newly formed limited liability company ("AB LLC") in exchange for all of the interests in AB LLC, and then distribute 50 percent of the interests in AB LLC to each of A and B. Thereafter, C would be admitted as a 66.67 percent member in AB Partnership (transforming it into ABC Partnership) in exchange for a capital contribution of $1,000x.

(ii) As was the case under Alternative 1, the admission of C into AB Partnership after the division presumably would not negate the applicability of the Division Regulations.

(iii) Under the Division Regulations, AB Partnership would be considered the "prior partnership." Both ABC Partnership and AB LLC would be "resulting partnerships."

(iv) Both resulting partnerships would be considered continuations of the prior partnership because the members of each resulting partnership had an interest of more than 50 percent in the capital and profits of the prior partnership. Moreover, because ABC Partnership is a continuation of the prior partnership and actually transferred the assets and liabilities, ABC Partnership is treated as the divided partnership. Thus, the Federal income tax characterization of the transaction again corresponds precisely to its state law form.

(v) Given that the admission of C occurs pursuant to a plan, there may be some risk that the Internal Revenue Service
(the “Service”) would argue that the transactions should be re-ordered. That is, the Service might argue that the transaction should be treated as if C were first admitted into AB Partnership (transforming it into ABC Partnership), and thereafter ABC Partnership transferred the undeveloped land to AB LLC and then distributed the interests in AB LLC to A and B.

(vi) Even if the Service were successful in such an argument, the result under the Division Regulations would change slightly, but not in a way that affects the business and tax goals of the parties. If the transaction were successfully re-ordered by the Service, ABC Partnership (as it would exist after C’s admission but prior to the division) would be the “prior partnership.” Both ABC Partnership (as it would exist after the division) and AB LLC would be “resulting partnerships.” ABC Partnership (as it would exist after the division) would be considered a continuation of the prior partnership because the members of ABC Partnership (as it would exist after the division) would have owned an interest of more than 50 percent in the capital and profits of the prior partnership. However, AB LLC would not be considered a continuation of the prior partnership, because A and B would not have owned more than 50 percent in the capital and profits of the prior partnership (C would have owned 66.67 percent). Because AB LLC would not be a continuation of ABC Partnership, AB LLC would not be bound by any elections that had been made by ABC Partnership. Nevertheless, because ABC Partnership (as it would exist after the division) would be a continuation of the prior partnership and actually transferred the assets and liabilities, ABC Partnership would be treated as the divided partnership. Thus, even if the Service successfully re-ordered the transaction, the fundamental Federal income tax characterization of the transaction would still correspond to its state law form, i.e., ABC Partnership would be treated as transferring the undeveloped land into AB LLC and then distributing the interests in AB LLC to A and B.

(vii) Goals Achieved

(a) Alternative 2 separates ownership of AB Partnership’s assets and gives C an ownership

69 See Reg. §1.708-1(d)(2)(ii).
interest in the office building, but not the undeveloped land.

(b) From the perspective of A and B, Alternative 2 is desirable because no contribution of the office building into a partnership occurs, and the partnership anti-mixing bowl rules thus will not apply to any exit strategy that they may choose to employ later in ABC Partnership.

(c) From C’s perspective, the fact that C is admitted into the historic AB Partnership instead of a new state law entity raises concerns about unknown or contingent liabilities in AB Partnership. Because Alternative 2 does not involve any deed transfer of the office building, Alternative 2 may avoid subjecting the value of the office building to local real property transfer tax. The value of the undeveloped land, however, may be subject to such tax.

c. Alternative 3: A and B Form AB LLC, AB Partnership Transfers Wanted Assets to AB LLC, then Admits C Into AB LLC

(i) Under Alternative 3, A and B would form a new limited liability company (“AB LLC”) owned 50 percent by each in exchange for small contributions of cash or property. AB Partnership would then transfer the office building to AB LLC in exchange for no or nominal consideration. Thereafter, C would be admitted as a member in AB LLC (transforming it into ABC LLC) in exchange for a capital contribution of $1,000x. C would receive a 66.67% membership interest, adjusted to take account of the cash or property that A and B transferred to AB LLC upon formation.

(ii) As was the case under Alternatives 1 and 2, the admission of C into AB LLC after the division presumably would not negate the applicability of the Division Regulations.

(iii) Moreover, the state law form for the transaction – formation of a “brother/sister” limited liability company followed by a transfer of assets by the prior partnership to the “brother/sister” entity for no or nominal consideration – does not constitute the “assets-up form” under Treas. Reg. §1.708-1(d)(3). Accordingly, the transaction should be
characterized under the "assets-over form" for Federal income tax purposes.\textsuperscript{70}

(iv) AB Partnership would be considered the "prior partnership," and both AB Partnership (as it exists after the division) and AB LLC would be "resulting partnerships." Both resulting partnerships would be considered continuations of the prior partnership because the members of each resulting partnership had an interest of more than 50 percent in the capital and profits of the prior partnership.

