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Taxation of Partnerships and LLCs
Complex Tax Issues

Chapter 4

Partnership Terminations

By

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Table of Contents

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A. PARTNERSHIP TERMINATIONS

1. **Introduction**. Partnership terminations may occur in various ways, carrying tax consequences that also vary (depending on the manor of the termination). Therefore, in order to determine the tax consequences of a partnership termination, the type of termination must be determined first. For tax purposes, a partnership terminates when the partnership either; (1) actually terminates[1] or is (2) deemed to terminate (which is referred to as a "technical" or "constructive" termination).

    a) **Actual Termination**. An actual termination of a partnership can occur of any one of <u>three ways</u>:

        i. 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,

        ii. Conversion from Multi-member to Single-member Entity. The partnership convert to a single-member owned entity, or

        iii. The partnership "incorporates."

    b) **Technical Termination**. A technical (or "constructive") termination of a partnership occurs if; within a 12-month period, there is a sale or exchange of 50% or more of the total interests in partnership capital and profits.[2]

B. ACTUAL TERMINATIONS – IRC SECTION 708(b)(1)(A)

1. **Introduction.** As previously mentioned, an "actual" termination a partnership can occur as a result of a cessation of business, conversion from a multi-member entity to a single-member entity, or an "incorporation" of a partnership (or LLC).

2. **Cessation of Business**. A partnership is terminated if no part of any business, financial operations, or venture of the partnership is carried on by any of its partners in a partnership. The courts have interpreted the phrase "no part" quite literally. In fact, the courts have stated that a partnership is not terminated even though its sole assets are notes receivable arising from the sale of partnership

[1] IRC section 708(b)(1)(A).
[2] IRC section 708(b)(1)(B).

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assets.[3] However, the Sixth Ciruit held that a partnership was terminated in the year that it ceased operations and distributed all of its assets with the exception of certain security deposits. The deposits were held by the partnership until it was determined that partnership's creditors did not have any legal claims over them. The partnership was considered terminated even though it had not distributed all of its assets.[4]

3. **Conversion of Partnership into a Single-Member Owned Entity**. By definition, a partnership must have at least two partners. When an event or transaction causes a multimember partnership (i.e., a state law partnership or an LLC that is treated as a partnership for tax purposes) to have only one partner or member, the entity ceases to be a partnership for tax purposes. When a multimember partnership ceases to be a partnership for tax purposes, a constructive liquidating of the partnership is deemed to occur, resulting in a constructive distribution of all partnership assets and liabilities to the remaining member. Consequently, the remaining member may have gain if a deemed distribution of cash exceeds the member's basis in his partnership interest (determined immediately before the deemed distributions). In addition, remaining member's basis in the remaining assets must be determined under IRC Section 732 (basis in distributed asset rules).[5] Revenue Ruling 99-6 provides two examples that illustrate the tax consequences to the remaining member of an LLC that had changed from a multi-member to single- member LLC.

[3] David A. Foxman, 41 TC 535 (1964), acq. 1966-2 CB 4, aff'd 352 F.2d 466, 65-2 USTC 9737, 16 AFTR 2d 5931 (3rd Cir. 1965).
[4] Herbert I. Goulder v. U.S., 95-2 USTC 50464, 76 AFTR 2nd 95-6001 (6th Cir. 1995)
[5] Revenue Ruling 99-6 and 84-111 (see Situation #3).

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EXHIBIT 1
Revenue Ruling 99-6: *Situation #1*

FACTS

1. A and B are equal partners in AB, LLC
2. A sells entire interest to B for $10,000.
3. The business continues being solely owned by B.

SOLUTION

1. Partnership treated as terminating under IRC Section 708(b)(1)(A) (i.e., an "actual" termination).
2. **Tax Treatment to A.** A will recognize gain or loss under IRC Section 741 (sale of a partnership interest).
3. **Tax Treatment to B**. Solely for purposes of determining the tax treatment to B, AB, LLC is deemed to make liquidating distributions of all assets to A and B.

A's Pre-Transaction Assets In B's Hands	B's Pre-Transaction Assets In B's Hands
• B is treated as purchasing the assets deemed distributed to A in liquidation of A's interest. • B's <u>basis</u> in the assets attributable to A's one-half interest in the partnership is equal to the purchase price ($10,000). • B's <u>holding period</u> on these assets begin on date of "purchase." Rev. Rul. 66-7.	• Upon termination of AB, LLC, B is considered to receive a distribution of those assets attributable to B's former interest, and B may be required to recognize gain under IRC Section 731 (i.e., B will have gain, if and to the extent, B is deemed to receive a cash distribution in excess of his basis in his partnership interest). • B's basis in the assets is determined under IRC Section 732(b). • B's holding period in these assets includes the partnership's holding period (except for purposes of IRC 735(a)(2)).

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EXHIBIT 2
Revenue Ruling 99-6: Situation #2

FACTS
1. C and D are equal partners in CD, LLC
2. Both C and D sell their interests to E for $10,000 each.
3. The LLC continues and operates under E, its sole owner.

SOLUTION
1. Deemed actual termination under IRC Section 708(b)(1)(A).
2. C and D will recognize gain or loss under IRC Section 741.
3. CD, LLC is deemed to make liquidating distributions of all assets to C and D but only for the purpose of determining asset basis for E.
4. Immediately after, E is deemed to purchase collectively, C and Ds assets for $20,000.

C & D's Pre-Transaction Assets In E's Hands	E's Pre-Transaction Assets In E's Hands
• E is treated as purchasing the assets deemed distributed to C & D in the deemed liquidation of C & D's interest. • E's <u>basis</u> in the assets attributable to C & D's respective interests in the partnership is equal to the purchase price ($10,000). [Compare Rev. Rul. 84-111, (Situation 3), which determines the tax consequences to a corporate transferee of all interests in a partnership in a manner consistent with *McCauslen*, and holds that the transferee's basis in the assets received equals the basis of the partnership interests, allocated among the assets in accordance with IRC Section 732(c)]. • E's <u>holding period</u> on these assets begin on date of "purchase." Rev. Rul. 66-7.	N / A

3. **Partnership Incorporations**. For tax purposes, the term "partnership incorporation" does NOT mean the actual legal process of converting a partnership to corporation under state law. Rather, it means the mere transfer of a partnership's assets and liabilities to a new or existing corporation, (often, but not necessarily, followed by the dissolution of the partnership). The tax treatment of partnership incorporations are governed by Rev. Rul. 84-111.

