

Notice of Proposed Rulemaking and Notice of Public Hearing

Termination of a Partnership under Section 708(b)(1)(B)

PS-5-96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the termination of a partnership upon the sale or exchange of 50 percent or more of the total interest in partnership capital and profits. The proposed regulations affect all partners and partnerships that terminate under section 708(b)(1)(B).

DATES: Written comments and requests to speak (with outlines of oral comments) at a public hearing scheduled for September 5, 1996, must be received by August 15, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (PS-5-96), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (PS-5-96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. The public hearing will be held in the IRS Auditorium, Seventh Floor, 7400 Corridor, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Steven R. Schneider, (202) 622-3060; concerning submissions and the hearing, Christina Vasquez, (202) 622-7190; (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Introduction

This document proposes to revise §1.708-1(b)(1)(iv) of the Income Tax

Regulations (26 CFR Part 1) under section 708(b)(1)(B) of the Internal Revenue Code (Code). This document also proposes revisions to other sections of the Income Tax Regulations to reflect the proposed revision to §1.708-1(b)(1)(iv).

Background

Section 708(b)(1)(B) provides that, for purposes of section 708(a), a partnership shall be considered terminated if within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. The Code and the legislative history to section 708(b)(1)(B) do not specify the tax consequences of that termination or the steps by which such a termination occurs.

However, §1.708-1(b)(1)(iv) of the Income Tax Regulations provides that, if a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: the partnership distributes its properties to the purchaser and the other remaining partners in proportion to their respective interests in the partnership properties; and, immediately thereafter, the purchaser and the other remaining partners contribute the properties to a new partnership, either for the continuation of the business or for its dissolution and winding up.

The distribution of property that is deemed to occur upon a termination under section 708(b)(1)(B) is treated like an actual distribution for federal tax purposes. As a result, a continuing partner may recognize gain under section 731(a) if the amount of money deemed distributed to the partner (including any money deemed distributed upon a shift in liabilities under section 752) exceeds the partner's basis in the partnership interest. In addition, the distribution may affect the basis of the partnership's assets because the basis of the distributed property in the hands of the partners (and thus in the hands of the reconstituted partnership) is determined under section 732(b) by reference to the partners' bases in their partnership interests. Another possible consequence of the deemed distribution is a change in the holding periods of the partners' interests in the partnership.

The deemed distribution of partnership property that occurs on a termination raises particular concerns with respect to the interaction of sections 708(b)(1)(B), 704(c), and 737. Section 704(c)(1)(A) requires that gain or loss with respect to property contributed to a partnership by a partner be shared among the partners so as to take into account any built-in gain or loss in the property at the time of the contribution. Section 704(c)(1)(B) provides that, if property contributed by a partner is distributed to another partner within five years, the contributing partner must recognize gain or loss in an amount equal to the gain or loss the partner would have been allocated under section 704(c)(1)(A) on a sale of the property by the partnership. Section 737 provides that, if property is distributed to a partner that had contributed other property to the partnership within five years, the distributee partner must recognize gain equal to the lesser of (i) the net precontribution gain on property contributed by the partner, or (ii) the excess of the value of the distributed property over the adjusted basis of the partner's interest in the partnership. Net precontribution gain is the net gain, if any, that would have been recognized by the distributee partner under section 704(c)(1)(B) if all partnership property contributed by the distributee partner within five years of the distribution had been distributed to another partner.

The legislative history of sections 704(c)(1)(B) and 737 indicates that Congress intended these sections to be coordinated with the rules governing partnership terminations under section 708(b)(1)(B). The legislative history states that such coordination will provide that (1) no gain is recognized under sections 704(c)(1)(B) and 737 as a result of a deemed distribution on termination; (2) the deemed distribution will not change the application of the sharing requirements of section 704(c) to precontribution gain or loss with respect to property contributed to the partnership before the termination; and (3) the constructive contribution of partnership property to a new partnership is treated as beginning a new five-year period for all contributed property to the extent that the pre-termination appreciation in the value of property was not already required to be

allocated to the original contributor (if any) of the property. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1355 (1989); H.R. Conf. Rep. No. 1018, 102d Cong., 2d Sess. 428 (1992). These results are difficult to integrate with the current regulations under section 708(b)(1)(B). The difficulty arises primarily because the section 708(b)(1)(B) regulations provide for a pro rata distribution of property to the partners, while the legislative history seems to contemplate that partnership property previously contributed to the partnership by a partner will be distributed to that partner, at least to the extent of the remaining built-in gain or loss in the property.

The IRS and Treasury Department recently issued final regulations under sections 704(c)(1)(B) and 737. Commentators, however, noted that the approach taken in the legislative history and the final regulations would not be required if the section 708(b)(1)(B) regulations did not create a deemed distribution of partnership property to the partners as part of a section 708(b)(1)(B) termination. The preamble to the final regulations indicated that the IRS and Treasury would consider issuing separate guidance on the interaction of sections 704(c) and 708(b)(1)(B) and invited additional comments and suggestions regarding the project.

