Planning for the Termination of an Interest in a Partnership - Withdrawals, Distributions and Other Exit Strategies

Michael G. Frankel

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PLANNING FOR THE TERMINATION
OF AN INTEREST IN A PARTNERSHIP – WITHDRAWALS,
DISTRIBUTIONS AND OTHER EXIT STRATEGIES

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DALLAS, TEXAS

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TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. TERMINATING A PARTNER'S INTEREST IN A PARTNERSHIP</td>
<td>1</td>
</tr>
<tr>
<td>A. Statutory And Regulatory Framework</td>
<td>1</td>
</tr>
<tr>
<td>1. Limited Recognition Of Gain And Loss</td>
<td>1</td>
</tr>
<tr>
<td>a. General Rule-No Recognition Of Gain</td>
<td>1</td>
</tr>
<tr>
<td>b. Reduction In Liabilities</td>
<td>1</td>
</tr>
<tr>
<td>c. Losses Generally Not Recognized</td>
<td>1</td>
</tr>
<tr>
<td>d. Nonrecognition By The Partnership</td>
<td>1</td>
</tr>
<tr>
<td>e. Exceptions</td>
<td>1</td>
</tr>
<tr>
<td>2. Basis Rules</td>
<td>2</td>
</tr>
<tr>
<td>a. Non-liquidating Distributions</td>
<td>2</td>
</tr>
<tr>
<td>b. Liquidating Distributions</td>
<td>2</td>
</tr>
<tr>
<td>c. Aggregate Theory Of Taxation</td>
<td>2</td>
</tr>
<tr>
<td>3. Allocation Of Basis Among Distributed Assets</td>
<td>2</td>
</tr>
<tr>
<td>4. Special Basis Allocation Rules - I.R.C. § 732(d)</td>
<td>3</td>
</tr>
<tr>
<td>5. Basis Adjustments Pursuant To I.R.C. § 734</td>
<td>4</td>
</tr>
<tr>
<td>a. Scope And Effect Of I.R.C. § 734</td>
<td>4</td>
</tr>
<tr>
<td>b. Allocation Of Basis Adjustments Under I.R.C. § 755</td>
<td>4</td>
</tr>
<tr>
<td>B. Tax Planning Possibilities</td>
<td>5</td>
</tr>
<tr>
<td>1. Typical Liquidation</td>
<td>5</td>
</tr>
<tr>
<td>2. Installment Sales</td>
<td>5</td>
</tr>
<tr>
<td>a. Partnership Immediately Liquidates</td>
<td>6</td>
</tr>
<tr>
<td>b. Partnership Remains In Existence</td>
<td>7</td>
</tr>
<tr>
<td>c. Preserving Negative Capital Accounts</td>
<td>7</td>
</tr>
<tr>
<td>3. Tax-Deferred Liquidations And Distributions</td>
<td>8</td>
</tr>
<tr>
<td>a. Like-Kind Exchange Prohibited.</td>
<td>9</td>
</tr>
<tr>
<td>b. Liquidations Involving Distributions Of Existing Assets</td>
<td>9</td>
</tr>
<tr>
<td>c. Basis Strips - Creative Uses Of I.R.C. §§ 732 And 754</td>
<td>10</td>
</tr>
<tr>
<td>(1) Distribution Of High Basis Property To Partner</td>
<td>11</td>
</tr>
</tbody>
</table>
(2) Distribution Of Low Basis Property To Partner
   B. ........................................................................................................ 12
d. Acquiring Assets To Effect The Liquidation .................................. 13
   (1) Liquidation Followed By Like-Kind Exchange ......................... 13
   (2) Purchase Followed By Liquidation ............................................. 14
   (3) Exchange Followed By Liquidation .......................................... 15
   (4) Limitation On Related Party Like-Kind Exchanges .................. 17

II. TERMINATING THE PARTNERSHIP .................................................. 18
   A. Applicability .................................................................................. 18
   B. Terminations Under I.R.C. § 708 ............................................... 18
      1. Tax Treatment Of Termination ............................................... 18
         a. General - Deemed Distribution/Recontribution .................... 18
         b. Effect On Basis ....................................................................... 19
         c. Impact Of I.R.C. § 754 Election .......................................... 19
      2. Other Potential Tax Consequences Of Termination ............. 20
         a. Recapture Of Investment Tax Credit .................................... 20
         b. Effect On Depreciable Lives .............................................. 21
            (1) Computation Of Depreciation ...................................... 21
            (2) Eligibility For ACRS .................................................. 22
            (3) Length Of Recovery Period ......................................... 23
         c. Tax Allocations Under I.R.C. § 704(c)(1)(A) ................... 24
         d. Closing Of Partnership’s Taxable Year ......................... 25
         e. Partnership Elections ....................................................... 25
         f. Holding Period For Partnership Assets ............................. 25
         g. I.R.C. § 724(b) Taint ......................................................... 26
      3. Avoiding Terminations ............................................................... 26
         a. Contributions To Partnerships And Corporations ........... 28
         b. Corporate Reorganizations ................................................. 28
         c. I.R.C. § 338 Elections ....................................................... 28
      5. Tiered Partnerships .. ................................................................. 29
      6. Permitted Transactions ............................................................. 31
   C. Partnership Mergers ................................................................. 31
PLANNING FOR THE TERMINATION OF AN INTEREST IN A PARTNERSHIP - WITHDRAWALS, DISTRIBUTIONS AND OTHER EXIT STRATEGIES

I. TERMINATING A PARTNER'S INTEREST IN A PARTNERSHIP.

A. Statutory And Regulatory Framework.

1. Limited Recognition Of Gain And Loss.

a. General Rule-No Recognition Of Gain. A partner does not recognize gain as a result of a distribution received from a partnership except to the extent that any money distributed exceeds the distributee partner’s adjusted tax basis in his interest in the partnership. Section 731(a)(1) of the Internal Revenue Code of 1986, as amended (hereinafter referred to as the "Code" or "I.R.C."). The foregoing rule applies to both liquidating and non-liquidating distributions.

b. Reduction In Liabilities. In applying I.R.C. § 731(a)(1), planners should remember that any reduction in a partner’s share of his partnership’s liabilities results in a deemed cash distribution. I.R.C. § 752(b). If the cash deemed distributed under I.R.C. § 752(b) exceeds the partner’s adjusted tax basis in his partnership interest, I.R.C. § 731(a)(1) requires that the partner recognize gain to the extent of the excess "distribution."

c. Losses Generally Not Recognized. Generally, a distributee partner is not entitled to recognize any loss on the liquidation of his interest. I.R.C. § 731(a)(2). A partner may, however, recognize loss if he receives only (i) cash, (ii) inventory, and/or (iii) "unrealized receivables" in complete liquidation of his partnership interest. Id.

d. Nonrecognition By The Partnership. A partnership is neither required nor entitled to recognize gain or loss on a distribution of cash or assets to its partners in respect of their interests in the partnership. I.R.C. § 731(b).

e. Exceptions. The general rules summarized above are inapplicable to the extent that I.R.C. § 736 (relating to payments made to a retiring partner) or I.R.C. § 751 (relating to disproportionate distributions of unrealized receivables and inventory items) provide otherwise. I.R.C. § 731(c). The foregoing rules are also
inapplicable if the distribution of property is characterized as part of a sale transaction under I.R.C. § 707(a)(2)(B), or if the distribution triggers gain under I.R.C. § 704(c)(1)(B) (contributing partner recognizes pre-contribution gain if the property is distributed to another partner within five years) or I.R.C. § 737 (contributing partner recognizes pre-contribution gain if the partnership distributes other property to the contributing partner within five years).

2. Basis Rules.

a. Non-liquidating Distributions. If a partnership distributes property other than cash to a partner in a non-liquidating distribution, the partner's adjusted tax basis in the property received will be the lesser of (i) the partnership's basis in the property immediately before the distribution or (ii) the partner's basis in his partnership interest less any money distributed to the partner in the same transaction (including money deemed distributed under I.R.C. § 752(b)). I.R.C. § 732(a).

b. Liquidating Distributions. If property other than money is distributed to a partner in liquidation of his interest in a partnership, the partner's adjusted tax basis in the distributed property will equal his basis in his partnership interest less any money distributed to him in connection with the liquidation of his interest. I.R.C. § 732(b).

c. Aggregate Theory Of Taxation. I.R.C. §§ 731 and 732 reflect a congressional decision to apply the aggregate theory of taxation in determining the treatment of withdrawals of property and partners. In effect, so long as a partner does not receive cash (or items treated as cash equivalents) in an amount greater than his tax basis in his partnership interest, Congress has chosen to permit deferral of any gain or loss inherent in the distributed asset until the partner disposes of the asset in a taxable sale, exchange, or other transaction. Congress altered this treatment for so-called "mixing bowl" transactions by enacting I.R.C. §§ 704(c)(1)(B), 707(a)(2)(B) and 737, all of which operate to trigger gain inherent in a contributed asset when the contributing partner is treated as having sold the property.