   Partnership incorporations can occur in one of three forms: (i) an assets-over transaction, (ii) an assets-up transaction, and (iii) an interests-over transaction. These forms of partnership incorporations may be compared to the transactional-forms associated with the merger of a partnership into another partnership (See Mergers, above). The major difference between the *partnership incorporations* and partnership mergers (with other partnerships) is that the form of partnership incorporation will generally be taxed in accordance with its form. Whereas, the form of partnership merger (with another partnership) may not always be taxed in accordance with its form. The following is a brief summary of the forms of partnership incorporation and the basis tax consequences associated with such forms:

   a) **Assets-Over Transaction**. In an assets-over transaction, the partnership contributes all its assets and liabilities to a corporation in exchange for stock in the corporation. The partnership then distributes the stock to its partners in complete liquidation of the partnership.

      Shareholders (former partners). A partnership's transfer of all its assets and liabilities in exchange for a controlling interest in a corporation generally is tax-free to the partnership (momentary shareholder).[6] However, the partnership will recognize gain if, and to the extent, the transferred liabilities exceed the partnership's basis in the contributed assets.[7] The partnership's basis in the corporate stock should be equal to the basis in the contributed assets, reduced by any liabilities assumed (or taken subject to) by the corporation, and increased by any gain recognized by the partnership in connection with the exchange (i.e., transfer of assets and liabilities in exchange for stock).[8] The holding period in the stock generally includes the holding period of the contributed assets to the extent the assets were capital and/or section 1231 property.[9] It should be noted that any gain recognized by the partnership will result in a corresponding increase to each partner's basis

[6] IRC Sec. 351(a).
[7] IRC Sec. 357(c).
[8] IRC Sec. 358(a).
[9] IRC Sec. 1223(1).

in his partnership interest, in an amount equal to each partner's allocable share in such gain.

Upon distribution of the stock, by the partnership to its partners, in liquidation of the partnership, each transferee partner will receive a basis in the distributed stock equal to his or her basis in the partnership interest (determined immediately before the distribution of the stock by the partnership).[10]

Corporation. The corporation takes a carryover basis in the contributed assets, increased for any gain recognized by the contributing partnership (resulting from the contribution to the corporation).[11] The holding periods of the contributed assets will carryover to the corporation.[12]

b) **Assets-Up Transaction**. In an assets-up transaction, the partnership distributes its assets and liabilities to the partners in complete liquidation of the partnership. The partners then contribute their stock into a corporation in exchange for stock in that corporation.

Shareholders (former partners). In the case of a distribution of assets and liabilities, by the partnership to its partners in liquidation of the partnership, a partner may be required to recognize gain on the distribution, but only if, and to the extent, (i) the distribution included cash and (ii) the distributed cash exceeds the partner's basis in his partnership interest.[13] The basis in the distributed assets will be determined by reference to the partner's basis in his partnership interest (determined immediately before the distribution).[14]

A transfer, by a shareholder (former partner), of assets and liabilities to a corporation in exchange for a controlling interest in such corporation should generally be tax-free to the contributing shareholder.[15] However, the shareholder must recognize gain if, and to the extent, the transferred liabilities exceed the shareholder's basis in the contributed assets.[16] The shareholder should then receive a basis in his stock equal to the basis in the contributed assets, reduced by the contributed liabilities, and increased by any gain recognized.[17] The holding period in the stock generally includes the holding

[10] IRC Sec. 732.
[11] IRC Sec. 362.
[12] IRC Sec. 1223(2).
[13] IRC Sec. 731(a).
[14] IRC Sec. 732.
[15] IRC Sec. 351(a).
[16] IRC Sec. 357(c).
[17] IRC Sec. 358(a).

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period of the contributed assets to the extent the assets were capital and/or section 1231 property.[18]

Corporation. The corporation takes a carryover basis in the contributed assets, increased adjusted for any gain recognized by the shareholders as a result of the contribution to the corporation.[19] The holding period of the contributed assets carries over to the corporation to the extent such assets are capital or section 1231 property.[20]

c) **Interests-Over Transaction**. In an interests-over transaction, the partners contribute their partnership interests into a corporation in exchange for the stock of the corporation.

Shareholders (former partners). A transfer, by a shareholder (former partner), of his or her respective partnership interest to a corporation in exchange for a controlling interest in the corporation should generally be tax-free to the contributing shareholder.[21] However, the shareholder will recognize gain if, and to the extent, the transferor's share of partnership liabilities exceed the transferor's basis in the contributed partnership interest.[22] Each shareholder's basis in stock is equal to his basis in the contributed partnership interest, reduced by the partner's share of partnership liabilities associated with the contributed partnership interest, and increased by any gain recognized in connection with the exchange.[23] The holding period in the stock generally includes the holding period of the contributed partnership interest except to the extent the stock is received for an interest in Section 751 assets that are neither capital asses or Section 1231 assets.[24]

In the case of a state law partnership, the entity ceases to exist as a partnership for both legal and federal income tax purposes. In the case of an LLC (treated as a partnership for tax purposes), continues to exist under state law, but ceases to exist for tax purposes).[25]

Corporation. The corporation's basis in the partnership assets is determined as if the assets were, first, distributed by the partnership to the partners, and then recontributed by the partners to the corporation.[26] Consequently, the basis in

[18] IRC Sec. 1223(1).
[19] IRC Sec. 362.
[20] IRC Sec. 1223(2).
[21] IRC Sec. 351(a).
[22] IRC Sec. 357(c).
[23] IRC Sec. 358(a).
[24] IRC Sec. 1223(1).
[25] Treas. Reg. 301.7701-3(a).
[26] Rev. Rul. 84-111.