Explanation of Provisions

The proposed regulations under section 708(b)(1)(B) provide that, if a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: the partnership transfers all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in liquidation of the terminated partnership, either for the continuation of the business or for its dissolution and winding up.

Under the proposed regulations, a termination under section 708(b)(1)(B) will no longer result in a deemed distribution of the terminated partnership's assets to the purchasing and remaining partners. As a result, the federal tax consequences of a termination that result from the deemed distribution of assets will no longer

occur on a section 708(b)(1)(B) termination. Such consequences include the possibility of gain under section 731(a), a change in the partnership's basis in partnership property, and the commencement of a new five-year period for purposes of sections 704(c)(1)(B) and 737. In addition, the interaction between section 704(c) and section 708(b)(1)(B) is greatly simplified under the proposed regulation. The section 704(c) property held by the terminated partnership (and deemed contributed to a new partnership) will continue to be treated as section 704(c) property in the hands of the new partnership under §1.704-3(a)(9). A distribution of property by the new partnership will have the same effect for purposes of section 704(c)(1)(B) and section 737 as a distribution from the terminated partnership. See §§1.704-4(c)(4) and 1.737-2(b)(1) as proposed to be amended by this document.

The proposed regulations do not change the federal tax consequences of a termination under section 708(b)(1)(B) to the extent that the consequences were not dependent on the deemed distribution. Such consequences will continue under the proposed regulations. For example, the tax year of the terminated partnership will still close as a result of the termination, the elections of the terminated partnership will be invalidated, and a termination will continue to be treated as a liquidation under the section 704(b) regulations.

In addition, the proposed regulations will not change the effect of a termination on the depreciation of partnership property by the new partnership. Property deemed contributed to the new partnership will continue to be subject to the anti-churning provisions of section 168(f)(5), which generally require the new partnership to depreciate the property as if it were newly-acquired property under the same depreciation system used by the terminated partnership. This result is required by statute and is not affected by the specific mechanics of a termination under section 708(b)(1)(B). See Code sections 168(f)(5); 168(i)(7); 168(e)(4) and (f)(10) (repealed 1986).

This document also contains proposed regulations under sections 704(b), 704(c)(1)(B), 743(b), 737, and 761(e). These proposed regulations relate to the elimination of a deemed distribution of partnership assets as part

of a section 708(b)(1)(B) termination. The proposed regulations under section 704(b) will eliminate the reference to a deemed contribution of partnership property by the partners of the continuing partnership. The proposed regulations under sections 704(c)(1)(B) and 737 provide that a termination under section 708(b)(1)(B) does not commence a new five-year period for partnership property and that a distribution of property by the new partnership will be treated in the same manner as a distribution by the terminated partnership would have been treated. Although the legislative history suggests the beginning of a new five year period for built in gain or loss in the property deemed contributed to the new partnership, that legislative history was commenting on a deemed contribution of property by the partners to the new partnership, as then required by the section 708 regulations. Under the approach proposed in this regulation, a new five year period is no longer appropriate.

The proposed regulations under section 743(b) provide that any special basis adjustment a partner has in assets of the terminated partnership as a result of a section 754 election will carry over to the new partnership. The proposed regulations under section 761(e) provide that the distribution of interests in the new partnership by the terminated partnership is not treated as a sale or exchange of the interests in the new partnership. This provision is necessary to prevent the distribution of interests in the new partnership from causing a termination of the new partnership.

Proposed Effective Date

This section is proposed to apply to terminations of partnerships under section 708(b)(1)(B) occurring on or after the date on which these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory

Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 5, 1996, at 10 a.m. in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by August 15, 1996, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by August 15, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Steven R. Schneider of the Office of Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART I—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805. * * *

Section 1.704-4 also issued under 26 U.S.C. 704(c). * * *

Par. 2. Section 1.704-1 is amended as follows:

1. Paragraph (b)(2)(iv)(l) is amended by removing the fourth sentence.

2. Paragraph (b)(5) *Example 13(v)* is amended by removing sentences five to the end and adding five new sentences in their place.

The revisions and addition read as follows:

§1.704-1 Partner's distributive share.

