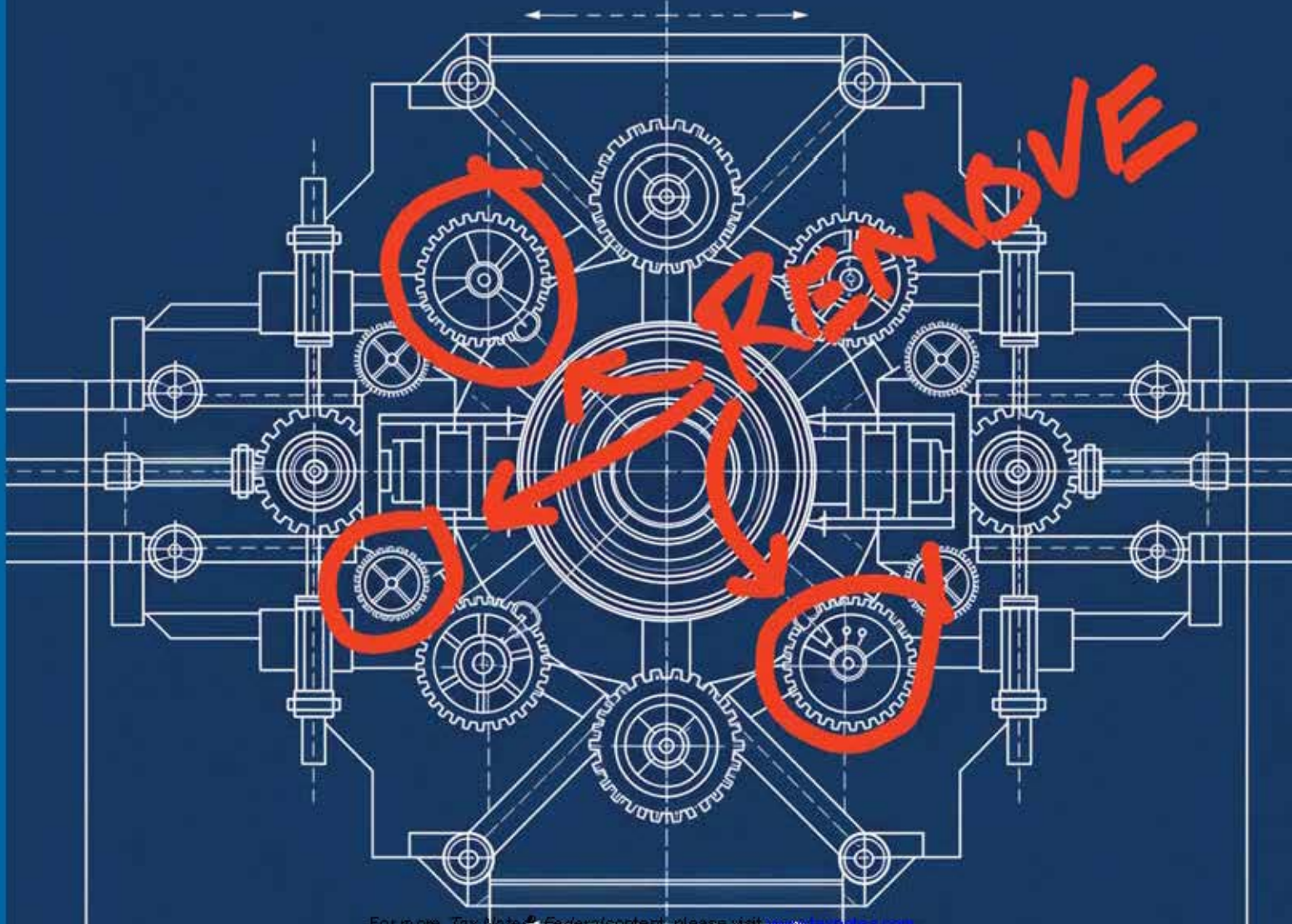
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# A Guide for Corporate Groups on Structuring Tax-Efficient Partnership Terminations




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# A Guide for Corporate Groups on Structuring Tax-Efficient Partnership Terminations