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the assets will be determined, first by reference to the partner's basis in his partnership interest (determined immediately before the deemed distribution).[27] Then the corporation will take a "carryover" basis in the assets, which are deemed to have been contributed to the corporation,[28] increased adjusted for any gain recognized by the shareholders as a result of the contribution to the corporation.[29] The corporation's holding period in the partnership assets includes the partnership's holding period.[30]

C. TECHNICAL TERMINATION – IRC SECTION 708(b)(1)(B)

1. **Basic Elements**. There are three basic elements of a technical termination are; (a) "within a 12-month period", (b) "sale or exchange", and (c) "50% or more of the interests in partnership capital AND profits."[31]

   a) **Within a 12-Month Period**. The sale or exchanges must occur with a 12-month period. The "12-month period" rule applies to any consecutive 12 months. If the same interest is sold more than once during a 12-month period, it is counted only once.

   b) **Sale or Exchange**. For purposes of a technical termination, a sale or exchange includes:

      - Sale of a partnership interest to another partner or to an outsider who becomes a partner,
      - Distribution of a partnership interest by a corporation as a dividend or in liquidation of the corporation.
      - Distribution of a partnership interest by an upper-tier partnership
      - Deemed sale or exchange of an interest in a lower-tier partnership (which occurs when the upper-tier partnership "technically" terminates).
      - Transfer of a partnership interest to a corporation in a section 351 incorporation
      - A corporation's transfer of a partnership interest pursuant to a tax-free reorganization (except an "F" reorganization).
      - Transfer of a partnership interest to a partnership in a section 721 transaction

[27] Rev. Rul. 84-111 and IRC section 732.
[28] Rev. Rul. 84-111.
[29] IRC Sec. 362.
[30] IRC Sec. 1223(2).
[31] IRC Sec. 708(b)(1)(B).

With respect to the question of whether a partnership constructively (or "technically") terminates under Sec. 708(b)(1)(B), due to the transfer of an interest in that partnership to another partnership, most tax commentators[32] assert that a termination does occur (provided all other criteria resulting in a termination are satisfied). Each commentator cites Reg. 1.708-1(b)(2). However, it should be noted that each commentator is careful to point out that the IRS has ruled inconsistently on this matter.

Of particular interest, are PLRs 8819083 and 8406045. In these rulings, the IRS appears to "sacrifice consistency for sound policy" by supporting a view that is consistent with the purposes of section 708(b)(1)(B) outlined above.

> **Note**: The Purpose(s) of IRC section 708(b)(1)(B). The technical termination rules of IRC section 708(b)(1)(B) were enacted for the following two reasons: (1) to prevent trafficking in partnerships with advantageous taxable years and thereby to inhibit avoidance of the IRC section 706(b) limitations on a partnership's ability to elect a taxable year other than that of its principal partners. (subsequent changes in the Code have greatly reduced the ability of partnerships to adopt or retain favorable taxable years. Thus, the original purpose of IRC section 708(b)(1)(B) has been eliminated in large measure; and (2) The provision serves a similar function under current law, however, in that it impedes trafficking in partnerships that own assets with favorable accelerated cost recovery system (ACRS) recovery periods.

These rulings contain statements asserting that a technical termination does not occur where the holders of the original partnership interests continue to hold a substantial portion of those interests indirectly through a newly formed (and inserted) intermediate partnership.

Excerpt from PLR 8819083: The purpose of these provisions is to cause a termination only when, in fact, a substantial portion of the ownership of a partnership shifts. In this case, the same partners who hold 100 percent of the interests in P will continue to hold, either directly or through Holdings, 100 percent of the interests in P after the transaction. Moreover, each partner's interest in P will remain unchanged by the transaction. It would be inconsistent with the

[32] McKee, Willis, BNA, etc.

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purposes of Section 708(b)(1)(B) of the Code to treat P as having terminated as a result of the Restructuring. In each year after the Restructuring, each partner's distributive share of each item of P's income, gain, loss, deduction and credit will the same as if the Restructuring had not occurred and the partners had continued to hold their interest in P directly.

Excerpt from PLR 8406045: The purpose of these provisions is to cause a termination only when, in fact, a substantial portion of the ownership of a partnership shifts. In this situation, the same partners who held 100 percent of the interests in P will hold, through Z, 100 percent of the interests in P and Q after the transaction. Although Z is an intermediate entity, the partners of Z will be the same partners P had prior to the division.

Sales or exchanges **do not** include transfer of a partnership by:

- Gift
- Bequest
- Inheritance
- Liquidation of a partnership interest (via retirement or otherwise)
- Contributions of property made to partnership by newly admitted partner in exchange for a partnership interest
- Conversion of a general partnership interest into a limited partnership interest
- Conversion of a general or limited partnership interest into a membership interest in a limited liability company

c) **50% or More of Partnership Capital AND Profits**. The emphasis here is on the word “and”. For a technical termination to occur, the interests sold or exchanged must constitute at least 50% of partnership capital and profits. For this purpose, a partner’s capital is based on the portion of partnership net assets that would be distributed to the partner upon that partner’s withdrawal from the partnership or upon the partnership’s liquidation. Except in the very simplest partnership arrangements, the only method to accurately determine a partner’s interest in partnership capital is to calculate the amount of partnership capital distributable upon liquidation after a hypothetical sale of all partnership property for FMV. A partner’s capital is not his tax capital account (unless it is equal to his FMV capital account).

Under the IRC Section 704(b) safe harbor capital account maintenance rules, partners can make an optional revaluation of all partnership property in certain situations. This revaluation is reflected in the various partners’

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book capital accounts. The partners' book capital accounts more clearly reflect the each partner's economic liquidation right at any time. It appears that if the revaluation results in the departing partner's book capital accounts equaling less than 50% of total capital (even if they had a 50% or greater tax capital account previously), a technical termination does not occur.

