PARTNERSHIP TERMINATIONS AND SECTION 1031

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SECTION 708: PARTNERSHIP TERMINATIONS

• Section 708(a) – General continuation rule
  • For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

• Section 708(b)(1) – General termination rule
  • For purposes of subsection (a), a partnership shall be considered as terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

• Section 708(b)(2) provides the operative termination provisions for partnership mergers & divisions.
PARTNERSHIP TERMINATIONS POST-TCJA

• Technical termination rule (former section 708(b)(1)(B)): Partnership terminated if 50% or more of its capital/profits interests were transferred in a 12-month period.
  • Repealed by TCJA.
  • But, no changes to the general termination provision in what is now section 708(b)(1).

• Legislative history (H.R. REP. NO. 115-409 (2017))
  • Concern with taxpayer electivity – the ability of taxpayers “electively to change partnership-level elections and attributes in a way which otherwise would not be permitted” by structuring transactions as terminations.
  • Congress did not intend to change the “present-law rule of section 708(b)(1)(A) [i.e., the current 708(b)(1) termination provision].”
  • Repeal of technical termination rule was a revenue raiser.
HISTORY BEHIND SECTION 708

- Case law had long concluded that the fact that a partnership had terminated under state law did not mean that the partnership had also terminated for federal tax purposes.
  - Guaranty Trust Co. v. Comm'r (1938): Death of partner in 2-person partnership caused partnership to dissolve under state law. Partnership did not terminate under federal law; tax year for surviving partner continued.
  - Similar authorities in connection with withdrawal or retirement of a partner.
- Rev. Rul. 144 (1953) – “Ordinarily, a partnership will be treated as continuing where the business of the partnership, or a substantial portion thereof, is continued.”
  - Affirmed prior state law authorities -- “A change in the membership of a partnership resulting from the death, withdrawal, substitution, or addition of a partner, or a shift of interest among exiting partners does not, in itself, effect a termination of a partnership for Federal income tax purposes.”

- Section 708 was enacted in 1954.
  - Statutory language mirrored IRS’s conclusion in Rev. Rul. 144.
OTHER TERMINATION AUTHORITIES

- How much activity is required to be a continuing partnership?
  - Partnership continues during its wind-up period; terminates on final dissolution of assets. Yagoda v. Comm’r (T.C. 1960); Skaggs v. Comm’r (T.C. 1980).
    - But, LaRue v. Comm’r (T.C. 1988): Holding that partnership had no business or assets, even though it was defending a lawsuit, had not formally dissolved, and could not dissolve without lender's consent.

- Transfer of assets can result in continuation, where assets are used to conduct the same business as prior partnership.
  - Neubecker v. Comm’r (T.C. 1975): 3-partner law practice dissolved under state law. 2 of the partners formed a new partnership, and took clients & cases with them. Interruption of business as new partnership switched offices was not a complete cessation of the old partnership’s business. New partnership treated as a continuation of the old.
  - Rev. Rul. 66-284, discussing same facts as Neubecker.
INTERPRETING SECTION 708(B)(1)

• Does the statute include an overlap/historic partner requirement?
  • “[A] partnership shall be considered as terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners [i.e., historic partners] in a partnership.”
  • “[A] partnership shall be considered as terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership [i.e., whether historic partners or new partners in the continuing partnership].”
    • The “any of its partners” condition is satisfied in every situation where the business continues to be operated in partnership form.

• What if the buyer partnership is newly formed (v. old and cold)?

• What if the selling/target partnership liquidates (v. liquidates v. holds assets and/or continues a business)?
EXAMPLE 1: A & B TRANSFER AB PARTNERSHIP INTERESTS TO C & D

- A & B each sell their AB Partnership interests to C and D. Post-transaction, C and D wholly own former AB Partnership.
- Does AB Partnership (in the hands of C & D) continue for tax purposes?
  - Does the lack of any overlap among the partners matter?
- Unlikely to implicate 1031 (unless partners have elected out of sub K pursuant to 761(a)).
  - Under 1031(e), partnership interest transfers would be treated as transfers of pro rata share of underlying assets.
EXAMPLE 2A: A & B TRANSFER AB PARTNERSHIP INTERESTS TO CD PARTNERSHIP