**by Oleg Polyatskiy**

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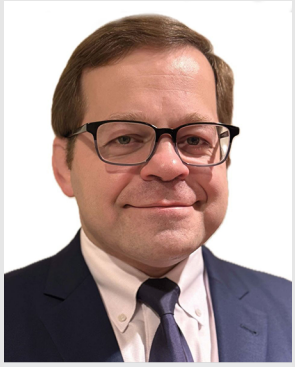
# A Guide for Corporate Groups on Structuring Tax-Efficient Partnership Terminations, Part 1

by Oleg Polyatskiy

Reprinted from *Tax Notes Federal*, October 19, 2026, p. 487

# A Guide for Corporate Groups on Structuring Tax-Efficient Partnership Terminations, Part 1

by Oleg Polyatskiy



Oleg Polyatskiy

Oleg Polyatskiy is a partner at McDermott Will & Schulte. He thanks David D. Sherwood for his thoughtful comments and assistance with this report.

In this report, the first installment of a two-part series, Polyatskiy explores concerns in and potential solutions for structuring partnership terminations and common transactions used by corporate groups to terminate partnerships.

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## I. Introduction

Corporate groups often wholly own a partnership as a result of (1) one group member initially owning some of a partnership interest, followed by another group member acquiring the remaining partnership interest from an unrelated

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partner; (2) a corporate group acquiring a group of entities that collectively own all the interests in a partnership; (3) a corporation with multiple owners liquidating under section 331 or section 332 by electing to be treated as a partnership under reg. section 301.7701-3(c); or (4) a corporate group forming a partnership to serve as a holding company or operating company.

After a partnership runs its course, a corporate group must decide how to terminate it in a tax-efficient manner. Careful planning is required when structuring a partnership termination because it involves various tax rules that may trigger gain recognition.

This two-part report is designed to be a guide for corporate groups on structuring a tax-efficient partnership termination. Part 1 begins with a high-level overview of the issues and potential solutions to consider when structuring a partnership termination, and then describes common transactions that corporate groups use to terminate partnerships. The remainder of part 1 and all of part 2 analyze in detail the tax rules that may trigger gain recognition upon a partnership termination and the planning techniques that can eliminate or reduce that gain.[1]

## II. Issues and Solutions

When structuring a partnership termination, tax practitioners should examine the issues and potential solutions outlined below and discussed throughout this report.

### A. Method of Terminating the Partnership

Determine the transaction that will be used to terminate the partnership. Corporate groups often terminate wholly owned partnerships with one of the following transactions:

- liquidation, by having the partnership distribute all assets and liabilities to the partners in liquidation of their partnership interests;
- incorporation, by effectuating an assets-over incorporation, assets-up incorporation, or interests-over incorporation; or
- nonrecognition transfers by all partners of their partnership interests to a single "old and cold" corporation (including one of the partners) via section 351 contributions, section 332 liquidations, or asset reorganizations under section 368(a)(1)(A), (C), or (D) (collectively, a nonrecognition transfer termination).

Before implementing a partnership termination, practitioners should also consider whether (1) the partnership should first redeem one or more partners by distributing assets to them in liquidation of their partnership interests, or (2) a partner should first transfer its partnership interest to another partner in a nonrecognition transaction under section 351, 332, or 368(a)(1)(A), (C), or (D).

Planning consideration: If one partnership termination method would result in gain recognition, consider whether another method would eliminate or reduce that gain.

### B. Section 731 Gain Attributable to a Partner's Negative Equity Basis

Determine whether any partner's share of partnership liabilities exceeds the partner's basis in its partnership interest (a negative equity basis). If so, the partner may recognize gain under section 731 when the partnership terminates.

Potential planning techniques:

- Have the partner with the negative equity basis assume qualified liabilities or its share of partnership liabilities in an amount at least equal to its negative equity basis.
- Eliminate the negative equity basis by combining the negative equity basis partnership interest with a positive equity basis partnership interest. This can be accomplished by either (1) having the partner with the negative equity basis transfer its partnership interest to another partner (with a positive equity basis that exceeds the transferring partner's negative equity basis) via an asset reorganization or a section 332 liquidation, or (2) having a partner with a positive equity basis that exceeds the other partner's negative equity basis transfer its partnership interest to the partner with the negative equity basis in a

[1] Oleg Polyatskiy, "A Guide for Corporate Groups on Structuring Tax-Efficient Partnership Terminations, Part 2," *Tax Notes Federal*, forthcoming.