A partner's interest in partnership profits may be very difficult to determine. For instance, what if the partner has one interest in partnership operating profits and a different interest in gain on the sale of partnership assets? Further, what about service partnerships - very often these types of partnerships determine the partners' respective profits interest after the end of the partnership tax year. There appears to be no guidance in the Code or regulations on how the profits interest should be determined. It would appear that any reasonable method could be used to determine a partner's profits interest – such as weighted average or a determination of the partner's actual share of profits for the year of transfer. It should be noted, however, that if the transferred interest is close to the 50% threshold, the calculation of the transferring partner's interest in profits and capital should be carefully documented.

2. **Construct of a Technical Termination**. Upon a technical termination, the following transactions are deemed to occur:

    a) The partnership is deemed to contribute all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership.

    b) Immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and other remaining partners in proportion to their respective interests in liquidation of the terminated partnership [either for the continuation of business of the new partnership or for its dissolution and winding up].

3. **Partnership Tax Returns – Filing Requirements**. For tax purposes only, a partnership is deemed terminate when the criteria under IRC Section 708(b)(1)(B) have been met. As a result, two short period returns must be filed; (i) a final return for the terminated partnership ("old partnership") – see Exhibit 3 below and (ii) an initial year return for the "new partnership" – see Exhibit 4 below.

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EXHIBIT 3
Federal Form 1065 – Preparation Issues

Final Return

1) Termination Date. The terminated partnership is considered to terminate on the day of the final sale or exchange that triggered the technical termination.

2) Short Period Return. A short period partnership return ("first short period return") is to be filed with a statement attached, which describes the transfers that triggered the technical termination [the statement is optional, it is not required].

3) Due Date. The due date, of the first short period return, is the 15th day of the fourth month following the end of the month in which the terminated partnership technically terminates.

4) Schedule L. Form 1065, schedule L (balance sheet) should reflect zero's in the "end of year" column.

5) Schedules M-2 and K-1. Form 1065, schedule M-2 (capital reconciliation) should reflect zero for "end of year" capital. Total partnership capital should be "zero'd out" by including an M-2 adjustment entitled "IRC section 708(b)(1)(B) Termination". A similar adjustment should be made to the capital reconciliation on each partner's federal schedule K-1 using the aforementioned description.

6) IRC Section 754 Election. Section 754 election and basis adjustments arising in connection with a technical termination of a partnership should always be made on the "final" short period return. The basis adjustments will have no immediate affect on partnership taxable income or loss.

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EXHIBIT 4
Federal Form 1065 – Preparation Issues

Initial Return

1) Start Date of New Partnership. The new partnership is considered to begin on the day following the final sale or exchange that triggered the technical termination of the terminated partnership.

2) Federal EIN. The new partnership should use the Federal EIN of the old partnership. However, if a new Federal EIN has been obtained the new partnership is permitted to use it. The basis and holding periods of the assets and liabilities of the terminated partnership carryover to the new partnership.

3) Schedule L. Schedule L. Form 1065, schedule L (balance sheet) should reflect zero's in the "beginning year" column.

4) Schedules M-2 and K-1. Form 1065, schedule M-2 (capital reconciliation) should reflect a positive M-2 adjustment entitled "Capital balance transfer pursuant to IRC Section 708(b)(1)(B)". A similar adjustment should be made to the capital reconciliation on each partner's federal schedule K-1.

5) Pre-Termination Elections. No pre-termination elections survive the technical termination of the old partnership. New partnership must make all new elections (i.e., method of accounting, tax year, etc.).

6) Restart Depreciation. All depreciable assets, "deemed transferred", must begin new depreciable lives as though the assets were acquired by the new partnership on the first day of the tax year for the "second short period return". These assets are subject to the anti-churning rules of IRC Section 168(f)(5).

7) Built-in Gain Property – IRC Section 704(c). Section 704(c) property received from the old partnership continues to be IRC Section 704(c) property in the hands of the new partnership.

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4. **Disadvantages of a Technical Termination.** The three primary disadvantages associated with a technical termination are:

    a) Two short period returns.

    b) Restart depreciable lives.

    c) Bunching of income for partners having tax years different than the partnership.

5. Technical Termination and Effect on Collateral Tax Items

The tax consequences of a technical termination on various collateral tax issues can be grouped into three categories; (1) Unaffected items, (2) Affected Items, and (3) Unresolved Items.

a) Unaffected Items

i. Federal EIN. The partnership's employer identification number (EIN) for the deemed new partnership remains the same as the EIN of the deemed terminated partnership.[33]

ii. Entity Classification. The check-the-box regulations of §301.7701-3 address technical terminations. Regs. §301.7701-3(e) states that an entity resulting from a transaction described in §708(b)(1)(B) is a partnership. Thus, an entity classified as a partnership will remain a partnership and will not default to an association.

iii. Carryover of Basis in Partnership Assets. There is also no change in basis of the assets of the partnership. Under §722, the basis of property contributed to a partnership is the basis of the property to the contributing partner plus any gain recognized under §721(b) relating to investment partnerships. Thus, the basis of the assets to the terminated partnership will carry over to the deemed new partnership. This is clearly illustrated in the example in Regs. §1.708-1(b)(4). Likewise, the holding period carries over under §735(b) and §1223(2).

iv. Carryover of Section 754 Basis Adjustments. Regs. §1.743-1(h)(1) explicitly provides that a partner's basis adjustment in partnership property in the deemed terminated partnership will carry over to the deemed new partnership, regardless of whether the new partnership makes a §754 election.

[33] Regs. §301.6109-1(d)(2)(iii).