(v) Because both AB Partnership and ABC LLC are continuations of the prior partnership, each could potentially qualify as the "divided partnership." The determination of which entity is the "divided partnership" is critical because it determines the "direction" of the transaction for Federal income tax purposes, i.e., whether AB Partnership is treated as contributing the office building to ABC LLC or whether ABC LLC is treated as contributing the undeveloped land to AB Partnership.\textsuperscript{71}

(vi) The Division Regulations contain two seemingly conflicting provisions that are relevant in determining whether AB Partnership or ABC LLC is the "divided partnership." The first provision is the second sentence of Treas. Reg. §1.708-1(d)(4)(i), which states: "If the resulting partnership that, in form, transferred the assets and liabilities in connection with the division is a continuation of the prior partnership, then such resulting partnership will be treated as the divided partnership." Applying this provision, AB Partnership would be treated as the divided partnership because it is the partnership that "in form" transferred the assets and liabilities (the office building) in connection with the division, and it is a continuation of the prior partnership. Therefore, AB Partnership (the divided partnership) would be treated as contributing the office building into ABC LLC in exchange for interests in AB LLC and immediately thereafter distributing such interests to A and B in partial liquidation of their interests in AB Partnership, with C being admitted into ABC LLC thereafter. Because the office building would be treated as contributed to ABC LLC, the partnership anti-mixing bowl

\textsuperscript{70} Reg. §1.708-1(d)(3)(i).

\textsuperscript{71} See Reg. §1.708-1(d)(4)(i), first sentence.
rules would apply, inhibiting the ability of A and B to exit ABC LLC later in a tax-deferred manner.

(vii) The second relevant but seemingly conflicting provision is the fourth sentence of Treas. Reg. §1.708-1(d)(4)(i), which states:

If a partnership divides into two or more partnerships without undertaking a form for the division that is recognized under paragraph (d)(3) of this section [i.e., “assets-over” or “assets-up”], or if the resulting partnership that had, in form, transferred assets and liabilities is not considered a continuation of the prior partnership, and more than one resulting partnership is considered a continuation of the prior partnership, the continuing resulting partnership with the assets having the greatest fair market value (net of liabilities) will be treated as the divided partnership.

(viii) Applying this provision, because the state law form for the division constitutes neither the “assets-over form” nor the “assets-up form,” ABC LLC would be treated as the divided partnership because it is the partnership that has the greatest fair market value of assets (net of liabilities). Therefore, ABC LLC (the divided partnership) would be treated as contributing the undeveloped land into AB Partnership in exchange for interests in AB Partnership and immediately thereafter distributing such interests to A and B in partial liquidation of their interest in ABC LLC, with C being admitted into ABC LLC thereafter. Under this characterization, no contribution of the office building into a partnership occurs, and the partnership anti-mixing bowl rules thus would not apply to any exit strategy that A and B may choose to employ later in ABC LLC.

(ix) Which of the two seemingly conflicting provisions prevails? The Preamble to the proposed regulations explained the rule contained in the fourth sentence of Treas. Reg. §1.708-1(d)(4)(i) as follows:

Finally, because in a formless division it generally will be unclear which partnership should be treated, for Federal income tax purposes, as transferring assets (i.e., the divided partnership) to another partnership (i.e., the recipient partnership) where more than one partnership is a continuation of the prior partnership, the proposed regulations provide that the continuing resulting partnership
with the assets having the greatest fair market value (net of liabilities) will be treated as the divided partnership. This issue also is present where the partnership that, in form, transfers assets is not a continuation of the prior partnership, but more than one of the other resulting partnerships are continuations of the prior partnership. The same rule applies to these situations.

(x) The reference to “formless divisions” arguably refers to divisions that occur by operation of state law without any explicit form, rather than to divisions that occur in a form that is not the prescribed “assets-over form” or “assets-up form.” In addition, Example 5 under the Division Regulations illustrates the application of the rule contained in the fourth sentence of Treas. Reg. §1.708-1(d)(4)(i) in the context of a division that occurs “by operation of state law, without undertaking a form.”

(xi) On the other hand, the fourth sentence Treas. Reg. §1.708-1(d)(4)(i) expressly refers to divisions that occur “without undertaking a form for the division that is recognized under paragraph (d)(3).” In light of this express reference and the general rule of statutory construction that the more specific rule should prevail over the more general, we believe that the fourth sentence of Treas. Reg. §1.708-1(d)(4)(i) should prevail where, as here, it arguably conflicts with the second sentence.

(xii) Goals Achieved

(a) Thus, in Alternative 3, ABC LLC should be treated as the divided partnership. As a result, the “direction” of the transaction would be reversed for Federal income tax purposes compared to the state law form, providing A, B and C with the best of both worlds.

(b) Under state law, AB Partnership transferred the office building subject to specified liabilities to the newly formed ABC LLC and C was then admitted into ABC LLC. C’s concerns about unknown or contingent liabilities in AB Partnership are therefore reduced or eliminated.

72 Reg. §1.708-1(d)(5) Example 5.

(c) For Federal income tax purposes, however, ABC LLC would be treated as contributing the undeveloped land into AB Partnership in exchange for interests in AB Partnership and immediately thereafter distributing such interests to A and B in partial liquidation of their interests in ABC LLC, with C being admitted into ABC LLC thereafter.

(d) As a result, for Federal income tax purposes, no contribution of the office building into a partnership occurs, and the partnership anti-mixing bowl rules therefore will not inhibit any exit strategy that A and B may choose to employ later in ABC LLC.