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section 351 contribution, asset reorganization, or section 332 liquidation. Thereafter, the partnership can terminate using any method described above.
- Terminate the partnership via a nonrecognition transfer termination, but the partner with the negative equity basis must transfer its partnership interest to the transferee corporation via an asset reorganization or section 332 liquidation.
- Generally, a partner's contribution of money or property to the partnership to eliminate its negative equity basis, followed by the partnership's termination and distribution of assets to that partner, may implicate the disguised sale rules. However, the contribution generally should not be treated as part of a disguised sale if it occurs before any plan or intention to terminate the partnership exists or if it would have occurred even without the partnership's distribution.

### C. Section 731 Gain Resulting From Partnership Distribution of Money

Determine whether any low-basis partner will receive a distribution of "money" (including cash, marketable securities, and deemed money distributions under section 752) exceeding the basis in its partnership interest. If so, the partner may recognize gain under section 731.

Potential planning techniques:
- Distribute nonmoney assets to the low-basis partner.
- Have the low-basis partner assume qualified liabilities or its share of partnership liabilities.
- Terminate the partnership via an interests-over incorporation.
- Terminate the partnership via a nonrecognition transfer termination; however, the low-basis partner should not be the transferee that receives all the partnership interests.
- Combine the low-basis partnership interest with a high-basis partnership interest in a tax-free transaction. Either partner may transfer its interest to the other through a section 351 contribution, asset reorganization, or section 332 liquidation. Ensure that the transferee partner's combined basis in the partnership interest exceeds the amount of money it will be distributed upon the partnership termination. Thereafter, the partnership may terminate using any method described above.
- Consider refinancing any short-term notes that may constitute money under section 731(c).

### D. Gain Under Section 751(b)

Determine whether the partnership's liquidating distributions alter the partners' relative interests in hot assets and cold assets, thereby triggering gain recognition under section 751(b).

Potential planning techniques:
- Consider applying the "hypothetical sale" approach set forth in prop. reg. section 1.751-1 instead of the "gross value" approach reflected in reg. section 1.751-1(b).
- Terminate the partnership by effectuating an interests-over incorporation or assets-over incorporation.
- Terminate the partnership via a nonrecognition transfer termination.
- Distribute contributed property back to the contributing partner.

### E. Gain Under Section 707

Determine whether contributions made before the partnership termination, together with the partnership's liquidating distributions, could be recharacterized as disguised sales under section 707.

Consider:
- Whether any partner contributed property to the partnership within two years before the partnership termination.
- Whether the partnership termination was contemplated as of the time the partner made the prior contribution.
- Whether the contribution would have occurred even if the partnership was not terminating.

Potential planning techniques:
- Terminate the partnership via an interests-over incorporation.

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- Terminate the partnership via a nonrecognition transfer termination.
- Structure a partnership liquidation in a manner that results in partners assuming only their share of partnership liabilities and being distributed property that is encumbered only by qualified liabilities, insofar as those liabilities should not implicate section 707.

### F. Gain Under Sections 704(c)(1)(B) and 737

Determine whether the partnership's liquidating distributions will result in gain recognition under sections 704(c)(1)(B) and 737 (the mixing bowl rules).

Potential planning techniques:

- Distribute the section 704(c) property back to the contributing partner.
- The partnership may terminate by effectuating an interests-over incorporation or assets-over incorporation.
- The partnership may terminate by having all the partners (including the section 704(c) contributing partner) transfer their partnership interests to another corporation (potentially including one of the partners, other than the section 704(c) contributing partner) in section 351 transfers, asset reorganizations, or section 332 liquidations.

### G. Gain Under Reg. Section 1.337(d)-3

Confirm that the partnership termination does not trigger gain recognition under reg. section 1.337(d)-3.

### H. Section 732(f)

Determine whether the terminating partnership's distribution will result in the partnership's subsidiary corporation reducing the basis in its assets or a partner recognizing gain under section 732(f).

Potential planning techniques:

- Have the partnership distribute the stock of a subsidiary corporation to a partner with a high basis in its partnership interest.
- Terminate the partnership via an interests-over incorporation and apply the single-partner approach.
- Terminate the partnership via a nonrecognition transfer termination and apply the single-partner approach.

### I. Debt Extinguishment

Determine whether the partnership termination will result in debt extinguishment that triggers gain recognition.[2]

Potential planning techniques:

- Refinance the note so that its fair market value equals its amount due, issue price, and basis.
- Have the partnership distribute the note to a nondebtor partner.
- Terminate the partnership by incorporating it.