* * * * *

(b) * * *

(5) * * *

Example 13. * * *

(v) * * * In accordance with paragraph (b)(2)(iv)(e) of this section, the partnership agreement provides that the partners' capital accounts are adjusted to reflect how unrealized taxable gain would have been allocated if the property distributed to the partners in liquidation of the partnership (i.e., the interest in the new partnership constructively received by the terminated partnership under §1.708-1(b)(1)(iv)) had been sold for its fair market value of \$40,000. Accordingly, the \$18,000 of unrealized gain (\$40,000 less \$22,000 adjusted tax basis) is credited to the partners' capital accounts as follows:

	Z	LK
Capital account following sale	\$11,000	\$11,000
Deemed sale adjustment....	9,000	9,000
Capital account before constructive liquidation.....	\$20,000	\$20,000

Constructive liquidating distributions of the interests in the new partnership are made with reference to its \$40,000 fair market value. Under section 732(b), the adjusted tax basis of the 50 percent interest in the new partnership constructively distributed to Z is equal to the \$11,000 adjusted tax basis of Z's partnership interest before the constructive liquidation, and the adjusted tax basis of the 50 percent interest in the new partnership constructively distributed to LK is equal to the \$20,000 adjusted tax basis of LK's partnership interest before the constructive liquidation. Under paragraph (b)(2)(iv)(d) of this section, the capital account of the terminated partnership with respect to the

new partnership would be \$40,000 (i.e., the fair market value of the property constructively contributed to the new partnership by the terminated partnership). The capital accounts of Z and LK with respect to the constructively distributed interests in the new partnership are stated at \$20,000 (i.e., one-half of the \$40,000 capital account of the terminated partnership). This *Example 13(v)* applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after the date on which these regulations are published as final regulations in the **Federal Register**.

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Par. 3. Section 1.704-4 is amended by revising paragraphs (a)(4)(ii) and (c)(3) to read as follows:

§1.704-4 Distribution of contributed property.

(a) * * *

(4) * * *

(ii) *Section 708(b)(1)(B) terminations.* A termination of the partnership under section 708(b)(1)(B) does not begin a new five-year period for each partner with respect to the built-in gain and built-in loss property that the terminated partnership is deemed to contribute to a new partnership following the termination. See §1.704-3(a)-(3)(ii) for the definitions of built-in gain and built-in loss on section 704(c) property. This paragraph (a)(4)(ii) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after the date on which these regulations are published as final regulations in the **Federal Register**.

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(c) * * *

(3) *Section 708(b)(1)(B) terminations.* Section 704(c)(1)(B) and this section do not apply to a deemed distribution of interests in a new partnership caused by a termination of a partnership under section 708(b)-(1)(B). A subsequent distribution of section 704(c) property by the new partnership to a partner of the new partnership is subject to section 704(c)(1)(B) to the same extent that a distribution by the terminated partnership would have been subject to section 704(c)(1)(B). See also §1.737-2(a) for a similar rule in the context of section 737. This paragraph (c)(3) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after the date on which these

regulations are published as final regulations in the **Federal Register**.

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Par. 4. In §1.708-1, paragraph (b)(1)(iv) is amended by removing the first sentence and adding two new sentences in its place to read as follows:

§1.708-1 Continuation of Partnership.

* * * * *

(b) * * *

(1) * * *

(iv) If a partnership is terminated by a sale or exchange of an interest, the following is deemed to occur: The partnership transfers all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter, the terminated partnership distributes an interest in the new partnership to the purchasing partner and the other remaining partners in liquidation of the terminated partnership, either for the continuation of the business of the new partnership or for its dissolution and winding up. The first sentence of this paragraph (b)(1)(iv) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after the date on which these regulations are published as final regulations in the **Federal Register**.

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Par. 5. Section 1.743-1 is amended by adding paragraph (d) as follows:

§1.743-1 Optional adjustment to basis of partnership property.

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(d) *Section 708(b)(1)(B) terminations.* A partner with a special basis

adjustment in property held by a partnership that terminates under section 708(b)(1)(B) will continue to have the same special basis adjustment with respect to property contributed by the terminated partnership to the new partnership under §1.708-1(b)(1)(iv). This paragraph (d) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after the date on which these regulations are published as final regulations in the **Federal Register**.

Par. 6. In §1.737-2, paragraph (a) is revised to read as follows:

§1.737-2 Exceptions and special rules.

(a) *Section 708(b)(1)(B) terminations.* Section 737 and this section do not apply to a deemed distribution of interests in a new partnership caused by a termination of a partnership under section 708(b)(1)(B). A subsequent distribution of section 704(c) property by the new partnership to a partner of the new partnership is subject to section 737 to the same extent that a distribution by the terminated partnership would have been subject to section 737. See also §1.704-4(c)(3) for a similar rule in the context of section 704(c)(1)(B). This paragraph (a) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after the date on which these regulations are published as final regulations in the **Federal Register**.

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Par 7. In §1.761-1, paragraph (e) is added to read as follows:

§1.761-1 Terms defined.

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(e) *Distribution of partnership inter-*

est. For purposes of section 708(b)(1)(B) and §1.708-1(b)(1)(iv), the distribution of an interest in a new partnership by a partnership that terminates under section 708(b)(1)(B) is not a sale or exchange of an interest in the new partnership. This paragraph (e) applies to terminations of partnerships under section 708(b)(1)(B) occurring on or after the date on which these regulations are published as final regulations in the **Federal Register**.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on May 9, 1996, 8:45 a.m., and published in the issue of the Federal Register for May 13, 1996, 61 F.R. 21985)