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v. Sec. 752 – Deemed Distributions. Practitioners often are concerned that a technical termination will cause deficit capital accounts to be triggered as gain. Only in rare situations would this occur. Generally, the partners' share of partnership liabilities remain the same before and after the termination, so there is no shifting of liabilities that could cause a deemed distribution of cash under §752 in excess of the partner's tax basis that could result in gain under §731(a).

vi. Allocation of Partnership Liabilities. The regulations under §752, addressing the allocation of partnership liabilities among the partners, apply in general to liabilities incurred after certain dates specified in Regs. §1.752-5(a). Regs. §1.752-5(c) states that a technical termination will not cause partnership liabilities incurred or assumed before the termination to be treated as incurred or assumed on the date of termination. Thus, in this case, the liabilities are "grandfathered."

vii. Netting of Liabilities. Regs. §1.752-1(f) provides for the netting of liability increases and decreases resulting from the same transaction. One of the transactions referred to in this regulation is a termination of the partnership under §708(b).

viii. "-7 Liabilities." Regarding what is known as -7 liabilities (generally, liabilities that do not create basis give rise to an immediate deduction or a nondeductible expense, and thus create built-in losses), Regs. §1.752-7(b)(4)(ii) states that, in determining whether a deemed contribution of assets and assumption of liability as a result of a technical termination is treated as a -7 liability transfer, only the -7 liabilities that were assumed by the terminating partnership as part of an earlier -7 liability transfer are taken into account, and only to the extent of the remaining built-in loss associated with that -7 liability.

ix. Revaluing Capital Accounts**.** As to capital accounts maintained under Regs. §1.704-1(b)(2)(iv), according to Regs. §1.704-1(b)(5), Example 13(v), the deemed termination of the old partnership and the deemed contribution to the new partnership are disregarded for purposes of the capital account maintenance. Thus, there is no need to revalue capital accounts.

x. Minimum Gain. Regarding minimum gain under Regs. §1.704-2, the regulations provide an example where a partnership terminates under §708(b)(1)(B), and states that the technical termination will be disregarded for purposes of maintenance of capital accounts and thus does not impact minimum gain.

xi. Deficit Restoration Obligation. If a partnership has a deficit restoration obligation (DRO), Regs. §1.704-1(b)(2)(ii)(c) requires that the DRO of a partner be satisfied upon the liquidation of the partner's interest. Presumably liquidation of the partner's interest in the terminated partnership does not trigger the DRO. For instance, Regs. §1.704-1(b)(2)(ii)(b)(3), which addresses obligations to restore deficit capital account balances, applies only after taking into account all capital account adjustments for the partnership under Regs. §1.704-1(b)(2)(iv). Regarding these rules, Regs. §1.704-1(b)(5), Example 13(v), provides that the deemed termination of the old partnership and the deemed contribution to the new partnership are disregarded for purposes of capital account maintenance.

xii. New Section 704(c) Layers. Under §704(c)(1)(A), where property is contributed to a partnership where the tax basis and value are different, this difference must be accounted for in determining income, gain, or loss. However, according to Regs. §1.704-3(a)(3)(i), no new §704(c) layer is created as a result of the deemed contribution. Nevertheless, it should be noted that if the transferor partner had contributed §704(c) property, the transferee partner would take the interest subject to the §704(c) component, but a §754 election would neutralize the impact of the §704(c) allocations under Regs. §1.704-3(a)(6)(ii) and Regs. §1.743-1(d)(1).

xiii. Disguised Sale Rules under Sections 704(c)(1)(B) and 737. In the technical termination fiction, there is a deemed contribution and a deemed distribution; therefore, the disguised sale of property rules of §704(c)(1)(B) and §737 could apply, which could cause gain in some situations where the contribution/distribution occurs within seven years. However, Regs. §1.704-4(c)(3) clearly states that §704(c)(1)(B) does not apply to deemed distributions of interests in a new partnership caused by the termination of a partnership under §708(b)(1)(B). Regs. §1.704-4(a)(4)(ii) requires that a termination of a partnership under §708(b)(1)(B) does not begin a new seven-year period[34] with respect to the built-in gain or loss property. Also, Regs. §1.737-2(a) expressly states that §737 does not apply to the deemed distribution of interests in a new partnership caused by a technical termination. This regulation does state that a subsequent distribution of property by the new partnership to a partner of the new partnership that was formerly a partner in the terminated partnership is subject to §737.

[34] The regulation says five-year period, but §704(c)(1)(B) was later amended to increase the five-year period to seven years. The regulation has not yet been amended to conform it to the amended statute.

xiv. Disguised Sale Rules under Section 707(a)(2)(B). The disguised sale rules of §707(a)(2)(B) do not apply to transfers resulting from a technical termination.[35]

xv. Distribution of Marketable Securities. Section 731(c) addresses the treatment of distribution of "marketable securities" as defined in subsection (c)(2). These can include securities other than actively traded securities. Regs. §1.731-2(g)(2) states that a technical termination will be treated as if there is no termination for purposes of §731(c).

xvi. Sale of Partner Interest: Section 741 Treatment. Section 741 provides that any gain or loss from the sale of a partnership interest is treated as a gain or loss from the sale of a capital asset, except to the extent of hot assets under §751. Regs. §1.741-1(b) clearly states that §741 will apply even though the sale of an interest results in a technical termination. It goes on to state that §741 will apply even in a two-person partnership where one member sells his interest to the other, or where both members sell their interests to a third party. Actually, Rev. Rul. 99-6 addresses these situations and states that, even though the purchaser is treated as purchasing assets, the selling partner or partners are treated as selling partnership interests.

xvii. Domestic Production Activities. Regarding the deduction for domestic production activities under §199 ("DPAD"), Regs. §1.199-8(e)(1)(i) provides that, in connection with contributions to corporations under §351 and partnerships under §721, the activities of the transferee do not include the activities of the transferor. However, Regs. §1.199-8(e)(1)(ii) provides that in the case of a technical termination, the transferee partnership is treated as performing the activities performed by the transferor partnership.

xviii. Mid-Contract Change in Taxpayer**.** Regarding the completed contract method of accounting under §460, Regs. §1.460-4(k) provides guidance for applying these rules in the case of a "mid-contract change in taxpayer" called the "constructive completion" rules. This is defined in part as a distribution of a contract to a partner or a distribution of an interest in a lower-tier partnership that holds such contract. However, Regs. §1.460-4(k)(2)(iv)(A) states that these rules do not apply to a technical termination of the partnership.

xix. Section 453B Disposition of Installment Note. If the terminated partnership holds an installment note receivable subject to §453 and §453A, a technical termination should not cause the deferred gain to be accelerated. Section 453B provides that, if an installment note is disposed of, the deferred gain is accelerated. Regs. §1.453-9(c)(2)

[35] Regs. §1.707-3(a)(4).