3. Allocation Of Basis Among Distributed Assets. If the distributee’s basis in the distributed assets is determined with respect to his basis in his partnership interest pursuant to I.R.C. § 732(a)(2) or 732(b), such basis
must be allocated among the distributed assets as follows: (i) first to any
unrealized receivables and inventory items under I.R.C. § 751 in an
amount equal to the partnership's adjusted basis in each property (or in
proportion to the partnership's basis in such properties if the basis to be
allocated is less than the partnership's aggregate basis therein), and (ii) to
the extent of any remaining basis, to any other distributed properties in
proportion to their bases in the hands of the partnership prior to the
distribution. I.R.C. § 732(c). Because I.R.C. § 732(c) requires the
distributee to allocate his basis among the distributed assets without regard
to their relative fair market values, it appears that these allocation rules
can result in the distributee obtaining an overstated basis in depreciable
assets and an understated (or zero) basis in non-depreciable assets (in
particular, goodwill) to the extent that the partnership has a low basis (or
no basis) in the non-depreciable assets. This result is in marked contrast
to the manner in which basis is allocated pursuant to the principles of
I.R.C. § 1060 under the so-called "residual" method when the assets of
a business are purchased. It should be noted that the principles of I.R.C.
§ 1060 are applicable to the extent that basis adjustments are to be made
pursuant to I.R.C. §§ 743(b) and 755 in connection with the transfer of
an interest in the partnership. Thus, as explained in greater detail in
I.B.3., infra, the opportunity to affirmatively utilize I.R.C. § 732(c) will
be limited if I.R.C. § 732(d) is applicable. See I.A.4, infra. For a
thorough discussion of this issue and a number of other exit strategies in
corporate joint ventures, see Freeman and Stephens, Using a Partnership
When a Corporation Won't Do: The Strategic Use and Effects of Partner-
ships to Conduct Joint Ventures and Other Major Corporate Business
Activities, 58 Taxes No. 12, 962, (December 1990) (hereinafter referred
to as "Freeman").

4. Special Basis Allocation Rules - I.R.C. § 732(d). If the distributee
acquired his partnership interest within the two year period immediately
preceding the distribution, the distributee's acquisition of such partnership
interest constituted a "transfer" for purposes of I.R.C. § 743(b), and the
election provided in section 754 ("section 754 election") was not in effect
for the taxable year of such acquisition, the distributee may elect to treat
as the partnership's basis in the distributed property the amount that would
have been the partnership's basis had a section 754 election been in effect
for the taxable year in which the distributee acquired his partnership
interest. I.R.C. § 732(d). In addition, I.R.C. § 732(d) and Treas. Reg.
§ 1.732-1(d)(4) provide that the section is mandatory, whether or not the
distribution is made within the prescribed two year period if, at the time
the interest was acquired by transfer: (i) the fair market value of all
partnership property other than money exceeded 110% of its adjusted
basis to the partnership, (ii) a basis allocation under I.R.C. § 732(c) upon
liquidation of the partner’s interest immediately after the transfer would have resulted in a shift in basis away from nondepreciable property to property subject to depreciation or amortization, and (iii) a special basis adjustment under I.R.C. § 743(b) would change the basis to the withdrawing partner of the property actually distributed. It should be emphasized that I.R.C. § 732(d) will not apply unless the distributee acquired his partnership interest pursuant to a "transfer." Thus, I.R.C. § 732(d) will not apply to a distributee partner who acquires his partnership interest in connection with his contribution of property to the partnership. Treas. Reg. § 1.743-1(a).

5. Basis Adjustments Pursuant To I.R.C. § 734.

a. Scope And Effect Of I.R.C. § 734. I.R.C. § 734(b) permits the partnership to adjust its basis in its property following a distribution of property to a partner if a section 754 election is in effect for the taxable year in which the distribution occurs and (1) the distributee recognizes gain or loss pursuant to I.R.C. § 731(a) and/or (2) the distributee’s basis in the distributed property (as determined pursuant to I.R.C. § 732(a)(2) or (b)) varies from the partnership’s basis in such property. If the distributee recognizes gain on the distribution or the distributee’s basis in the distributed property is less than the partnership’s basis in such property, the partnership must increase (or step-up) its basis in its remaining property to the extent of the gain recognized and/or the excess of the partnership’s basis over that of the distributee. I.R.C. § 734(b)(1). If the distributee recognizes a loss on the distribution or the distributee’s basis in the distributed assets is greater than the partnership’s basis in such property, the partnership must decrease (or step-down) its basis in its remaining property to the extent of the loss recognized and/or the excess of the distributee’s basis over that of the partnership. I.R.C. § 734(b)(2).

b. Allocation Of Basis Adjustments Under I.R.C. § 755. If I.R.C. § 734(b) is applicable, the basis adjustments required thereunder must be made pursuant to I.R.C. § 755. In general, the basis adjustments are to be made so as to reduce the difference between the fair market values and tax bases of the remaining partnership properties. I.R.C. § 755(a). A special rule, however, requires the basis adjustments to be made to the remaining properties of the partnership that are of a "like character" to the distributed property, but in no event below zero. I.R.C. § 755(b). For this purpose, I.R.C. § 755(b) divides partnership property into two categories: (1) capital assets and I.R.C. § 1231(b) assets and (2)
all other property of the partnership. If the basis adjustment that
is allocated to class (1) or (2) cannot be made due to an absence
of property in such class or an insufficient amount of basis of
property in such class, the unused adjustment amount is carried
forward indefinitely and applied when property in that class is
subsequently acquired. For a more thorough discussion of the
manner in which I.R.C. § 755 operates, see 2 W. McKee,
W. Nelson & R. Whitmire, Federal Taxation of Partnerships and
Partners, ch. 25 (1977 & Supp. 1990) [hereinafter referred to as
"McKee"].

B. Tax Planning Possibilities.

1. Typical Liquidation. In most instances, the liquidation of a partnership
occurs after the partnership's taxable disposition of its assets. In such
cases, there is very little that can be done from a tax planning standpoint.
Rather, the partnership will simply collect sales proceeds from its
purchaser and then distribute such proceeds to its partners (after satisfying
or providing for satisfaction of its liabilities). The net proceeds available
for distribution to the partners, as well as gain or loss realized by the
partnership on the sale, will be distributable and allocable among the
partners in the manner provided in the partnership agreement.

2. Installment Sales. The Tax Reform Act of 1986 (the "1986 Act"), the
Revenue Act of 1987 (the "1987 Act"), and the Technical and
Miscellaneous Revenue Act of 1988 (the "1988 Act"), included provisions
limiting the availability and utility of installment sales treatment. The
1986 Act disallowed use of the installment method for purposes of
computing alternative minimum tax liability and added the "proportionate
disallowance rule," which treated part of a taxpayer's debt as a payment
on its installment notes. The 1987 Act prospectively repealed the complex
and controversial proportionate disallowance rule. The 1987 Act also
eliminated the installment sale option for all dealers (except those dealing
in time-shares and certain residential lots). See I.R.C. §§ 453(b)(2)(A)
and 453(l). In addition, the 1987 Act added two special rules that may
apply to any non-dealer sale of business or rental real property for more
than $150,000. The 1988 Act extended these two special rules to all non-
dealer sales of property for more than $150,000, except (i) personal use
property (e.g., a personal residence), (ii) farming property, (iii) time-share
interests, and (iv) certain residential lots. See I.R.C. § 453A. First, any
pledge of the installment note as collateral for a loan triggers recognition
of the deferred gain element. I.R.C. § 453A(d). Second, if the
taxpayer's total installment obligations received during the year exceed
$5,000,000, the taxpayer must pay "interest" at the applicable federal rate.
on the deferred tax liability attributable to use of the installment method. I.R.C. § 453A(a) and (c); see Rubin & Cavanagh, Real Estate Installment Sales Under the 1987 Act, 41 Tax Notes 219 (Oct. 10, 1988). For purposes of applying the $5,000,000 test, each partner is treated as owning a proportionate part of the partnership’s installment obligations. H.R. Conf. Rep. No. 495, 100th Cong., 1st Sess. 930 (1987). Thus, the interest charge rule is applied at the partner, rather than at the partnership, level. The interest charge, however, only applies to the portion of the installment obligations for the year that exceed $5,000,000. For example, assume that A sells property for a $20,000,000 installment note with payments beginning in the year after the sale and that A’s basis in the property sold is $12,000,000. For the year of sale the deferred gain is $8,000,000 ($20,000,000 - $12,000,000). The portion of the note subject to the interest rule, which is referred to as the "applicable percentage," is 75% (($20,000,000-$5,000,000) / $20,000,000). In the year of sale, therefore, the interest charge applies to 75% of the deferred gain or $6,000,000 (.75 x $8,000,000). The "deferred tax liability" on the deferred gain (calculated using a 28% maximum statutory rate) is $1,680,000. Assuming an applicable federal rate for the last month of the year of sale of 10%, the interest due for the year of sale would equal $168,000. If A receives a $10,000,000 principal payment during the next year, A’s deferred gain is reduced to $4,000,000 ($8,000,000 x $10,000,000 / $20,000,000) and the interest charge applies to the deferred tax liability associated with 75% of such deferred gain, or $3,000,000, and A’s deferred tax liability (assuming the same maximum statutory rate) would be $840,000. Assuming an applicable federal rate for the last month of the year of 12%, the interest due for such second year would equal $100,800. A must follow the same interest calculation method for each year until the installment note is paid in full.