### J. Distribution of a Note

Determine whether the terminating partnership's distribution of a note to a partner results in a basis reduction in the note in the hands of the distributee partner, requiring the distributee to later recognize gain upon the (actual or, in the case of an intercompany obligation, deemed) repayment of the note.

Potential planning techniques:

- Have the partnership distribute the note to another partner so its basis is not reduced.
- Have the note be repaid, and the partnership can distribute the cash.
- Terminate the partnership via an assets-over incorporation.

### K. Consolidated Return: Intercompany Obligation

Determine whether the terminating partnership's distribution of a note receivable or note payable to a corporate partner results in that note becoming an intercompany obligation that is deemed satisfied and reissued under reg. section 1.1502-13(g)(5).

Potential planning techniques: Consider refinancing the note so that its FMV equals its issue price and basis.

[2]Debt extinguishment refers to the extinguishment of debt for U.S. federal income tax purposes, regardless of whether that debt continues to be respected as debt for corporate purposes (*e.g.*, debt between a corporation and its disregarded entity may be treated as debt for corporate purposes but is disregarded for federal income tax purposes).

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### L. International Issues to Consider

#### 1. Gain under section 721(c).

Determine whether the partnership is a section 721(c) partnership. If so, the U.S. transferor partner may recognize gain under the regulations promulgated under section 721(c) when the partnership terminates.

Potential planning techniques:

- Have the section 721(c) partnership redeem the foreign partners by distributing to them non-section-721(c) property in liquidation of their partnership interests, which should result in the section 721(c) regulations no longer applying to the partnership. Thus, subsequent termination of that partnership should not trigger gain under the section 721(c) regulations.
- Terminate the section 721(c) partnership via liquidation without triggering gain recognition under the section 721(c) regulations by distributing the section 721(c) property back to the U.S. transferor.[3]
- Terminate the section 721(c) partnership without triggering gain under the section 721(c) regulations by incorporating into a domestic corporation via either an assets-over incorporation or an interests-over incorporation.

#### 2. Gain under section 367.

If the partnership is being incorporated into a foreign corporation, determine whether any domestic partner will recognize gain under section 367.

### M. Loss Recognition Under Section 731 or Section 165

Determine whether the partnership termination can be structured in a way that would allow a partner to recognize the built-in loss in its partnership interest under section 731 or section 165.

## III. Common Transactions Used by Corporate Groups

A corporate group generally may terminate a wholly owned partnership by either (1) a partnership liquidation, (2) a partnership incorporation, or (3) a nonrecognition transfer termination.[4]

However, before implementing a partnership termination, practitioners should consider whether (1) the partnership should first redeem one or more partners by distributing assets to them in liquidation of their partnership interests, or (2) a partner should first transfer its partnership interest to another partner in a nonrecognition transaction under section 351, 332, or 368(a)(1)(A), (C), or (D). The circumstances in which that redemption or nonrecognition transfer of a partnership interest may be beneficial are examined below.

### A. Terminating a Partnership via Liquidation

A partnership may terminate via liquidation by distributing all its assets and liabilities to its partners and then dissolving as a legal entity.[5] Alternatively, the partnership can distribute its assets and liabilities to all but one partner in full redemption of their partnership interests, leaving the remaining partner as the sole owner of the legal entity. Although the remaining partner, in form, does not receive a distribution of any assets in redemption of its partnership interest, for tax purposes, the terminating partnership is treated as having distributed all its assets and liabilities to all partners.

Terminating a partnership via liquidation involves the partnership distributing assets to its partners, and the distribution involves various code sections that may trigger gain recognition: sections 731, 751(b), 707 (disguised sale rules), 704(c)(1)(B), 737 (mixing bowl rules), and 732(f). Thus, a liquidation may be less attractive than an interests-over incorporation, which does not involve a partnership distribution to the partners

[3] Reg. section 1.721(c)-5(b).

[4] In a partnership termination, the legal entity may either be dissolved or continue to exist as a disregarded entity or a corporation for federal income tax purposes.

[5] Section 708(b)(1); reg. section 1.708-1(b)(1).



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and does not involve the foregoing code sections that may trigger gain.

## B. Terminating a Partnership via Incorporation

A partnership also may terminate by incorporating via assets-over incorporation, assets-up incorporation, or interests-over incorporation.[6] A consolidated group often does not object to incorporation because adding another corporation generally does not materially increase the group's administrative burden.