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provides that, where the Code provides for exceptions to the recognition of gain or loss in the case of certain dispositions, no gain or loss shall result "under section 453(d)." This regulation lists contributions of property to a partnership by a partner under §721 as an example of such exceptions. The regulation refers to §453(d), which now applies to elections out of the installment provisions; dispositions are not contained in §453B. Presumably, the exception in the regulation remains applicable.

xx. Section 1031 Like-Kind Exchanges. Although not explicitly stated in the Code or regulations, in connection with like-kind exchanges under §1031, the person relinquishing the property must be the person receiving the replacement property, because the Code and regulations refer to "the taxpayer." However, the IRS has ruled privately that the replacement property can be received by the deemed new partnership in connection with a technical termination.[36]

xxi. TEFRA Audits. Technical terminations should have no impact on a TEFRA audit or the status of the Tax Matters Partner for the audited year. The reason given by CCA 200908042 is that the partners, and not the partnership, are the parties to the TEFRA procedures. The CCA cited Chef's Choice Produce, Ltd. v. Comr.[37] Also, according to CCA 201004032, released on January 29, 2010, the termination would not apply for purposes of TEFRA because §708 applies "for purposes of this subchapter" and, thus, "arguably" would not apply to the TEFRA subchapter.

xxii. Section 469(g) – Fully Taxable Disposition. Partners of the terminated partnership may have suspended losses under §469, the passive activity loss rules. Section 469(g) states that, in connection with a fully taxable disposition, any suspended loss is deductible. Will the technical termination result in these suspended losses being deductible in the year of the deemed termination? The answer is "no" because the transfer does not result in a taxable transaction in connection with a technical termination.

xxiii. Qualified Small Business Stock. Section 1045 provides that, in the case of any sale of "qualified small business stock" held by a taxpayer for more than six months, under certain conditions the gain can be deferred if the taxpayer purchases other qualified stock. Section 1045(b)(2) states that a taxpayer is treated as having purchased any property if the unadjusted basis of such property would be the cost. Thus, if the terminated partnership was the original purchaser of the qualified small business stock, the deemed new partnership should also be treated as the purchaser.

[36] PLR 200812012.
[37] 95 T.C. 388 (1990).

xxiv. Tax Credit Recapture – Section 38. As to credits, a technical termination has no impact on certain credits, either specifically or under the “mere change in form” exception. Regs. §1.47-3(f) provides that no recapture occurs from a disposition of §38 property by reason of a mere change in form of conducting the business. A mere change in form occurs where the basis of the property to the transferee is determined in whole or in part by the basis of the transferor.[38] Section 38 includes 35 different credits. One of the requirements to meet the change-in-form exception is that the transferor retain a “substantial interest” in the §38 property. Regs. §1.47-3(f)(2) defines a “substantial interest” in the case of a partner as an interest equal to or greater than the partner's interest before the change. Thus, a technical termination of a partnership should be a mere change in form that should not cause credit recapture.

xxv. Tax Credit Recapture – New Markets Credit. Prop. Regs. §1.45D-1(e)(4), issued on August 8, 2008, addresses the new markets tax credit under §45D (one of the 35 credits under §38), and clearly states: “A termination under section 708(b)(1)(B) of a [community development entity] that is a partnership is not a recapture event.”[39] If the terminating partnership is a CDE, because of the deemed distribution of interests in that new partnership to the purchasing partner and the other remaining partners, a recapture event may be triggered under §45D(g)(3)(C) and Regs. §1.45D-1(e)(2)(iii). However, because the sale of a QEI is not a recapture event under §45D(g)(3) and because the remaining partner or partners are not being cashed out, the IRS and the Treasury Department do not believe that the sale of a QEI that causes the termination of a CDE partnership under §708(b)(1)(B) should trigger recapture. Accordingly, the proposed regulations provide that a termination under section 708(b)(1)(B) of a CDE partnership is not a recapture event.

xxvi. Publicly Traded Partnerships. Certain publicly traded partnerships that are traded on an “established securities market” or are “readily tradable on a secondary market” are taxed as corporations under §7704, enacted in 1987. These terms are not defined in §7704 but are defined in regulations effective for years after 1995. Regs. §1.7704-1(l)(2) provides for a transition period. Regs. §1.7704-1(l)(4) provides that a termination of a partnership under §708(b)(1)(B) is disregarded in determining whether a partnership qualified for the transition period. Also, in determining whether a partnership is an existing partnership for purposes of §7704, Regs. §1.7704-2(g)(2)(i) also provides that a technical

[38] In Siller Brothers, Inc. v. Comr., 89 T.C. 256 (1987), the court held that recapture occurred when a 50% partner purchased the interest of the other 50% partner. Such a transaction is addressed in Rev. Rul. 99-6, 1999-6 I.R.B. 6.

[39] It is interesting that the IRS specifically addressed technical terminations in connection with the new markets credit but has not done so with all of the other 34 credits. Perhaps this is because the new markets credit is one of the newer credits.

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termination does not by itself terminate the status of an existing partnership.

b) Affected Items

i. Partnership Tax Year Closes. Regs. §1.708-1(b)(3) clearly states that the partnership taxable's year closes on the date on which the partnership terminates. The regulation refers to Regs. §1.706-1(c)(1), which states that the termination of a partnership is not necessarily governed by the "dissolution, liquidation, etc." of a partnership under local law. For fiscal year partners, this could cause a bunching of income or loss to the partners.

ii. Restart of Depreciation. As a result of a technical termination, depreciation must be restarted, as if all of the assets are being placed in service. Section 168(i)(7)(B) lists transactions in which depreciation methods and lives carry over.[40] These transactions include contributions to partnerships and distributions from partnerships. However, §168(i)(7) (flush language) states that this rule does not apply in the case of a termination of a partnership under §708(b)(1)(B). Thus, a commercial building with a 39-year life having an original cost of $3,900,000 and accumulated depreciation of $1,000,000 after 10 years would be depreciated by the deemed new partnership based on $2,900,000 over 39 years. There is no "step into the shoes" concept.