If a partnership sells its property pursuant to an installment sale, the partnership will either (i) distribute a portion of the installment note to each partner and then liquidate or (ii) remain in existence until the partnership has collected and distributed all of the installment payments due under the note. In either case, (i) each partner must determine his liability, if any, under the interest charge rule of I.R.C. § 453A and (ii) to the extent that the partnership’s gain inherent in the property disposed of is subject to recapture as ordinary income, such amount must be immediately recognized by the partnership (and thus the partners) pursuant to I.R.C. § 453(i).

a. Partnership Immediately Liquidates. If the partnership transfers an undivided interest in the installment note to each of its partners, such transfers will not constitute a gain triggering disposition of
the note. I.R.C. § 453B; Treas. Reg. § 1.453-9(c)(2). Instead, the partners will recognize gain as the note is paid; each partner's installment gain will be determined with reference to his basis in his partnership interest (which may differ from the partnership's basis in the assets sold). See Treas. Reg. § 1.453-9; I.R.C. § 732(b).

b. **Partnership Remains In Existence.** If the partnership remains in existence and collects the payments made under the note, the partnership will report gain as the payments are made, the partners will recognize such gain pursuant to I.R.C. § 703(a), and the partners will recognize gain or loss upon the liquidation of the partnership in accordance with the provisions of I.R.C. § 731(a). But see Temp. Reg. § 1.453C-6T.

c. **Preserving Negative Capital Accounts – Wrap Around Mortgages.** Ordinarily, an installment sale by a partnership whose partners have negative balances in their capital accounts will result in gain recognition by such partners to the extent of their negative balances because negative capital account balances typically exist when the partnership's liabilities exceed its tax basis in its assets. If the installment purchaser assumes the partnership's liabilities (or acquires the partnership's assets subject to such liabilities), the partnership, notwithstanding its ability to report gain under the installment method, will be required to recognize gain equal to the excess of the liabilities assumed (or taken subject to) over its tax basis in the assets sold. To avoid this result, a partnership may sell its assets for a so-called "wrap note" in an amount equal to the agreed upon gross value of the assets sold. Such note "wraps around" the partnership's existing indebtedness. If the sale is properly documented, the partnership will not be deemed to have sold its assets subject to its liabilities and the partnership will not be treated as receiving taxable payments from the purchaser until payments are actually made on the wrap note. Although the Service had attacked this result and issued a temporary regulation supporting its position, taxpayers prevailed in litigation and the Service has now acquiesced. See *Professional Equities, Inc. v. Commissioner*, 89 T.C. 165 (1987) (Treas. Reg. § 15A.453-1(b)(3)(ii) held invalid; Tax Court's decisions in *Stonecrest v. Commissioner*, 24 T.C. 659 (1955); *Estate of Lamberth v. Commissioner*, 31 T.C. 302 (1958); and *Union Pacific Corp. v. Commissioner*, 39 T.C. 721 (1963) may still be relied upon), acq., 1988-2 C.B. 1. If a partnership sells its assets for a wrap note, it appears advisable for the partnership to remain in existence.
because there are no cases that have applied the Stonecrest rationale to a liquidation of a partnership following a sale on a wrap-around mortgage basis. Although the cases that have considered wrap-around mortgages have dealt only with the manner in which the installment sale rules are to be applied to such sales, it is possible that if the partnership is liquidated, the liabilities that were deemed neither assumed nor taken subject to at the partnership level should continue to be includible in the partners' bases in their interests in the wrap note.

3. **Tax-Deferred Liquidations And Distributions.** In some instances, one partner may desire to have his interest in a partnership terminated while the other partner wishes to continue his ownership of an interest in the partnership's assets or business. Alternatively, one partner may wish to obtain complete ownership of the partnership's assets and business. An easy solution, of course, would be for one partner (the "withdrawing partner") to sell his interest in the partnership to the other partner (the "continuing partner"). In the real world, however, this solution may not be readily available unless the continuing partner has an option to purchase the withdrawing partner's interest or the withdrawing partner has an option to require the continuing partner to purchase his interest. Instituting a buy-sell procedure may solve this problem, but many partnership agreements do not contain buy-sell procedures and, even if such procedures are available, there can be no assurance that the withdrawing partner would elect to sell (if the continuing partner triggers the procedure) or that the continuing partner would elect to buy (if the withdrawing partner triggers the procedure). As a result, the termination of a partner's interest in his partnership will often require the partners to negotiate and cooperate with one another to determine a course of action that is acceptable to both the continuing partner and the withdrawing partner. If the withdrawing partner is willing to terminate his interest in the partnership on a taxable basis, the partners can negotiate a purchase of the withdrawing partner's interest by the partnership or the continuing partner. If the withdrawing partner has a negative balance in his capital account, the withdrawing partner's recognized gain on the sale of his interest will equal the sum of (i) such negative balance and (ii) any cash or other consideration received. If the purchase price payable to the withdrawing partner is evidenced by a note of the continuing partner, the withdrawing partner should be eligible to report his gain under the installment method. But see I.R.C. § 453(i) (recapture income recognized in year of disposition); Rev. Rul. 89-108, 1989-37 I.R.B. 13 (installment method unavailable to extent installment note received on sale of partnership interest represents compensation for the selling partner's share of gain on substantially appreciated inventory). Furthermore, if the
withdrawing partner has a negative balance in his capital account at the
time of the sale, the withdrawing partner will be required to recognize
gain equal to such negative balance in the year of the sale unless the trans-
action is structured as a partnership redemption and, under I.R.C. § 736,
the withdrawing partner continues to be treated as a partner in the partner-
ship and thereby is permitted to continue to include a portion of the
partnership's liabilities in the basis of his partnership interest.

If the withdrawing partner has a substantial negative balance in his capital
account and such partner is unwilling to dispose of his interest in the
partnership if the disposition will trigger gain at least equal to such
negative balance, then the partnership must liquidate the withdrawing
partner's interest in a tax-deferred manner. Set forth below are certain
possible means for structuring such a tax-deferred liquidation.

a. **Like-Kind Exchange Prohibited.** Prior to the enactment of the
1984 Act, the withdrawing partner could have exchanged a general
partner interest in the partnership for a general partner interest in
another partnership. *See Gulfstream Land & Development Corp.
v. Commissioner, 71 T.C. 587 (1979); Estate of Meyer v.
Commissioner, 58 T.C. 311 (1972), aff'd per curiam, 503 F.2d
566 (9th Cir. 1974); Miller v. United States, 12 AFTR 2d ¶ 5244
(S.D. Ind. 1963); but see Rev. Rul. 78-135, 1978-1 C.B. 256.
The 1984 Act added I.R.C. § 1031(a)(2)(D), which specifically
states that an exchange of a partnership interest for another
partnership interest will not qualify for like-kind exchange
treatment. Thus, the only way that the withdrawing partner can
avoid gain on the termination of his interest in the partnership is
to receive a distribution of property (other than money) from the
partnership in liquidation of his interest and thereby qualify for
nonrecognition treatment under I.R.C. § 731(a).

b. **Liquidations Involving Distributions Of Existing Assets.** If the
partnership owns more than one significant asset or more than one
business, the partnership can terminate the withdrawing partner's
interest by simply having the partnership distribute a substantial
asset (or one of its businesses) to the withdrawing partner. If the
value of the asset(s) distributed are not equal to the then fair
market value of the withdrawing partner's interest in the
partnership, one of the partners may be required to make a
compensating cash payment. If cash is paid to the withdrawing
partner and such cash exceeds his tax basis in his partnership
interest, he will be required to recognize gain to the extent of the
excess cash received. If the withdrawing partner pays cash to the
partnership (or the continuing partner), his tax basis in the assets distributed to him will be correspondingly increased. There are four important caveats regarding this approach. First, if the withdrawing partner has a negative balance in his capital account, it is essential that the assets distributed to him be subject to a sufficient amount of debt so that he can avoid having to take such negative balance into income. Second, both partners must be mindful of the hidden trap of I.R.C. § 751 which may apply if (i) the partnership owns inventory or (ii) its assets are subject to depreciation recapture (or such partnership otherwise has unrealized receivables). Third, if the distributed property was contributed by the remaining partner within five years of the distribution, gain may be recognized by the continuing partner to the extent provided in I.R.C. § 704(c)(1)(B). Fourth, if the withdrawing partner contributed other appreciated property within five years of the distribution, gain may be recognized by such partner to the extent provided in I.R.C. § 737. For a thorough discussion of I.R.C. § 751, see 2 McKee, supra, ch. 21.