- A & B each sell their AB Partnership interests to newly formed CD Partnership, in exchange for Property Y.
- The transaction seems like it could qualify as a deemed asset purchase under Rev. Rul. 99-6 (Situation 2).
  - But, 99-6 does not apply if unless AB Partnership terminates.
- Is CD Partnership a continuation of AB Partnership for tax purposes?
  - What if CD Partnership was ACD Partnership (and A was a 1% owner)?
  - What if CD Partnership were old & cold?
EXAMPLE 2B: A & B TRANSFER AB PARTNERSHIP INTERESTS TO CD PARTNERSHIP; 1031 EXCHANGE

- A & B each sell their AB Partnership interests to old & cold CD Partnership, in exchange for Property Y. The transaction is intended to qualify as a deemed asset purchase under Rev. Rul. 99-6 (Situation 2) and a 1031 exchange to CD Partnership.
  - But, 99-6 does not apply unless AB Partnership terminates.
  - Failure to qualify as a deemed asset purchase under Rev. Rul. 99-6 (Situation 2) would bust 1031 treatment.
  - CD Partnership is old & cold so can satisfy the qualified use requirement.
  - CD Partnership would have received partnership interests (rather than Property X) as replacement property in exchange for Property Y.
  - Outside of merger rules, likelihood of re-characterizing an old and cold partnership as a continuation of another partnership seems low.
EXAMPLE 3A: AB PARTNERSHIP TRANSFERS ASSETS TO CD PARTNERSHIP

- AB Partnership sells Property X to newly formed CD Partnership in exchange for Property Y.
  - *Stephen/Brad: Are there situations where a newly formed entity can be used to effect a 1031 exchange? The questions re: continuation treatment are more likely to arise when an entity is newly formed.*

- CD Partnership could be viewed as a continuation of AB Partnership if 708 does not require overlap among the partners.
EXAMPLE 3B: AB PARTNERSHIP TRANSFERS ASSETS TO CD PARTNERSHIP; QI INVOLVED

- [Brad to flesh out]
THE 5 KEY PRINCIPLES FOR PARTNERSHIP EXCHANGES

1. The same taxpayer that starts a 1031 Exchange must complete the 1031 Exchange.

2. Both the “relinquished” property and the “replacement” property must be “held for productive use in a trade or business or for investment.” (the “Held For Test”)

3. § 1031(a) excludes 1031 Exchanges involving partnership interests. [TIC interests?]

4. “Substance over Form” and Court Holding doctrines apply.

5. Assignment of income (Mitchell and Pau - California cases)
THE 4 TYPICAL FACT PATTERNS

1. Partnership distributes relinquished property to partner, who immediately sells and does a 1031 Exchange.

2. Partnership does a 1031 Exchange, and immediately distributes replacement property to partner.

3. Partner contributes relinquished property to partnership, which immediately sells and does a 1031 Exchange.

4. Partner does 1031 Exchange, and immediately contributes replacement property to partnership.
EXAMPLE 1

- A, an individual, purchases Parcel 1 for $1,000,000 in a 1031 exchange.
- Partner A wishes to take on Partner B who will contribute $250,000 cash for Cap X immediately after the exchange.
SCENARIO 1

• A is an Individual
• As an individual A went from a sole proprietorship to a partnership for tax purposes upon the admission of B. This contribution is proximate to the exchange.

Did A satisfy the “qualified use” requirement?
KEY AUTHORITIES

• **Magneson v. Commissioner, 753 F. 2d 1490 (9th Cir. 1985)**
  Partner level exchange followed by contribution to a partnership. Exchange respected.

• **Bolker v. Commissioner, 760 F. 2d 1039 (9th Cir. 1985)**
  Relinquished property distributed by liquidating corporation to Taxpayer, followed by an exchange by the Taxpayer. Exchange respected.
IRS RULINGS

• Rev. Rul. 77-297 – Taxpayer A agreed to sell ranch to Taxpayer B. Taxpayer A found replacement property. Taxpayer B purchased the replacement property and exchanged it with Taxpayer A. Exchange respected for Taxpayer A but not respected for Taxpayer B, since Taxpayer B did not hold the property in a trade or business.

