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Decoding the Tax Cuts and Jobs Act – Part III: IRC § 708 and the Partnership Termination Rules Have Changed

By Larry Brant and Steven Nofziger on 1.22.18 | Posted in Legislation, Partnership Tax, Tax Laws, Tax Planning, Tax Procedure

BACKGROUND/PRIOR LAW

Under IRC § 708(a), a partnership is considered as a continuing entity for income tax purposes unless it is terminated. Given the proliferation of state law entities taxed as partnerships today (e.g., limited liability companies and limited liability partnerships), a good understanding of the rules surrounding termination is ever important.

Prior to the Tax Cuts and Jobs Act ("TCJA"), IRC § 708(b)(1) provided that a partnership [1] was considered terminated if:

1. No part of any business, financial operation, or venture of the partnership continues to be carried on by any of the partners of the partnership; or

2. Within any 12-month period, there is a sale of exchange of 50% or more of the total interests of the partnership's capital and profits.

Special termination rules set forth in IRC § 708(b)(2)(A) apply in the case of a merger or consolidation of partnerships (e.g., two or more partnerships combine into one partnership). Additionally, special termination rules contained in IRC § 708(b)(2)(B) apply when there is a division of a partnership (e.g., a partnership divides into two or more partnerships).

The termination described above in paragraph 2 is commonly called a "technical termination." The tax impact of a technical termination may be unwanted and/or unexpected. As a consequence, caution around technical terminations was always necessary.

Under Treasury Regulation § 1.708-1(b)(4), a technical termination resulted in:

- A deemed contribution of all of the partnership's assets and liabilities to a new partnership in exchange for interests in the new partnership, followed by

- A deemed distribution of the interests in the new partnership to the purchasing partners and the other remaining partners in proportion to their respective interests in the terminated partnership.

Many transactions involving the direct or indirect sale or exchange of partnership interests, including disguised sales, could lead to a technical termination of the partnership. Transfers of partnership interests by gift or devise were ignored for purposes of determining if a technical termination occurred. Additionally, in the case where a partnership interest was sold by a partner to another partner, followed by a sale of the same partnership interest to a third party, the transfer was only counted once. After the deemed contribution of interests to a new partnership and the deemed distribution of interests in the new partnership, the partnership's tax year closed on the date of the sale or exchange creating the termination. The partnership, however, continued as a legal entity. In fact, it was able to continue using the same Employer Identification Number as it used prior to the termination. That does not sound so scary!

Unfortunately, the results of a technical termination could be disastrous if they were not anticipated. The results included:

1. Tax Return Reporting. A partnership that underwent a technical termination had to file two short-year tax returns – one for the year ended on the date of the termination and one for the year ended on the normal end of the tax year. Failure to file a partnership tax return can lead to penalties under the Code, including IRC §§ 6698 and 6722. Consequently, proper tax reporting was important.

2. Distortion of Income. A partnership that underwent a technical termination often created a bunching of income for its partners when the partners had different tax years than the partnership. This likely resulted in disgruntled partners.

3. Tax Elections. In general, tax elections of a partnership ended on the date of a technical termination. So, unless the new partnership made new elections, the old elections ceased to apply.

These elections included, but were not limited to:

A. The method used to compute depreciation with respect to partnership property.

B. The choice of inventory method.

C. The election to reinvest condemnation proceeds in qualifying property and thereby avoid the recognition of gain on condemnations pursuant to IRC § 1033.

D. The election to expense certain depreciable assets under IRC § 179.

E. The election not to report gain under the IRC § 453 installment method.

F. The election to capitalize organizational expenses under IRC § 709(b).

G. The IRC § 754 election to adjust the basis of partnership assets upon the transfer of a partnership interest or upon certain distributions from the partnership.

H. The IRC § 1042 election to purchase qualified replacement property following a sale of stock to an employee stock ownership plan.

I. The election under Treasury Regulation § 1.1363-2(e) to adjust the basis of partnership assets for the last-in, first-out (LIFO) recapture amount triggered upon the conversion of a C corporation to an S corporation or upon a tax-free transfer of a partnership interest from a C corporation to an S corporation.

4. Additional Unexpected Tax Results. Lots of unexpected tax implications could follow a technical termination, including but not limited to:

A. The basis in the assets of the terminated partnership carried over to the new partnership, but the depreciation time clock reset, likely resulting in a pass through of a lower annual depreciation deduction to the partners going forward.

B. A partner with a negative capital account may have been faced with unanticipated taxable income upon the termination and possibly an underpayment of estimated taxes.

TAX CUTS AND JOBS ACT

As part of the House Bill, lawmakers sought to modify IRC § 708(b)(1) by eliminating subsection (B) and the possibility of a technical termination when there is, within any 12-month period, a sale of exchange of 50% or more of the total interests in the partnership's capital and profits. The Senate Bill contained no similar provision. The Conference Agreement, however, followed the House Bill with respect to this provision. Consequently, this provision was part of the TCJA signed by President Trump on December 22, 2017. It is effective for all taxable years beginning after 2017.

The repeal of the technical termination rule set forth in IRC § 708(b)(1)(B) is a welcome change. It simplifies some of the tax planning for sales and exchanges of partnership interests. Also, it eliminates one of the numerous tax traps that existed in Subchapter K for the unwary.

All that said, tax practitioners need to be aware that subsection (A) of IRC § 708(b)(1) still exists. Consequently, the termination of an entity taxed as a partnership will still occur when the business, financial operation or venture of the entity ceases to be carried on by any of the

partners.

Stay tuned! We will continue reporting on numerous other changes to the Code under the TCJA.

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[1] For purposes of this blog post, when we reference a "partnership," we are referring to an entity that is taxed for Federal income tax purposes as a partnership, including state law partnerships, limited liability companies and limited liability partnerships.

Tags: Decoding the Tax Cuts and Jobs Act, Individual Income Tax, Internal Revenue Code, Internal Revenue Service, IRC § 708, IRS, limited liability companies (LLCs), Limited Liability Partnerships (LLPs), partnership termination, Tax Cuts and Jobs Act, technical termination