Basis Strips - Creative Uses Of I.R.C. §§ 732 And 754. The flexibility afforded by Subchapter K may enable the partners to terminate the interest of one of the partners on a tax-deferred basis and, in so doing, achieve a variety of other tax objectives. The following discussion is a summary of several tax planning techniques which are discussed, in detail, in Freeman, supra. The scenarios summarized below assume that the partnership owns two properties having equal fair market values, one of which has a low tax basis (the "Low Basis Property") and the other of which has a tax basis equal to the fair market value of such property (the "High Basis Property"). The Low Basis Property was originally contributed by Partner A and the High Basis Property was originally contributed by Partner B. Partner A's tax basis in its partnership interest is substantially less than the fair market value of such interest, while Partner B's tax basis in its partnership interest is approximately equal to the fair market value thereof. Each property has been owned by the partnership for at least five years (thus making I.R.C. §§ 704(c)(1)(B) and 737 inapplicable) and none of the partnership's assets consist of inventory or unrealized receivables (thus making I.R.C. § 751 inapplicable). The partnership does not own any property that is being accounted for using the Deferred Sale Method provided for in the I.R.C. § 704(c)(1)(A) proposed regulations. Following the distribution of property to Partner A or Partner B, a nominal interest in the partnership will be owned by a third party and, thus, the
partnership will continue in existence for federal income tax purposes. It is assumed that the distribution will be treated as governed by I.R.C. § 736 and not I.R.C. § 741.

(1) Distribution Of High Basis Property To Partner A. Under this scenario, the partnership would distribute the High Basis Property to Partner A in complete redemption of its interest in the partnership. So long as the liabilities assumed or taken subject to by Partner A in connection with such distribution are equal to its share of the partnership's liabilities immediately prior to the distribution, the distribution to Partner A will be tax-free pursuant to I.R.C. § 731(a)(1). Under I.R.C. § 732(b), Partner A's adjusted tax basis in the High Basis Property will be equal to its adjusted tax basis in its interest in the partnership. If the High Basis Property consists of more than one asset, Partner A must allocate its basis among such assets in accordance with the rules of I.R.C. § 732(c), i.e., since there are no unrealized receivables or inventory items, the basis must be allocated among other distributed properties in proportion to their respective tax bases in the hands of the partnership. If the partnership has not previously made an election under I.R.C. § 754, such an election should be made for the taxable year during which the redemption distribution takes place. So long as such election is timely made, the partnership will be entitled to step-up its tax basis in the Low Basis Property to reflect the fact that the partnership’s tax basis in the High Basis Property immediately before the distribution exceeded Partner A’s tax basis in such property, as determined under I.R.C. § 732(b). As noted at I.A.5.b., supra, such basis-step-up would be allocated among the remaining assets of the partnership in accordance with the rules of I.R.C. § 755. Such additional basis would then be available to reduce the gain recognized by the partnership on a sale of the Low Basis Property. In addition, to the extent the Low Basis Property is depreciable, additional depreciation deductions would be available to the partnership. If an election under I.R.C. § 754 is not timely made, the partnership will forego the basis step-up opportunity afforded by I.R.C. § 734(b) and the amount of income that must be recognized by the partnership upon its subsequent disposition of the Low Basis Property will be increased accordingly. In addition, to the extent that the Low Basis Property consists of depreciable
assets, the partnership will forego any additional depreciation deductions that a basis step-up would have permitted.

(2) Distribution Of Low Basis Property To Partner B. Under this scenario, the partnership would distribute the Low Basis Property to Partner B in complete redemption of its interest in the partnership. Such distribution will be non-taxable to both Partner A and Partner B so long as the amount of liabilities assumed or taken subject to by Partner B in connection with the redemption does not exceed its share of the partnership’s liabilities immediately prior thereto. Pursuant to I.R.C. § 732(b), Partner B’s basis in the Low Basis Property will be equal to its basis in its partnership interest. If the Low Basis Property consists of more than one asset, I.R.C. § 732(c) will be applicable and Partner B’s basis must be allocated among the distributed assets in proportion to the bases of such assets to the partnership. As discussed in Freeman, supra, so long as no portion of the partnership’s tax basis in the Low Basis Property is allocated to non-depreciable assets, then no portion of Partner B’s tax basis in the Low Basis Property will be allocated to non-depreciable assets. It should be noted that, if the distribution to Partner B was made within two years following a purchase by Partner B of its interest in the partnership and an election under I.R.C. § 754 was not in effect at the time of such purchase, the rules of I.R.C. § 732(c) may be overridden by I.R.C. § 732(d), in which event part of Partner B’s basis would be allocated in accordance with the principles of I.R.C. § 1060, which principles might require an allocation of basis to non-depreciable assets. It should be noted that if the Low Basis Property is distributed to Partner B, it is advisable for the partnership not to make an election under I.R.C. § 754. If such election is not made, the partnership’s tax basis in the High Basis Property will remain unchanged and the partnership will recognize less gain on the sale of the High Basis Property. In addition, the partnership may compute its depreciation deductions with respect to the High Basis Property based on the historical tax basis of such property. On the other hand, if an election under I.R.C. § 754 is made (or has been made with respect to a prior taxable year), the partnership will be required to reduce its basis in the High Basis Property pursuant to I.R.C. § 734(b)(2).
d. **Acquiring Assets To Effect The Liquidation.** Most partnerships consist of a single business operation. It is thus unlikely that the partnership will own assets that could be distributed to a withdrawing partner in the manner described above. To liquidate the withdrawing partner's interest on a tax-deferred basis, therefore, such interest must be exchanged for other property in a transaction that takes advantage of the nonrecognition rule of I.R.C. § 731(a)(1). There appear to be three possible alternatives. For a complete discussion of the issues discussed below, see Cuff, *Planning for Partnership Exchanges Under Section 1031*, 68 Taxes 339 (May 1990).

(1) **Liquidation Followed By Like-Kind Exchange.** Under this alternative, the partnership would liquidate and convey undivided interests in its assets to the partners. The withdrawing partner would then exchange its undivided interest for like-kind property in a transaction designed to qualify under I.R.C. § 1031. The major flaw with this alternative is that, following the liquidation of the partnership, the partners would own undivided interests in an operating business and, as such, might be deemed partners for federal income tax purposes. In such event, the withdrawing partner's attempt to effect a tax-free exchange would be frustrated by I.R.C. § 1031(a)(2)(D) which prohibits exchanges involving partnership interests. *See Madison Gas & Electric Co. v. Commissioner*, 633 F.2d 512 (7th Cir. 1980), aff'g, 72 T.C. 521 (1979) (partnership found to exist for tax purposes where utility companies co-owned a power plant that produced electricity which the utilities took in kind, notwithstanding that the utilities had elected out of Subchapter K of the Code); *compare* Rev. Rul. 75-374, 1975-2 C.B. 261 (co-owners of an apartment complex not partners for tax purposes where a management company was engaged to manage and maintain the complex); Rev. Rul. 79-44, 1979-1 C.B. 265 (co-owners of farm properties held tenants-in-common and not partners for tax purposes). A second issue concerning this alternative is whether the exchange subsequent to the liquidation would violate the "held for productive use in a trade or business or investment" requirement of I.R.C. § 1031(a)(1). In *Chase v. Commissioner*, 92 T.C. 874 (1989), the Tax Court found I.R.C. § 1031 inapplicable to an exchange of property allegedly distributed from a partnership before the exchange. In *Chase*, however, the
taxpayers failed to respect the partnership distribution form they had chosen and, as a result, the court found that, in substance, the partnership had disposed of the property. Because the *Chase* decision involved "bad facts," the effect of an exchange following a partnership liquidation remains unclear. See generally *Magneson v. Commissioner*, 81 T.C. 767 (1983), *aff'd*, 753 F.2d 1490 (9th Cir. 1985) (exchange followed by contribution to partnership qualified as a like-kind exchange); *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985) (like-kind exchange following I.R.C. § 333 liquidation qualified for nonrecognition treatment); *Mason v. Commissioner*, 55 T.C.M. (CCH) 1134 (1988) (I.R.C. § 731 liquidating distribution followed by I.R.C. § 1031 like-kind exchange qualified for nonrecognition to the extent of like-kind property); *Maloney v. Commissioner*, 93 T.C. 89 (1989) (like-kind exchange followed by I.R.C. § 333 liquidation qualified for nonrecognition treatment). Furthermore, if the transaction is structured so that there is not a complete liquidation, but rather a distribution of an undivided interest in property in complete redemption of a partner's interest followed by the exchange of the undivided interest for other like-kind property, the structure might have to withstand scrutiny under the step transaction doctrine to determine whether, in substance, the withdrawing partner sold his partnership interest to the third party. Compare *Harris v. Commissioner*, 61 T.C. 770 (1974) (liquidating distribution of undivided interest in shopping center respected where undivided interest was leased back to the distributing partnership) with *Crenshaw v. United States*, 450 F.2d 472 (5th Cir. 1971) *cert. denied*, 408 U.S. 923 (1972) (liquidating distribution of undivided interest in real property ignored where undivided interest was recontributed to the distributing partnership as part of a prearranged series of transactions). The critical differences between *Harris* and *Crenshaw*, are addressed in *Kelley, The Tax-Deferred Limited Partnership Buyout: The Substance Is the Form,* 3 J. of Partnership Tax'n No. 2, 117 (Summer 1986) (hereinafter referred to as "Kelley").