### 1. Assets-over incorporation.

A partnership can incorporate by contributing all its assets and liabilities to a new corporation and then distributing the corporation stock to its partners in liquidation of the partnership (assets-over incorporation).[7] The assets-over incorporation may be effectuated either by having the partnership actually contribute assets and liabilities to a corporation and distribute stock[8] or by making an election to be treated as a corporation under reg. section 301.7701-3(c).[9]

### 2. Assets-up incorporation.

A partnership can incorporate by distributing its assets and liabilities to its partners, followed by the partners contributing those assets and liabilities to a new corporation (assets-up incorporation).[10]

In practice, corporate groups rarely use an assets-up incorporation because it involves a partnership distribution of assets, which involves various code sections that may trigger gain recognition: sections 731, 751(b), 707, 704(c)(1)(B), 737, and 732(f).

### 3. Interests-over incorporation.

A partnership can incorporate by having all the partners contribute their partnership interests to a new corporation (interests-over incorporation).[11]

For purposes of determining the partners' tax consequences, the partners are treated as transferring their partnership interests to a new corporation under section 351.[12]

However, in determining the corporation's tax consequences, there is a question whether (1) the corporation should be treated as receiving the partnership's assets from the partners, as though the partnership liquidated and distributed all its assets to the partners and then the partners transferred the assets to the corporation (the Rev. Rul. 99-6[13] approach), or (2) the corporation should be treated as receiving the partnership interests from the partners, as though the partners transferred all their partnership interests to the corporation and then the partnership liquidated into (its single owner) the corporation (the single-partner approach). Although the IRS is of the view that the Rev. Rul. 99-6 approach applies,[14]

[6] Rev. Rul. 84-111, 1984-2 C.B. 88.

[7] *Id.* at Situation 1.

[8] The assets-over incorporation may be effectuated by having the partners form a new limited liability company in which the partners have the same rights as they have in the old entity that is treated as a partnership, and then having the partners contribute all their interests in the old entity to the LLC. For tax purposes, the LLC should be treated as a continuation of the partnership, while the old entity should be treated as a disregarded entity. Later, the LLC can contribute the old entity, which holds all the assets of the partnership, to the new corporation, followed by the LLC distributing the corporation stock to its partners in termination of the LLC as a partnership.

[9] Reg. section 301.7701-3(g)(1)(i).

[10] Rev. Rul. 84-111, Situation 2.

[11] *Id.* at Situation 3.

[12] *Id.*

[13] Rev. Rul. 99-6, 1999-1 C.B. 432.

[14] REG-111119-99, 65 F.R. 1572 ("In the context of partnership incorporations, Rev. Rul. 84-111 distinguishes among all three forms of incorporation. However, with respect to the Interest-Over Form, the revenue ruling respects only the transferors' conveyances of partnership interests, while treating the receipt of the partnership interests by the transferee corporation *as the receipt of the partnership's assets (i.e., the Assets-Up Form)*. The theory for this result, based largely on *McCauslen v. Commissioner*, 45 T.C. 588 (1966), is that the transferee corporation can only receive assets since it is not possible, as a sole member, for it to receive and hold interests in a partnership (i.e., a partnership cannot have only one member; so, the entity is never a partnership in the hands of the transferee corporation).") (emphasis added); Rev. Rul. 99-6, Situation 2 ("Rev. Rul. 84-111, 1984-2 C.B. 88 (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 section 732(c)." *McCauslen* applied the assets-up approach.).

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there is support for the notion[15] that the single-partner approach should apply.

A partnership distributes assets to its partners when it terminates through liquidation or an assets-up incorporation and distributes corporate stock when it terminates through an assets-over incorporation. As discussed above, a partnership distribution implicates various code sections that may trigger gain recognition: sections 731, 751(b), 707, 704(c)(1)(B), 737, and 732(f). By contrast, an interests-over incorporation does not involve a deemed partnership distribution to the partners, and thus it does not implicate those provisions that may trigger gain. For this reason, corporate groups often terminate partnerships through an interests-over incorporation.

### C. Terminating a Partnership by Transferring All Partnership Interests in Nonrecognition Transfers to an Old and Cold Corporation

A partnership can terminate by having all partners transfer their partnership interests to a single old and cold corporation (including one of the partners) in nonrecognition section 351 contributions, section 332 liquidations, or asset reorganizations under section 368(a)(1)(A), (C), or (D) (defined above as a nonrecognition transfer termination).