• Rev. Rul. 84-121- Taxpayer B had Option to acquire land from Taxpayer A. Taxpayer B exercised and paid by transferring separate real estate, acquired solely for the exchange. Exchange respected for Taxpayer A but not respected for Taxpayer B, because the property B acquired before the exchange was not used in his trade or business.
CALIFORNIA CASES

• Appeal of Pau (California Office of Tax Appeals)- Sale negotiated by partnership. Property distributed to partners to do a 1031 exchange on the day of sale. Exchange not respected.

• Appeal of Mitchell (California Office of Tax Appeals) – Shortly before sale of property, partnership distributed TIC interests in property to Taxpayers. Taxpayers exchanged their TIC interests. Very similar facts to Pau. However, exchange respected. The Office of Tax Appeals the partners had discussed for years the possibility of doing a sale that allowed some partners to do a 1031 exchange. The Court noted that a drop and swap was the only method of achieving this goal.

• In Re Rago (California Board of Equalization)- Acquisition of TIC interests followed by contribution to corporation as required by loan documents. Exchange respected.
**GAGNE v. GAGNE**

- Colorado Court of appeals decision in 2019
  - Non tax case but court ordered dissolution of LLC and mandated that the parties do 1031 exchanges to separate so that each of mother and son owned an entire property.
  - Will a court ordered dissolution impact the “qualified use” requirement?
CHASE v. COMMISSIONER, 92 TC 874 (1989)

- Partnership claimed to have distributed an interest in property to a partner and sold the property. Partner sought to treat the sale of his interest as a 1031 exchange.
  - Exchange not respected
    - Partnership never liquidated
    - Only the general partner took a TIC; but stayed in the partnership
    - Partnership agreement didn’t allow distribution
    - Partnership didn’t report the transaction as a drop of a TIC
    - Books and records did not reflect the TIC
    - Profits shared under partnership agreement even after TIC was created
SCENARIO 1 (CONT.)

- What if B became a partner after the sale of the relinquished property but before the acquisition of Parcel 1 – (i.e., while A’s proceeds are still in the QI account)?

- Did this violate the “same taxpayer” requirement?
SCENARIO 2

• A is a single member disregarded LLC

• Upon admission of B, A is no longer a single member disregarded LLC – thus a deemed partnership formation.

• Qualified use requirement?

• Same taxpayer requirement?
SCENARIO 3

• A is an existing partnership with partners B, C, & D.
  • A issues a 20% interest to E for cash
  • Does this have any impact on the exchange?

• What if A distributes the cash to member B (within 2 years of E’s admission?)
  • Is this a disguised sale under IRC section 707(a)(2)(B).
  • Does this distribution have any impact on the exchange?
SCENARIO 4

• Partner E contributes $1.1 million cash to ABCD partnership
• Partner E thus acquires a 52% partnership interest after Parcel 1 is sold and while the proceeds from its sale are in a QI account.
  • Does this cause a deemed partnership termination?
  • Same taxpayer requirement?
  • What if the cash E contributed is distributed to the other partners 6 months later?

• Is the result different if instead Partner E purchases a 52% interest in ABCD from the other partners?
SCENARIO 5

• Facts are same as in Scenario 4 except E objects to investing in ABCD partnership since it might have residual liability from prior transactions. Consequently, immediately prior to the admission of E to ABCD, ABCD is converted to an LLC and each of A, B, C, & D contribute there interests in ABCD to Newco LLC. E invests in Newco. ABCD LLC is not dissolved, but rather is maintained as a wholly owned subsidiary of Newco LLC.

• Does it matter if the foregoing occurs before, during or after the sale of Parcel 1 but before the purchase (or identification of a replacement property)?
TCJA ‘17

• Pre TCJA partnership would terminate under §708 if within a 12-month period there is a sale or exchange of a 50% or greater interest in partnership capital or profits.