(2) **Purchase Followed By Liquidation.** Under this approach, the partnership would (i) purchase a new asset or business and (ii) liquidate the withdrawing partner's interest by distributing the newly-acquired asset(s) to him. Subject to
running the gauntlet of I.R.C. § 751, this approach should qualify for the nonrecognition treatment accorded by I.R.C. § 731(a)(1), although there are no cases or rulings specifically addressing and approving this structure. The safest approach to implement this strategy would be for the partnership to borrow funds or use funds generated from its operations to purchase the new asset or business and distribute such assets or business to the withdrawing partner. However, if the partnership is incapable or unwilling for business reasons to borrow funds or utilize partnership funds to purchase the property, the parties might wish to consider an alternative strategy whereby the continuing partner would contribute cash (or its credit) to the partnership, the partnership would purchase the property, and the new property would be distributed by the partnership to the withdrawing partner. The IRS may argue that, under the step transaction doctrine, as successfully argued in Crenshaw v. United States, and/or under I.R.C. § 707(a)(2)(B), the transaction should be recast as a purchase of the withdrawing partner’s interest in the partnership. For a complete analysis of this issue, see Kelley, supra. Furthermore, it is possible that the regulations under I.R.C. § 707(a)(2)(B) will be amended to speak to this issue when they finally address disguised sales of partnership interests. It should be noted that if the partnership’s existing assets consist in whole or in part of substantially appreciated inventory or are subject to depreciation recapture, I.R.C. § 751 may prove to be an insurmountable obstacle. Finally, if the withdrawing partner has a negative balance in its capital account, care must be taken to ensure that the assets distributed to such partner are subject to a sufficient amount of debt.

(3) Exchange Followed By Liquidation. The third approach for unwinding the partnership should be considered only if the second approach is undesirable because of the traps created by I.R.C. § 751 or the risks created by Crenshaw. Under this approach, the partnership would exchange a portion of its assets for like-kind property that is acceptable to the withdrawing partner and then liquidate, with the withdrawing partner being distributed the like-kind property and the continuing partner being distributed the remaining assets of the partnership. If the continuing partner needs or wants the assets transferred by the partnership as part of
the like-kind exchange, the continuing partner might purchase such assets from the third party who participated in the exchange (such person, presumably, is interested in selling his property for cash). Beware, however, of Crenshaw if the last step is taken. If the form of the transactions is respected they should be treated as follows for federal income tax purposes:

(a) The exchange by the partnership would not result in any gain or loss to the partnership (or the partners) pursuant to I.R.C. § 1031.

(b) The liquidation of the partnership should be tax-free to the partnership and the partners under I.R.C. § 731. If the partnership owns substantially appreciated inventory or unrealized receivables, it is important that the liquidating distributions to the partners include proportionate parts of those items. It should be noted that if the partnership's assets are subject to depreciation recapture and are exchanged for other depreciable assets that are of like-kind, the recapture taint will carry over to the assets received in the exchange. Treas. Reg. §§ 1.1245-2(c)(4), 1.1250-3(d)(4). A distribution of those assets solely to the withdrawing partner can thus effectively result in his receiving sufficient tainted assets to avoid any adverse treatment under I.R.C. § 751.

(c) The ability of the partnership to effect a like-kind exchange involving multiple properties, whether or not the properties constitute a business, may be restricted. See Rev. Rul. 89-121, 1989-2 C.B. 203 (clarifying Rev. Rul. 85-135, 1985-2 C.B. 181 and Rev. Rul. 57-365, 1957-2 C.B. 521 by ruling that the nature of the underlying assets of the businesses being exchanged rather than merely the businesses themselves must be analyzed to determine whether or not a like-kind exchange has occurred); Treas. Reg. § 1.1031(j) (while it is beyond the scope of this outline to analyze these regulations in depth, these regulations require a detailed analysis of the properties transferred and properties received by the taxpayer according to groupings of properties that are either of like-kind or like class and provide that
nonrecognition treatment generally does not apply to properties transferred that cannot be matched with property of like-kind or class in the exchange, as well as with respect to money and other non-qualifying property such as inventory or intangibles). For a more thorough discussion of exchanges of multiple properties and businesses, see Bogdanski, On Beyond Real Estate: The New Like-Kind Exchange Regulations, 48 Tax Notes 903 (Aug. 13, 1990).

(4) Limitation On Related Party Like-Kind Exchanges. The 1989 Act added sections 1031(f)-(h) to provide limitations on the availability of nonrecognition treatment under I.R.C. § 1031 for certain exchanges between related parties. I.R.C. § 1031(f)(1) provides that if a taxpayer exchanges property with a related person and I.R.C. § 1031 generally accords nonrecognition treatment to the transaction, the taxpayer nevertheless will be required to recognize gain or loss on the exchange if either (A) the related person disposes of property received in the exchange from the taxpayer or (B) the taxpayer disposes of the property received in the exchange from the related party within two years of the date of the last transfer that was part of the exchange. This limitation does not apply to dispositions (i) after the taxpayer or the related person dies, (ii) in a compulsory or involuntary conversion if the original exchange occurred prior to the threat or imminence of the conversion, or (iii) with respect to which the taxpayer establishes that neither the exchange nor the disposition had a tax avoidance purpose. For purposes of this provision, a related party means any person related to the taxpayer under I.R.C. § 267(b). I.R.C. § 1031(f)(3). Furthermore, I.R.C. § 1031(f)(4) provides that I.R.C. § 1031 does not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of I.R.C. § 1031(f). Finally, I.R.C. § 1031(g) provides that the running of the two-year holding period in I.R.C. § 1031(f)(1)(C) is suspended during any period with respect to which a party's risk of loss with respect to the property was substantially terminated.

It should be noted that I.R.C. § 1031(f), as proposed by the House of Representatives, would have made I.R.C.
§ 1031 unavailable to taxpayers if (i) the property relinquished by the taxpayer had not been held directly by the taxpayer for at least one year or the property received by the taxpayer is not held directly by the taxpayer for one year after the exchange or (ii) the property relinquished and the property exchanged were not similar or related in service or use. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1342. Thus, had the House's version passed, the Ninth Circuit's decision in Bolker, supra, that property received in liquidation from a corporation and exchanged immediately thereafter meets the holding "for use in a trade or business or for investment" would have been legislatively overruled.

II. TERMINATING THE PARTNERSHIP.

A. Applicability. If a partner does not withdraw from a partnership but instead sells his interest to a third party, the partner generally will recognize gain or loss on the sale of his interest under I.R.C. § 741 (subject, of course, to the possible applicability of I.R.C. § 751). In this regard, if this sale results in the transfer of 50% or more of the capital and profits of the partnership within a twelve-month period, the sale will trigger a constructive termination of the partnership under I.R.C. § 708. Since a constructive termination can have a dramatic effect on the remaining partners and the operation of the partnership for tax purposes, this section of the outline generally describes some of the effects and planning considerations connected with constructive terminations.

B. Terminations Under I.R.C. § 708. If within any twelve-month period 50% or more of the total interests in the capital and profits of a partnership is sold or exchanged, the partnership is considered to have terminated for federal income tax purposes. I.R.C. § 708(b)(1)(B). Such a termination can have a number of adverse consequences for the partners, the most significant of which are discussed below. See Birkeland & Postlewaite, Constructive Termination of a Partnership - A Fresh Look, 39 Tax Law. 701 (1986) [hereinafter referred to as "Birkeland"] (thorough discussion of terminations under I.R.C. § 708).

1. Tax Treatment Of Termination.

a. General - Deemed Distribution/Recontribution. Under Treas. Reg. § 1.708-1(b)(1)(iv), if a partnership is terminated as a result of a sale of exchange of an interest, the following is deemed to occur: (i) the partnership is deemed to distribute its properties to the purchaser of the partnership interest and the other remaining
partners in proportion to their respective interests in the partnership properties, and (ii) the purchaser and other remaining partners are deemed to recontribute the properties immediately thereafter to a new partnership for continuation of the business or for its dissolution and winding up. A partner only will recognize gain upon a I.R.C. § 708(b)(1)(B) termination of a partnership if the partner's share of cash held by the partnership exceeds the adjusted basis of his partnership interest.

b. **Effect On Basis.** The termination of a partnership under I.R.C. § 708(b)(1)(B) and the distribution/recontribution treatment under the regulations may have an effect on the basis of the assets of the new partnership. I.R.C. § 732(b) provides that the basis of property deemed distributed to a partner upon a termination is equal to the partner's adjusted basis in his partnership interest less any money distributed to the partner. Thus, if the adjusted basis of the partner's interest in the partnership exceeds the amount of cash and adjusted basis of the assets deemed distributed because the partner purchased his interest for a price in excess of his share of the adjusted basis of partnership assets, then the basis of the assets in the hands of the partner is "stepped-up" to equal the partner's adjusted basis in his partnership interest.