For purposes of determining the transferor partners' tax consequences, the partners are treated as transferring their partnership interests to the transferee corporation.[16]

However, in determining the transferee's tax consequences, there is a question whether the Rev. Rul. 99-6 approach or single-partner approach applies. The IRS believes the Rev. Rul. 99-6 approach applies,[17] but there is support for the notion[18] that the single-partner approach should apply.

Similar to interests-over incorporation, when a partnership terminates via nonrecognition transfer termination, the partnership is not treated as making a distribution to the partners, and thus it does not implicate certain code sections that may trigger gain.

### D. Redeeming Partners Before the Partnership Termination

Before a partnership terminates, it may redeem one or more partners by distributing assets in liquidation of their partnership interests. A redemption of a partner may be useful when a nonmember of the corporate group owns an interest in the partnership and the corporate group wants to redeem that interest before terminating the partnership via an incorporation or nonrecognition transfer termination. A redemption of a partner may also be useful when the partner cannot (or does not want to) participate in the partnership's incorporation or nonrecognition transfer termination because the partner does not want to own shares in the transferee corporation, or for some other reason.

### E. A Partner Transfers Its Partnership Interest to Another Partner in a Nonrecognition Transaction

Before terminating a partnership, one partner may transfer its partnership interest to another partner in a nonrecognition transaction under section 351, 332, or 368(a)(1)(A), (C), or (D). In determining the transferor partner's tax consequences, the transferor partner is treated as transferring its partnership interest to the transferee partner. As described below, a partner with a negative equity basis or a low basis in its partnership interest may transfer its interest to another partner with a high basis in its partnership interest to avoid gain recognition

[15] *See* Eric B. Sloan and Dina A. Wiesen, *Partnership Mergers and Divisions: A User's Guide — The Partnership Tax Practice Series: Planning for Domestic and Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances* (2025) ("There are two reasons why it is not clear if the IRS was correct in saying that the rulings are similar. First, the reference to section 732(c) in Rev. Rul. 84-111 (Situation 3) undermines the IRS's argument that the two rulings are alike. In Rev. Rul. 84-111 (Situation 3), the corporate transferee's 'basis for the assets received in the exchange equals the basis of the partners in their partnership interests allocated in accordance with section 732(c).' If assets had been contributed, the corporate transferee's basis would have been determined under section 358. By referencing section 732(c), the ruling strongly implies that the corporate transferee received assets in liquidation of a partnership from the partnership. Second, the General Counsel Memoranda underlying Rev. Rul. 84-111 (Gen. Couns. Mems. 37,540 and 38,144) explained the corporate transferee's basis should be determined as if the partnership liquidated and the partners then contributed the assets to the partnership, but similar language was not included in Rev. Rul. 84-111 as published. That language was removed some time before the ruling was published, which arguably supports reading Rev. Rul. 84-111 as adopting a single-person partnership and respecting the form chosen by the taxpayer.").

[16] Rev. Rul. 99-6; Rev. Rul. 84-111, Situation 3.

[17] *See supra* note 14.

[18] *See supra* note 15.



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under section 731 upon the partnership termination.

### F. Summing Up

Common methods used by corporate groups to terminate a partnership include partnership liquidation, three types of partnership incorporation, and a nonrecognition transfer termination. Also, before a partnership terminates, the partnership may redeem one or more partners, or one partner may transfer its interest to another partner in a nonrecognition transaction. The tax treatment of each method of partnership termination is different. Thus, if one method results in gain recognition, consider whether another method would eliminate or reduce that gain.

The discussion below describes tax rules that may trigger gain on a partnership termination and planning techniques — including alternative termination methods — that may eliminate or reduce that gain.

## IV. Section 731 Gain Attributable to a Partner's Negative Equity Basis

Upon a partnership termination, a partner may recognize gain under section 731 equal to the amount by which its share of partnership liabilities exceeds its basis in the partnership interest (defined above as a negative equity basis). Thus, in terminating a partnership, it is important to determine whether any partner has a negative equity basis in its partnership interest and, if so, structure the partnership termination in a manner that eliminates or reduces the gain attributable to the negative equity basis.