• Technical partnership terminations repealed under TCJA ‘17
**SCENARIO 6**

- **Sale by individuals ABC&D of all of their interest in partnership ABCD to E for cash.**
  - Can individuals ABC&D deposit their proceeds with a QI and exchange?
    - See Rev. Rul. 99-6 (deemed sale of all interests by partners, deemed purchase of property under purchaser)

- **Sale by partnership ABCD of Parcel 1 to E for all cash.**
  - Good exchange but apparently the partners must stay together.

  - Partnership will still terminate under section 708(b) if “no part of *any* business, financial operation, or venture of the partnership continues to be carried on . . . .”

  - Could the sale of Parcel 1, even if proceeds are reinvested in Parcel 2, cause a partnership termination? Is a 1031 exchange a continuation of the business activities of the partnership?
EXAMPLE 2

• Assume ABC is a regarded partnership that in a single section 1031 exchange recently purchased parcels 1, 2 and 3;

• ABC wishes to admit D who will contribute $250,000 for Cap X on Parcel 1. ABC does not wish to give D any interest in parcel’s 2 and 3. D does not wish to be exposed to the liabilities of Parcels 2 and 3.

• Can D be admitted solely with respect to Parcel 1?

• Can ABC spin off Parcel 1 into a separate partnership after the acquisition of parcel 1?

EXAMPLE 3

• ABCD partnership sells Parcel 1 for $1,000,000. ABCD plans to purchase Parcel 2 for $3,000,000 by reinvesting $750,000 of the $1,000,000 proceeds from the sale of Parcel 1, incurring a new $2,250,000 nonrecourse mortgage on Parcel 2. Assume ABCD partnership has a zero basis in Parcel 1. Upon the sale of Parcel 1, partner D wishes to cash out her 25% interest for $250,000. Solely after ABCD is ready to commit to purchase Parcel 2, E commits to acquire a 20% partnership interest in exchange for a cash contribution of $250,000. E’s cash contribution will be retained by the partnership.
• The $250,000 cash paid to D will result in $250,000 of gain to the partnership (assuming zero basis in Parcel 1).

• Can that gain be specially allocated to D?

• Will the allocation be regarded as having "substantial economic effect"?

• Is there a different result if there was a prior book up of partnership assets under Treas. Reg. 1.704(b)(2)(iv)(f).

• Can the transaction be reclassified as a sale of a partnership interest by D to the new investor?

• Can partners ABC purchase partner D’s interest and then resell it to the new investor?

• Can a TIC interest be distributed to D who can sell for cash? If a new investor replaces D’s capital in the new deal, will the form be respected?

• What can you do if E won’t invest in an existing entity that has a history of potential creditor and/or environmental claims?
EXAMPLE 4

- ABC LLC owns Property 1 with an adjusted tax basis of $500,000, a FMV of $2,000,000 and is subject to a mortgage of $1,000,000.

- ABC LLC sells Property 1 on 12/31/19 for $2,000,000 and deposits $1,000,000 with a QI. The mortgage is paid off with the remaining $1,000,000 of proceeds of the sale.

- ABC LLC purchases Property 2 on 3/15/20 as its replacement property for $2,500,000 ($1,000,000 cash from the QI and a mortgage of $1,500,000).

- A, the managing member, is required to sign a typical “bad boy” carveout guarantee.
EXAMPLE 4 (CONT.)

• Does the Bad Boy guarantee by A cause any tax consequences to the LLC or its members?

• What if A’s guarantee is not limited to the “Bad Boy” acts?

• If the purchase of the replacement property falls through, so that no exchange is consummated, in what year is the gain recognized?
EXAMPLE 5

• Assume TP owns an oil pipeline (treated as real property) with an adjusted basis of $2,000,000. TP enters into a JV agreement with oil producer X pursuant to which TP contributes the pipeline, valued at $10,000,000, to the JV, and X contributes cash of $6,000,000 which is immediately distributed to TP. As a result, TP owns a 40% JV interest and X owns a 60% JV interest. How is this transaction treated for TP? Can TP structure the transaction as a 1031 exchange?