Each partner's basis in the assets distributed to him is allocated in accordance with I.R.C. § 732(c). When the assets are deemed to be recontributed to the new partnership, the new partnership receives a basis in the assets which equals the partners' bases in such assets pursuant to I.R.C. § 723. This treatment allows the partnership to obtain the step-up in basis attributable to the purchasing partner's purchase of an interest in the partnership at a price which exceeds the partner's share of the adjusted basis of the assets in the hands of the old partnership. Following the recontribution, the partnership must allocate taxable items in respect of the recontributed assets pursuant to I.R.C. § 704(c)(1)(A).

c. **Impact Of I.R.C. § 754 Election.** A different basis adjustment allocation will be obtained if a partnership is terminated under I.R.C. § 708(b)(1)(B) and such partnership has in effect an election under I.R.C. § 754. Under these circumstances, the Service has ruled that the bases of the partnership's assets are adjusted pursuant to I.R.C. §§ 743 and 755 prior to their deemed distribution to the partners. Rev. Rul. 86-73, 1986-1 C.B. 282. This same result occurs if the section 754 election is made for the

2. Other Potential Tax Consequences Of Termination.

a. Recapture Of Investment Tax Credit. If a partnership distributes an I.R.C. § 38 property to its partners, the distribution will be deemed a disposition of the property for purposes of I.R.C. § 47 unless the distribution is deemed to constitute a "mere change in the form of conducting the trade or business." I.R.C. § 47(b). Although the distribution to the partners would appear to merely constitute a change in the form of conducting the partnership’s trade or business, this exception will not be available unless the distributee partners take an adjusted tax basis in the distributed property that is determined solely by reference to the basis of the property in the hands of the distributing partnership. Treas. Reg. § 1.47-3(f)(1)(ii)(d). If a partnership is terminated under I.R.C. § 708(b)(1)(B), the partnership’s assets are deemed distributed to its partners and then recontributed by the partners to a new partnership. Treas. Reg. § 1.708-1(b)(1)(iv). On the deemed distribution to the partners, such partners take an adjusted tax basis in the distributed assets equal to the adjusted tax bases of their interests in the partnership (which may differ from the "inside" basis of such assets in the hands of the partnership). I.R.C. § 732(b). Upon the deemed recontribution to the new partnership, the new partnership’s adjusted tax basis in the assets will be equal to the sum of the partners’ adjusted tax bases in such assets. I.R.C. § 723. Thus, the new partnership’s adjusted tax basis in the assets may differ from that of the old partnership. Because of this difference (or potential for difference), it has been concluded that the termination of a partnership under I.R.C. § 708 will result in the recapture of any investment tax credits previously claimed by the terminated partnership (or its predecessor in interest, i.e., a partner who may have contributed the I.R.C. § 38 property to the partnership after he placed such asset in service). See 1 McKee, supra, at ¶ 12.05 [2][g]; Birkeland, supra, at 725-27. This conclusion is based exclusively on a mechanical reading of Treas. Reg. § 1.47-3(f)(1). Until 1987, no court had addressed the issue of whether an actual or constructive liquidation of a partnership results in the recapture of investment tax credits. In 1987, however, the Tax Court held the regulation to be both valid and applicable to a transaction that resulted in the termination of a general partnership. See Siller Brothers, Inc. v. Commissioner, 89 T.C. 256 (1987) (partner P purchased partner L-P’s 50%
partnership interest causing the partnership to constructively liquidate; partner P required to recapture investment tax credits previously claimed in respect of I.R.C. § 38 property of the partnership); see also Long v. United States, 652 F.2d 675 (6th Cir. 1981), rev'd, 79-2 U.S.T.C. ¶ 9612 (W.D. Tenn. 1979) ("transferred basis" regulation held valid; S corporation shareholder required to recapture investment tax credits previously claimed on S corporation assets distributed to shareholder in liquidation).


(1) Computation Of Depreciation. Prior to the enactment of the accelerated cost recovery system ("ACRS") in 1981, taxpayers were generally allowed to depreciate their assets over their economic useful lives in accordance with either the straight-line method of depreciation or one of certain specified accelerated methods of depreciation. See I.R.C. § 167. In the case of depreciable real property, a taxpayer was generally allowed to use either the straight-line method or the 150% declining balance method so long as either the taxpayer itself constructed the property or the original use of the property commenced with the taxpayer; if the taxpayer did not construct the property and the original use of the property did not commence with the taxpayer, the taxpayer was generally allowed to use only the straight-line method of depreciation. See I.R.C. § 167(j). Under the ACRS (which is generally available for property placed in service after December 31, 1980), assets are divided into several recovery classes; the cost of an asset assigned to a particular recovery class is recovered over the period of years specified for such recovery class. See I.R.C. § 168. Originally, depreciable real property was assigned to a fifteen-year class and the cost of such property could be recovered over a fifteen-year period using percentages generally determined in accordance with the 175% declining balance method. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201(a), 95 Stat. 172, 203-18. The recovery period for real property has been lengthened four times since the original enactment of the ACRS. First, the 1984 Act lengthened the recovery period from fifteen years to eighteen years for property placed in service after March 15, 1984 (1984 Act § 111(a), 98 Stat. at 631). Second, the Imputed Interest Simplification Act of
1985 lengthened the recovery period from eighteen years to nineteen years for property placed in service after May 8, 1985 (Pub. L. No. 99-121, § 103(a), 99 Stat. 505, 509). Third, the 1986 Act lengthened the recovery period from nineteen years to twenty-seven and one-half (residential rental real property) or thirty-one and one-half years (commercial real property) for property placed in service after December 31, 1986 (Pub. L. No. 99-514, § 201(a) (codified at I.R.C. § 168)). In addition, the 1986 Act generally permits a taxpayer to depreciate real property using only the straight-line method of depreciation. I.R.C. § 168(b)(3). Finally, the Revenue Reconciliation Act of 1993 lengthened the recovery period for commercial real property to thirty-nine years.

If a partnership that holds depreciable real property is constructively terminated pursuant to I.R.C. § 708(b)(1)(B) after December 31, 1986, it is thus necessary to determine (i) with respect to its property that was not eligible for depreciation pursuant to the ACRS at the time of the constructive termination, whether the reconstituted partnership will be permitted to depreciate such property pursuant to the ACRS and, if not, whether the reconstituted partnership will be permitted to continue any accelerated depreciation of such property by the terminated partnership and (ii) with respect to its property that was being depreciated pursuant to the ACRS at the time of the termination, whether the reconstituted partnership will be permitted to continue to depreciate such property over the recovery period (and using the method) that the terminated partnership was using at the time of the termination.

(2) Eligibility For ACRS. The ACRS contains a series of "anti-churning" rules that are designed to assure that the ACRS is utilized only with respect to property placed in service after 1980 (and, for property other than real property, generally only with respect to property placed in service after 1986). See I.R.C. § 168(f)(5). The anti-churning rules, for example, operate to prevent a taxpayer who placed depreciable real property in service prior to 1981 from causing such asset to become eligible for the ACRS simply by transferring such asset after 1980 to a related person. See I.R.C. § 168(f)(5)(A)(i). If a partnership holding depreciable real property placed in
service prior to 1981 is constructively terminated pursuant to I.R.C. § 708(b)(1)(B) after 1980, under the anti-churning rules, such property would be eligible for the ACRS only if there is no person (or group of persons) that owns or owned more than 10% of the interests in both the terminated partnership and the reconstituted partnership. See I.R.C. § 168(e)(4)(B) and (D) (prior to amendment by the 1986 Act). Thus, if a partnership holds depreciable real property placed in service prior to 1981 and 90% or more of the total interest in the partnership's capital and profits is transferred (within a twelve-month period) after 1980, such property would be eligible for depreciation pursuant to the ACRS. With respect to any property that does not become eligible for depreciation pursuant to the ACRS by reason of the above rules, the reconstituted partnership will not be considered to be the "original user" of such property and thus will be required to depreciate the remaining tax basis of such property using the straight-line method (certain residential rental property will qualify for the 125% declining balance method). See I.R.C. § 167(j).

(3) Length Of Recovery Period.

(a) The 1984 Act. In the case of a constructive termination of a partnership after March 15, 1984, the House-Senate Conference Committee Report for the 1984 Act indicated that the reconstituted partnership must use the eighteen-year recovery period with respect to the entire unrecovered tax basis of its depreciable real property even though the terminated partnership was using a fifteen-year recovery period. H.R. Rep. No. 861, 98th Cong., 2d Sess. 1006 (1984). The Joint Committee on Taxation eased this restriction somewhat by providing that the reconstituted partnership must use the eighteen-year recovery period only if, and to the extent that, the tax basis of the property was increased by reason of the constructive termination. General Explanation, supra, at 329.