Generally, a partner ends up with a negative equity basis as a result of its basis in the partnership interest first increasing equivalently with any increase in its share of partnership liabilities, and then its basis decreasing on account of the partnership's distributions and deductions without any equivalent decrease in its share of partnership liabilities. More specifically, partnership liabilities are allocated among the partners.[19] Any increase in a partner's share of the partnership liabilities, or any assumption by a partner of partnership liabilities, is treated as a contribution of money by that partner to the partnership, which increases the partner's basis in the partnership interest by that amount.[20] A partnership's subsequent distributions and allocations of deductions to the partner reduce the partner's basis in its partnership interest without reducing its share of partnership liabilities, which may result in its basis in the partnership interest decreasing below its share of partnership liabilities (that is, a negative equity basis).[21]

When a partnership terminates, a partner may recognize gain under section 731 equal to the amount by which its share of partnership liabilities exceeds its basis in the partnership interest (a negative equity basis). In particular, a partner recognizes gain under section 731(a) to the extent that it is distributed money exceeding its basis in the partnership interest.[22] A partner is treated as having been distributed money to the extent that its share of partnership liabilities decreases.[23] Upon a partnership termination, a partner's share of partnership liabilities decreases to zero, and thus the partner is treated as having been distributed money equal to the amount of its share of partnership liabilities (minus any partnership liabilities that the partner assumes, if any).[24] If a partner's share of partnership liabilities exceeds its basis in the partnership interest (that is, a negative equity basis) upon a partnership termination, that partner may be treated as having been distributed money exceeding its basis in the partnership interest, which may result in the partner recognizing that excess amount as section 731 gain.[25]

For example, a partnership incurs a $100 liability and allocates $50 of it to partner A, resulting in partner A's basis in the partnership interest increasing from $10 (its initial basis) to $60. Later, partner A receives a $15 distribution from the partnership and is allocated $15 of partnership deductions, resulting in it having a

[19] Reg. section 1.752-2; reg. section 1.752-3.

[20] Section 752(a); reg. section 1.752-1(b); section 722.

[21] Section 733; section 705(a)(2).

[22] Reg. section 1.731-1(a)(1)(i).

[23] Section 731(c)(1)(A); section 752(b).

[24] Section 752(a); section 752(b); reg. section 1.752-1(f).

[25] Section 731(a)(1).



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basis in the partnership interest of $30, while its share of partnership liabilities is still $50 (that is, a negative equity basis of $20). Upon the partnership termination, partner A's share of partnership liabilities decreases from $50 to $0, and thus partner A is treated as having been distributed $50 in cash, and because its basis in the partnership interest is only $30, it recognizes $20 of section 731 gain.

A termination of a partnership in which a partner has a negative equity basis may result in the partner recognizing section 731 gain. Below we describe possible techniques that may be used to eliminate or reduce the amount of section 731 gain that a partner with a negative equity basis must recognize on a partnership termination.

### A. Techniques to Eliminate Section 731 Gain Attributable to a Partner's Negative Equity Basis

#### 1. Capital contribution.

Generally, a partner's negative equity basis can be eliminated by having the partner contribute money (or property with basis) to the partnership equal to the amount of its negative equity basis. That contribution increases the partner's basis in the partnership interest up to the amount of its share of partnership liabilities, thereby eliminating its negative equity basis and allowing the partnership to terminate without the partner recognizing section 731 gain on account of the negative equity basis.[26] This technique, however, may trigger gain recognition under the disguised sale rules. The partner's contribution and the partnership's subsequent property distribution to the partner upon the partnership termination may be stepped together to be treated as a taxable sale of property by the partnership to the partner under the disguised sale rules set forth in reg. section 1.707-6. Whether those rules apply depends principally on whether the contribution would have been made without the liquidating distribution. If the contribution is made for an independent reason, then the but-for test should not be satisfied, and the contribution generally should not be recharacterized as part of a sale. Under reg. section 1.707-6, a transfer of money or other consideration (including assumption of liability) by a partner to a partnership and a transfer of property (excluding money) by the partnership to the partner constitute a sale of property by the partnership to the partner if, based on all the facts and circumstances, (1) the transfer of money or other consideration would not have been made but for the transfer of property (but-for test); and (2), in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.[27]

If a partner makes a contribution to the partnership before there is any intention or plan of terminating the partnership, then the contribution and the partnership's subsequent liquidating distribution of property to the partner upon the partnership termination should not be stepped together to be treated as a taxable sale of property under the disguised sale rules, insofar as the but-for test should not be satisfied.