How is depreciation computed in the year of termination by both the terminated partnership and the deemed new partnership, as there are specific rules for dispositions and short tax years? Depreciable assets are subject to various conventions, such as the half-year convention, the mid-month convention, and the mid-quarter convention. The half-year convention treats all property disposed of during the year as disposed of on the midpoint of the year; the mid-month convention, which generally applies to real property, treats all property disposed of during a month as disposed of on the midpoint of the month. The mid-quarter convention treats all property disposed of during the year as disposed of on the midpoint of the quarter. Prop. Regs. §1.168-2(f)(1) addresses the computation of deprecation in connection with short years. However, those regulations were proposed in 1984 and address ACRS property, not MACRS property, which most of the property in use today is.

Although it is clear that the deemed new partnership restarts deprecation based on new lives using the adjusted basis of the property contributed by the terminated partnership, there is confusion as to how to apply the

[40] For a special rule involving New York Liberty Zone property and technical terminations, see Regs. §1.1400L(b)-1(g)(2).

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averaging convention rules to the short period returns.[41] Adding to the confusion is the fact that §168(i)(7)(A) addresses the deprecation by the transferee and not the transferor.

iii. Bonus Depreciation. As to qualified or 50%/100% bonus depreciation property, Regs. §1.168(k)-1(b)(5)(iii) states that such property placed in service by the terminated partnership is treated as originally placed in service by the deemed new partnership on the date such property is deemed contributed to the new partnership.[42]

NOTE: Although the impact on depreciation in some areas is unclear, it is not so with amortization under §197. A technical termination does not cause amortization to restart. Regs. §1.197-2(g)(2)(iv) provides that the carryover basis rules of Regs. §1.197-2(g)(2)(ii) apply.

iv. New Elections Required. The new partnership resulting from a technical termination must make any elections that it wants, e.g., recurring item under §446(h) and property tax accrual under §461(c). As to an election under §754 to adjust the basis of partnership property, Regs. §1.708-1(b)(5) provides that where there is a technical termination, a §754 election (including a §754 election on its final return) — that is in effect for the taxable year of the terminated partnership in which the sale occurs — applies with respect to the incoming partner. Therefore, the bases of partnership property are adjusted under §743 and §755 before their deemed contribution to the new partnership.

v. Elections Under Section 704(c)(1)(A). As to elections under §704(c)(1)(A) for methods of accounting for the difference between the basis and value of contributed property, Regs. §1.704-3(a)(2) provides that a new partnership formed as the result of the termination of a partnership under §708(b)(1)(B) is not required to use the same method as the terminated partnership used as to the property deemed contributed to the new partnership. And Regs. §1.704-3(a)(3) provides that property deemed contributed to a new partnership as a result of a technical termination is treated as §704(c) property in the hands of the new partnership only to the extent that the property was §704(c) property in the hands of the terminated partnership immediately before the termination.

vi. Retirement Plans. Regarding employer qualified pension, profit-sharing and stock bonus plans under §401, Regs. §1.401-10(e)(1) and (2) state that a partnership is considered to be the employer of each of the

[41] For a detailed discussion of these complex and confusing depreciation rules as to terminations, see McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners, ¶13.05[2][k].
[42] See also Regs. §1.168(k)-1(f)(1)(ii) (addressing dispositions of qualified property in the same year the property is placed in service).

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partners. This regulation also states that a partnership is deemed to be continuing regardless of local law until such time as it is terminated within the meaning of §708. This includes real terminations and technical terminations. Thus, for purposes of §401, a technical termination is not disregarded. This rule is repeated in Regs. §1.401-12(e)(2)(i), relating to determining an employee's period of service.

c) Unresolved Items

i. <u>Section 195 Start-Up Costs</u>. The deductibility of start-up costs under §195 is unclear. Section 195(b)(2) states that if a "trade or business is completely disposed of by the taxpayer" the unamortized balance is deductible. So the question is whether a transfer of the assets and liabilities to the deemed new partnership is a "disposition" for this purpose. Also, who is "the taxpayer"? On the surface it would appear that the business has been completely disposed of as the transferee is a deemed new partnership (although it retains the same EIN of the transferor). On the other hand, §708(a) opens with "for purposes of this subchapter," i.e., subchapter K dealing only with partnership; §195 is not a part of subchapter K. As to who is "the taxpayer," §7701(a)(14) defines "taxpayer" as "any person subject to any internal revenue tax." Section 7701(a) defines "person" as including a partnership. Although partnerships are not subject to income taxes, they are subject to other taxes such as employment and excise taxes. Therefore, in connection with a technical termination, the terminated partnership could be "the taxpayer." However, it is not clear because of some the arguments the IRS could make, as discussed below in connection with organizational costs.

ii. <u>Section 709 Organization Costs</u>. As to organizational costs, §709(b)(2) states that "in any case in which a partnership is liquidated," any deferred expenses may be deducted. Regs. §1.709-1(b)(2) states that if there is a "winding up and complete liquidation of the partnership" before the end of the amortization, the unamortized amount is a partnership deduction under §165 in its final year. Does "any case" as used in the Code apply to a technical termination? Unlike a deduction for the remaining balance of amortized start-up costs under §195 that require that a "business" be "completely disposed of," §709(b)(2) requires that the partnership be "liquidated." In connection with a technical termination, the partnership that incurred the organizational costs is terminated, so such costs should be deductible. However, the IRS could argue that the deemed new partnership is merely the old partnership's successor. The IRS ruled in Rev. Rul. 70-241[43] that a corporation could not deduct its unamortized organizational costs under §248 where there was an §368(a)(1)(F) reorganization. Also, the IRS could argue that, because the costs relate to the organization of the partnership, and under local law the partnership

[43] 1970-1 C.B. 84.