(b) The 1986 Act. The 1986 Act added a statutory provision specifically applicable to constructively terminated partnerships. I.R.C. § 168(l)(7)(A) provides that, in the case of any property trans-
ferred in certain specified transactions (including transactions under I.R.C. §§ 721 and 731), the transferee shall be treated as the transferor for purposes of computing the deduction for depreciation with respect to that portion of the basis of the property in the hands of the transferee that does not exceed the basis of the property in the hands of the transferor. As a result of this rule, property transferred in one of the specified transactions will be deemed to have been placed in service by the transferee at the time it was actually placed in service by the transferor. Thus, if a transfer occurs after December 31, 1986, the transferee will be allowed to continue to use the recovery period and the depreciation method applicable to the property in the hands of the transferor. I.R.C. § 168(i)(7)(B) provides, however, that such rule "shall not apply in the case of a termination of a partnership under section 708(b)(1)(B)." Consequently, the deemed distribution and recontribution of the property of a partnership that has been constructively terminated pursuant to I.R.C. § 708(b)(1)(B) will be treated as actual transfers of the property for purposes of determining the length of the recovery period and the method of depreciation applicable to such property in the hands of the reconstituted partnership. Thus, if a constructive termination occurs, the property of the reconstituted partnership will be considered to have been placed in service at the time of the constructive termination and the rules enacted in the 1986 Act (i.e., the twenty-seven and one-half or thirty-one and one-half-year recovery period and the required use of the straight-line method for real property) will be applicable to such property.

c. **Tax Allocations Under I.R.C. § 704(c)(1)(A).** If (i) a partnership is terminated under I.R.C. § 708 and (ii) the fair market value of the assets at the time of the termination differs from the partners' adjusted tax bases in their partnership interests, then the reconstituted partnership must allocate its income, gain, loss, and deductions among its partners in accordance with the principles of I.R.C. § 704(c)(1)(A) and the regulations promulgated thereunder.
d. **Closing Of Partnership's Taxable Year.** Pursuant to Treas. Reg. § 1.708-1(b)(1)(iii) (b), the constructive termination of a partnership pursuant to I.R.C. § 708(b)(1)(B) closes the taxable year of the terminated partnership as of the day of the sale or exchange that results in the transfer of 50% or more of the total interest in the partnership's capital and profits. The taxable year of the reconstituted partnership begins on the immediately succeeding day. As a result, the terminated partnership will be required to file a final federal income tax information return covering the period from the end of its immediately preceding taxable year until (and including) the day on which the terminated partnership’s taxable year closes. The early closing of the terminated partnership’s taxable year can result in a "bunching" of more than twelve months of partnership income in a single taxable year of a partner if the partner has a taxable year that differs from the partnership's taxable year.

e. **Partnership Elections.** A number of other elections that are made at the partnership level, e.g., bad debt deduction election, choice of accounting method, and choice of inventory method, must be made by the new partnership because the old partnership’s elections do not carry over to the new partnership. See generally, Birkeland, *supra*, at 721.

f. **Holding Period For Partnership Assets.** Under a literal reading of the Code and regulations, the holding period of the assets in the hands of the newly-reconstituted partnership should include the holding period of the assets in the hands of the old partnership since I.R.C. §§ 735(b) and 1223(2) so require with respect to distributions and Treas. Reg. § 1.723-1 so requires with respect to contributions. However, in *McClausen v. Commissioner*, 45 T.C. 588 (1966), the Tax Court held that the purchase of a partner’s entire interest in a two-person partnership must be treated as a purchase of the assets of the partnership with the result that the purchased property’s holding period did not carry over to the new partnership. While this complete termination of a two-person partnership is factually dissimilar to a constructive termination in which the reconstituted partnership continues, the scope of the *McClausen* holding is unclear. Nevertheless, two commentators suggest that the holding period of the assets of the new partnership should include the holding period of the assets in the hands of the old partnership. Birkeland, *supra*, at 729; Palmer, 237-2nd T.M., *Dispositions of Partnership Interests - Sales and Exchanges*, p. A-45.
g. **I.R.C. § 724(b) Taint.** Under I.R.C. § 724(b), in the case of any property contributed to a partnership by a partner that was an inventory item in the hands of the partner immediately before the contribution, any gain or loss recognized by the partnership on the disposition of such property during the five-year period beginning on the date of such contribution will be treated as ordinary income or loss, as the case may be. I.R.C. § 724(d)(3) applies such tax treatment also to any substituted basis property received when the tainted property is disposed of in a nonrecognition transaction or a series of nonrecognition transactions. I.R.C. § 7701(a)(42) defines "substituted basis property" as property that is transferred basis property or exchanged basis property. Under I.R.C. § 7701(a)(43), "transferred basis property" is property having a basis determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor, and "exchanged basis property" is defined in I.R.C. § 7701(a)(44) as property having a basis determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined. A "nonrecognition transaction" is defined to include any disposition of property in a transaction in which gain or loss is not recognized in whole or in part.

Upon the deemed termination of a partnership under I.R.C. § 708, the old partnership's assets deemed received by the new partners will constitute exchanged basis property (since their basis is determined under I.R.C. § 732(b) by reference to the new partners' bases in their partnership interests). Upon the deemed recontribution of those assets to the new partnership, the assets will constitute transferred basis property (since their basis will be determined under I.R.C. § 723 by reference to their basis in the new partners' hands). Accordingly, since the deemed distribution and recontribution is a series of nonrecognition transactions (under I.R.C. §§ 731 and 721), the I.R.C. § 724(b) taint will continue to apply to the 724(b) assets of the new partnership after the I.R.C. § 708 termination, and the five-year taint period will be determined by reference to the original contributions of such property to the old partnership.

3. **Avoiding Terminations.** I.R.C. § 708(b)(1)(B) is applied in a mechanical manner. Thus, the partners may avoid termination under I.R.C. § 708(b)(1)(B) by reorganizing the partnership prior to a transfer so that the interest transferred does not represent an interest of 50% or more of either the capital or profits interests in the partnership. See Priv. Ltr.
Rul. 8851004 (Aug. 21, 1988) (transfer by partner of 20% interest more than one year following the same partner's transfer of a 45% interest will not cause partnership termination); Priv. Ltr. Rul. 8517022 (Jan. 25, 1985) (transfer by partner of a 1% interest in a partnership more than one year after the partner transferred a 49% interest to the same transferee did not cause the partnership to terminate); Priv. Ltr. Rul. 7952057 (Sept. 25, 1979) (transfer by partner of a .1% interest in a partnership more than one year after the partner transferred a 49.9% interest to the same transferee did not cause partnership to terminate notwithstanding pre-existing plan); 3 A. Willis, J. Pennell, & P. Postlewaite, *Partnership Taxation* § 161.06 (4th ed. 1989) [hereinafter referred to as "Willis"]; Birkeland, *supra*, at 713-14. The following example illustrates this technique: A and B each own a 50% capital interest and a 50% profits interest in Partnership. A desires to transfer his interest to C. Immediately prior to A’s transfer, B makes an additional capital contribution to Partnership that, based upon the *fair market value* of Partnership's assets at that time, increases B’s capital interest in Partnership to 51% and decreases A’s capital interest in Partnership to 49%. When A transfers his interest in Partnership to C, he transfers less than a 50% capital interest and a termination of Partnership has thus been avoided. To ensure success (particularly where A’s interest in capital is greater than 50%) it is essential that B own *more than* a 50% interest in capital following his contribution. For this purpose capital should be tested in two ways and B’s capital interest should exceed 50% under both tests. The first test requires (i) valuing Partnership’s assets, (ii) crediting any unrealized appreciation or depreciation to the partners’ capital accounts, and (iii) having B contribute fresh capital so that his capital account balance exceeds A’s capital account balance by more than a de minimis amount. The second test merely requires a comparison of the actual capital contributions made to Partnership and is designed to deal with situations involving a decrease in the value of Partnership’s assets. The partners’ capital accounts must be adjusted upon B’s fresh contribution and income, gain, loss, and deduction must thereafter be allocated in accordance with the principles of I.R.C. § 704(c)(1)(A). To avoid any suggestion that B’s fresh contribution is transitory or otherwise should be ignored, the partners should amend the partnership agreement to provide that their adjusted capital accounts will bear preferential returns and that their capital accounts and preferential returns will have the first priority for distributions made following sales, refinancings, and other capital transactions. This particular technique is premised upon B’s fresh contribution to Partnership in exchange for an additional capital interest being treated as something other than a transfer of an interest in Partnership for purposes of I.R.C. § 708(b)(1)(B).
4. Potential Pitfalls Under I.R.C. § 708. The following transactions involving partnership interests constitute transfers that can cause a termination under I.R.C. § 708:

a. Contributions To Partnerships And Corporations. The contribution of a partnership interest to a partnership or a corporation is treated as a transfer of the contributed interest for purposes of I.R.C. § 708(b)(1)(B) even if such contribution is accorded tax-free treatment by I.R.C. § 721 or 351. See Treas. Reg. § 1.708-1(b)(1)(ii); Evans v. Commissioner, 447 F.2d 547 (7th Cir. 1971), aff'g, 54 T.C. 40 (1970), acq., 1978-2 C.B. 2; Rev. Rul. 81-38, 1981-1 C.B. 386; 1 McKee, supra, at ¶ 12.03[1]; Birkeland, supra, at 708-12.