• Can TP still structure the transaction as a 1031 exchange if instead X contributes only $4,000,000 to JV, which is distributed to TP, resulting in TP owning a 60% interest in JV going forward? Any related party concerns? See PLR 200709036.
Goals:
1. Transfer Relinquished Property as part of 1031 exchange
2. Divide JV, by creating New JV to hold replacement property
3. Add new investors in Replacement Property JV
4. Hold Replacement Property and Retained Property in separate JVs
STEP 1: RELINQUISHED SPE ENTERS INTO EXCHANGE AGREEMENT

QI

Exchange Documents

Relinquished SPE LLC

Relinquished Property

JV LLC
EIN: OLD

GP

Investors

Retained SPE LLC

Retained Property
STEP 2: RELINQUISHED SPE LLC TRANSFERS RELINQUISHED PROPERTY

- **GP**
- **Investors**
- **JV LLC EIN: OLD**
- **Retained SPE LLC**
- **Retained Property**
- **Relinquished SPE LLC**
- **Relinquished Property**
- **QI**
- **Buyer**

The image illustrates the flow of property and transactions involving the Relinquished SPE LLC, the Relinquished property, QI, and other entities.
MISDIRECTION DIVISION:
ENTITY GOES ONE DIRECTION UNDER STATE LAW, OTHER DIRECTION UNDER TAX LAW

Benefits:
1. Don’t have to negotiate loan on Retained Property—stays with JV
2. EIN stays with exchanging entity—"vesting rule"
DIVISION BASICS

- **Dividing Partnership** retains EIN
- **Continuing Partnership**
  - Partners owned at least 50% of prior partnership
- Tax follows form if
  - Continuing partnership distributes property
  - Form is
    - **Assets-up**
      - Distribute property to members
      - Members contribute to new entity
    - **Assets-over**
      - Contribution property to new entity
      - Distribute interests in new entity to members
  - Dividing partnership is entity that actually distributes, if more than one continuing partnerships
ADVANCED DIVISION BASICS

• Disregard form if
  • Neither assets-up nor assets-over
  • More than one continuing partnership
• Dividing Partnership is entity that has assets of greatest value
• Misdirection Division
  • Unrecognized form
    • Interests-over
      • Members contribute some interests in JV LLC to new entity
      • JV distributes Relinquished SPE LLC to new entity in redemption of all interests in JV LLC
  • Default form
    • Assets-over
      • Dividing partnership deemed to
        • Contribute assets to new entity
        • Distribution interests in new entity to members
STEP 3: JV LLC SPINS OFF RELINQUISHED SPE LLC: STRUCTURE AS INTERESTS-OVER, SO TAKES ASSETS-OVER

New JV LLC  
EIN: OLD

i. X% of JV LLC Interests

ii. Relinquished SPE LLC

QI  
$$

GP

Investors

New JV LLC is the Divided Partnership

JV LLC  
EIN: NEW

Retained SPE LLC

Retained Property
STEP 4: ID REPLACEMENT
PROPERTY

QI

$\$

ID

New JV LLC
EIN: OLD

Relinquished
SPE LLC

Exchange Rights

Retained SPE LLC

Retained Property

JV LLC
EIN: NEW

Retained SPE LLC

EIN: NEW

GP

Investors
STEP 5: FORM REPLACEMENT SPE, ADMIT NEW INVESTORS, AND ACQUIRE REPLACEMENT PROPERTY

- **i.** QI
  - Seller
  - Replacement Property
  - $$

- **ii.** New Investors
  - New JV LLC
  - EIN: OLD
  - $$

- **iii.** Replacement SPE LLC
  - Relinquished SPE LLC
  - $$

- **GP**

- **Investors**
  - JV LLC
    - EIN: NEW
  - Retained SPE LLC
  - Retained Property
STRUCTURE FOLLOWING EXCHANGE AND DIVISION

New Investors

New JV LLC EIN: OLD

Replacement SPE LLC

Replacement Property

GP

Investors

JV LLC EIN: NEW

Retained SPE LLC

Retained Property

Relinquished SPE LLC

Replacement Property

Retained Property

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THANK YOU!