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did not terminate, the costs created a benefit that continues for the deemed partnership. Thus, as with start-up costs, it is not clear whether a technical termination results in a deduction for the remaining balance of unamortized organization costs.[44]

iii. Section 709 Syndication Costs. As to syndication costs under §709, such costs would not be deductible in any case, as the Code clearly states that "no deduction" shall be allowed to the partnership or to the partner for syndication costs. For purposes of both the computation of tax basis and the capital account maintenance rules under §704(b), these costs are to be distributed to the partners in accordance with §705(a)(2)(B) and Regs. §1.704-1(b)(2)(iv)(b).

iv. Unamortized Loan Costs. Courts have held that when a mortgage is prepaid or when the property subject to the mortgage is disposed of, the unamortized loan costs are immediately deductible.[45] In Longview Hilton Hotel Co. v. Comr., a deduction was allowed when the corporation was dissolved and the mortgage was assumed by its shareholders.[46] In Rev. Rul. 86-67,[47] the IRS concluded that a taxpayer's death, corporate dissolution and a sale of mortgage property all terminate the use of loan proceeds and mark the time for the deduction of the unamortized loan costs. In citing several cases, including Longview, the IRS said that these cases "are not concerned with the nature of the termination of the taxpayer's liability. Thus, any form of termination of the taxpayer's liability with respect to the related debt should be sufficient to allow deduction of any amortized loan costs." Based on this statement, it appears that loan costs should be deductible by the terminating partnership, although it is not clear that they are.

v. Section 736 Payments to Partners. Section 736 allows partners in certain cases to treat retirement payments as §736(a) payments (generally ordinary income to the partner and deductible by the partnership) or §736(b) payments (generally capital gain to the partner and capitalizable by the partnership). So will the treatment agreed to by the partner and the terminated partnership be recognized by the deemed new partnership? Rev. Rul. 75-154[48] holds that retirement payments being made to a retired partner under §736(a) would continue to be deductible by the deemed new partnership. This ruling was issued under the old technical termination regulations. Thus, one would think that the same conclusion

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[44] If an election has not been made to amortize organization or start-up costs, then the balance of the capitalized costs carry over to the deemed partnership as any other costs. The only deductible costs are those where an election is made.
[45] See S&L Building Corp. v. Comr., 19 B.T.A. 788 (1930) (deduction allowed in year mortgage was assumed by the purchaser of the property). See also Anover Realty Corp. v. Comr., 33 T.C. 671 (1960).
[46] 9 T.C. 180 (1947).
[47] 1986-1 C.B. 2338.
[48] 1975-1 C.B. 186.

would be reached by the IRS under the new regulations, especially because the IRS held in PLR 200812012, mentioned above, that in connection with a like-kind exchange under §1031, the replacement property can be received by the deemed new partnership in a technical termination.

vi. Section 1033 Condemnations. If the condemned property was owned by the terminated partnership, can the replacement be made by the deemed new partnership? Again, one would think that the IRS would allow the deemed new partnership to be treated as a continuation of the terminated partnership for this purpose, especially based on PLR 200812012 dealing with an exchange under §1031. On the other hand, the requirements of §1033 are in some cases much stricter than those in §1031.[49]

vii. Acceleration of deferred income for advance payment for goods and long-term contracts under §451. Regs. §1.451-5(f) provides that acceleration occurs if the taxpayer "ceases to exist in a transaction other than one to which §381(a) applies." Does a technical termination cause the taxpayer to cease to exist? Rev. Proc. 97-27[50] provides rules for changing one's accounting method. Section 7 of Rev. Proc. 97-27 addresses adjustments under §481 required as a result of a change in an accounting method. Under §481, a taxpayer that ceases business must take the balance of a §481 adjustment into income. Section 7.03(3)(b)(v) of Rev. Proc. 97-27 provides examples of transactions treated as cessation of a business, including where "the assets of a trade or business to which the §481(a) adjustment relates are contributed to a partnership." Because the assets of the terminated partnership are deemed contributed to the new partnership, would this trigger the balance of any §481 adjustment?

viii. Section 724 Inventory Characterization. Section 724 provides that if inventory is contributed to a partnership, it remains inventory to the partnership for five years even if, as to the business of the partnership, it is not inventory or property held for sale. Presumably the contribution to the deemed new partnership will not cause the five-year period to start over as there would be no policy reason for extending the taint. However, there is no guidance in §724, nor are there regulations under §724.

ix. Section 1202 – Small Business Stock. Section 1202 provides a partial exclusion for gain from certain "small business stock." One of the requirements for such stock is that the seller generally must be the original holder of the stock. Section 1202(h) provides exceptions for certain tax-free transfers. Paragraph (2) lists transfers by gift, at death, and "from a partnership to a partner." Regs. §1.1202-2(d) provides

[49] For example, in Rev. Rul. 67-25, 1967-1 C.B. 156, the IRS ruled that raw land was not like-kind to a building for purposes of §1033, although these appear to be like-kind under §1031.
[50] 1997-1 C.B. 680.

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additional guidance for transfers in connection with death, divorce, and disability and mental incompetency. There is no guidance on stock contributed to a partnership, which would be the case in connection with a technical termination. This area remains unclear as well.

x. Section 1244. The application of §1244, which provides for ordinary loss treatment on §1244 stock, is unclear. Section 1244 applies only to the individual or partnership to whom the stock is issued by the corporation. Accordingly, Regs. §1.1244-1(b)(2) states that ordinary loss treatment is not available to a partner to whom the stock is distributed by a partnership. Nothing is said in the regulation regarding stock acquired by a partnership from a contribution of the stock by a partner. Therefore, it is unclear whether the deemed new partnership would be entitled to ordinary loss treatment on §1244 stock sold. There is no original cost basis rule for either §1202 or §1045, as there is for the gain deferral for qualified small business stock in §1245(b)(2).

xi. Restart of Depreciation – Methodology in a Short Year. As discussed earlier, there is some uncertainty in how depreciation is to be computed in the year of termination for both the terminated partnership and the deemed new partnership under the various averaging conventions.

D. EXAMPLES

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