b. Corporate Reorganizations. If a corporation's assets are acquired in a "stock for assets" reorganization under I.R.C. § 368(a)(1)(C) and the acquired assets include an interest in a partnership, such partnership interest should be deemed transferred for purposes of I.R.C. § 708(b)(1)(B). See Birkeland, supra, at 711. Although the Service initially ruled that a transfer of a partnership interest pursuant to a merger under I.R.C. § 368(a)(1)(A) did not constitute a transfer for purposes of I.R.C. § 708(b)(1)(B), Priv. Ltr. Rul. 8444069 (July 31, 1984), the Service subsequently revoked that ruling and held that a transfer had occurred for purposes of I.R.C. § 708(b)(1)(B). Priv. Ltr. Rul. 8643062 (July 31, 1986). In Rev. Rul. 87-110, 1987-2 C.B. 159, the Service officially ruled that a transfer of an interest in a partnership from one corporation to another in a transaction qualifying under I.R.C. §§ 361(a) and 368(a)(1) constitutes an exchange for purposes of I.R.C. § 708(b)(1)(B), except in the case of a reorganization that qualifies under I.R.C. § 368(a)(1)(F).

c. I.R.C. § 338 Elections. If (i) a corporation owns a partnership interest, (ii) the stock of such corporation is acquired in a transaction that constitutes a "qualified stock purchase," and (iii) an election is made in respect of such purchase under I.R.C. § 338(g) or (h)(10), the question arises as to whether the deemed transfer of the corporation's assets constitutes a sale or exchange for purposes of I.R.C. § 708(b)(1)(B). It appears that there is no clear answer to that question. See Birkeland, supra, at 710-11; Jones, The Application of Section 338 to a Corporation Owning a Partnership Interest, 1 J. Partnership Tax'n 34, 45-46 (1984) [hereinafter referred to as "Jones"]; 3 Willis, supra, at ¶ 161.09 n. 72. It can be argued that the adjustment to the basis of
corporate assets resulting from an I.R.C. § 338 election is not an appropriate time for applying the constructive termination rules of I.R.C. § 708(b)(1)(B) and that the constructive termination of a partnership was not contemplated by the drafters of I.R.C. § 338. See Jones, supra, at 45-46. In addition, it can be argued that if the deemed transfer of assets pursuant to I.R.C. § 338 should be considered to be an actual transfer for other federal income tax purposes, such transfer should constitute "an assignment to a successor in interest" for purposes of I.R.C. § 708(b)(1)(B). These arguments, however, are subject to several responses. First, I.R.C. § 338 specifically refers to the deemed transfer of assets resulting from an election under § 338 as a sale. Second, it appears that the phrase "assignment to a successor in interest" (as used in Treas. Reg. § 1.708-1(b)(1)(ii)) was not intended to encompass transactions that otherwise possess the characteristics of an actual sale. In the Regulations the phrase "assignment to a successor in interest" is closely connected with the term "gift" and the Service has interpreted the phrase narrowly. See 3 Willis, supra, at § 161.08 n. 52. Finally, it is clear that the deemed sale of assets resulting from an I.R.C. § 338 election is to be treated as an actual sale for certain other federal income tax purposes. For example, the deemed sale is an event that gives rise to the recognition of gain or loss by the acquired corporation. See Temp. Treas. Reg. § 1.338-4T(h)(1). As stated in the temporary Regulations issued under I.R.C. § 338 (albeit in response to a question regarding the applicability of a basis adjustment pursuant to I.R.C. § 743(b) when the acquired corporation holds a partnership interest at the time of the acquisition), "[t]he provisions of subchapter K of the Code (relating to partners and partnerships) apply as if the deemed sale and purchase under section 338(a) were an actual sale and purchase." Temp. Treas. Reg. § 1.338-4T(l)(3). Consequently, although no authority specifically addresses the issue, it is likely that the deemed transfer resulting from an election under I.R.C. § 338 constitutes a sale for purposes of I.R.C. § 708(b)(1)(B).

5. Tiered Partnerships. In Rev. Rul. 87-50, 1987-1 C.B. 157, the Service held that if a sale of a partner's interest in a "parent" partnership results in a termination of the parent under I.R.C. § 708(b)(1)(B), then, for purposes of I.R.C. § 708(b)(1)(B), such sale also causes an exchange of the parent partnership's interest in the subsidiary partnership. Conversely, if a sale of a partner's interest in a parent partnership does not result in a termination of the parent under I.R.C. § 708(b)(1)(B), then, for purposes of I.R.C. § 708(b)(1)(B), such sale does not cause an exchange

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PARTNER X
  
PARENT PARTNERSHIP
  
SUB PARTNERSHIP
  
PARTNER Y
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a. X owns a 60% interest in Parent. Parent owns an 80% interest in Sub. X sells his 60% interest. Does Parent constructively terminate? (Yes). Does Sub terminate? (Yes). Parent is treated as exchanging an 80% interest in Sub upon the deemed liquidation of Parent. See Rev. Rul. 87-50.

b. X owns a 60% interest in Parent. Parent owns a 49% interest in Sub. X sells his 60% interest in Parent. Does Parent terminate? (Yes). Does Sub terminate? (No). There is not an exchange of at least a 50% interest in Sub.

c. X owns a 40% interest in Parent. Parent owns a 50% interest in Sub. Y owns a 30% interest in Sub. X sells his 40% interest in Parent and Y sells his 30% interest in Sub. (Note: X has an effective interest of 20% in Sub). Does Parent constructively terminate? (No). Does Sub constructively terminate? (No). The entity approach is adopted. Even though X sold an effective 20% interest in Sub, which, together with the sale by Y, would constitute a 50% sale of the interests in Sub, the sale by X is not considered a sale of any interest in Sub. See Rev. Rul. 87-51.

d. X owns a 50% interest in Parent. Parent owns a 40% interest in Sub. Y owns a 30% interest in Sub. X sells his 50% interest in Parent, and Y sells his 30% interest in Sub. Does Parent constructively terminate? (Yes). Does Sub constructively terminate? (Yes). The constructive termination of Parent causes an exchange of a 40% interest in Sub. Such exchange, together
with the sale by Y of his 30% interest in Sub, causes a constructive termination of Sub.

e. X owns a 50% interest in Parent. Parent owns a 40% interest in Sub. Y owns a 5% interest in Sub. X sells his 50% interest in Parent, and Y sells his 5% interest in Sub. Does Parent constructively terminate? (Yes). Does Sub constructively terminate? (No). There has not been an exchange of at least a 50% interest in Sub.


a. The issuance by the partnership of an interest therein in connection with a capital contribution to the partnership. This is true even though the contributing partner acquires 50% or more of the total interests in the partnership’s capital and profits as a result of the contribution. See Rev. Rul. 75-423, 1975-2 C.B. 260; see also Colonnade Condominium, Inc. v. Commissioner, 91 T.C. 793 (1988) (disregarding contribution form and characterizing transaction as sale of partnership interests); Oehlschlager v. Commissioner, 55 T.C.M. (CCH) 839 (1988) (one key factor in distinguishing between contribution and sale or exchange of partnership interest is whether property transferred for partnership interest becomes a partnership asset).

b. The redemption of an interest in the partnership.

c. The disposition of an interest in the partnership by gift (including an assignment to a successor in interest), bequest or inheritance. It is not clear what the phrase "successor in interest" means or is intended to apply to. See 1 McKee, supra, at ¶ 12.03[1].

C. Partnership Mergers. If partnerships merge, I.R.C. § 708(b)(2)(A) provides that the resulting partnership is considered to be a continuation of the merging partnership whose members own interests of more than 50% of the capital and profits of the resulting partnership. For a discussion of the tax consequences of such mergers, see McGilsky & Bolling, Tax Implications of Partnership Mergers, 66 Taxes 606 (1988). For a discussion of the Service’s view of issues related to mergers of partnerships, see Rev. Rul. 90-17, 1990-1 C.B. 119 (ruling that, in the context of a merger of three partnerships, if the resulting partnership is treated as a continuation of one of the merging partnerships under I.R.C. § 708(b)(2)(A), liquidating distributions by the other merging partnerships of 50%
or more of the capital and profits interests in the resulting partnership do not cause the resulting partnership to terminate under I.R.C. § 708(b)(1)(B).