Also, if a partner makes the contribution to the partnership shortly before (or as of the time of) its termination, the contribution and the terminating partnership's distribution of property to that partner should not be stepped together to be treated as a sale under the disguised sale rules as long as the contribution would have been made even without the terminating partnership's distribution of assets to the partner. This is the case because the disguised sale rules apply only if the partner's contribution would not have been made *but for* the terminating partnership's distribution of property.[28] For example, a partner with a negative equity basis can have a deficit restoration obligation that requires it to make a contribution upon the partnership termination, regardless of whether the terminating partnership distributes any property to the partner. A contribution by that partner to satisfy its deficit restoration obligation generally should not result in the contribution and the terminating

[26] Section 722.

[27] Reg. section 1.707-6(a); reg. section 1.707-3(b)(1). Facts and circumstances similar to the ones set forth in reg. section 1.707-3(b)(2) may indicate the existence of a sale.

[28] Reg. section 1.707-6(a); reg. section 1.707-3(b).



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partnership's distribution of property being stepped together to be treated as a sale under the disguised sale rules.[29]

Generally, however, if a partner contributes money (or property) to the partnership in connection with the partnership termination, that contribution and the terminating partnership's distribution of property to the partner may be stepped together under the disguised sale rules to be treated as though the partnership sold the property to the partner in a taxable sale.[30] Thus, when a partner must eliminate its negative equity basis shortly before the partnership termination, rather than contributing cash (or property) and being subject to the disguised sale rules, the partner may eliminate its negative equity basis by assuming partnership liabilities, as explained below.

### 2. Partner's assumption of partnership liabilities.

A partner's assumption of its share of partnership liabilities or of qualified liabilities may eliminate its negative equity basis without implicating the disguised sale rules, thereby allowing the partnership to terminate without gain recognition (1) under section 731 on account of the negative equity basis, and (2) under reg. section 1.707-6 on account of a disguised sale of property.

A partner's assumption of partnership liabilities in an amount equal to its negative equity basis eliminates its negative equity basis, insofar as that liability assumption is treated as a contribution of money by the partner to the partnership that increases the partner's basis in the partnership interest up to the amount of its share of partnership liabilities.[31] Moreover, a partner's assumption of the partnership's qualified liabilities, or of its share of partnership liabilities, is exempt from the disguised sale rules.[32]

#### *a. Partner's assumption of a qualified liability.*

Generally, if a partnership distributes to a partner property encumbered by a liability, the partner's assumption of that liability may be treated as consideration paid by the partner to the partnership in exchange for the partnership's sale of property under the disguised sale rules.[33] However, there is an exception for a qualified liability: A partnership's distribution of property encumbered by a qualified liability to a partner is not treated as part of a sale under the disguised sale rules.[34] A partnership's liability is generally treated as a qualified liability to the extent that it is:

- a liability that was incurred by the partnership more than two years before the earlier of the date the partnership agrees in writing to transfer the property or the date the partnership transfers the property to the partner, whether or not the liability has encumbered the transferred property throughout the two-year period;
- a liability that was not incurred in anticipation of the transfer of the property to a partner, but that was incurred by the partnership within the two-year period before the earlier of the date the partnership agrees in writing to transfer the property or the date the partnership transfers the property to the partner and that has encumbered the transferred property since it was incurred;
- a liability that is allocable under the rules of reg. section 1.163-8T to capital expenditures with respect to the transferred property;
- a liability that was incurred in the ordinary course of the trade or business in which the property transferred to the partner was used or held, but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business; or

[29] Reg. section 1.704-1(b)(2)(ii)(b)(3). Note that a partner's deficit restoration obligation might be less than the partner's negative equity basis, and thus the mere fact that the partner restores its deficit restoration obligation does not necessarily mean that the partner will not have a negative equity basis immediately thereafter.

[30] Reg. section 1.707-6; reg. section 1.707-3(b).

[31] Section 752(a); section 722.

[32] Reg. section 1.707-6(b)(2)(i); reg. section 1.707-6(b)(1).

[33] Reg. section 1.707-6(a); reg. section 1.707-3(b).

[34] Reg. section 1.707-6(b)(2)(i) provides that "if a transfer of property by a partnership to a partner is not otherwise treated as part of a sale, the partner's assumption of or taking subject to a qualified liability is not treated as part of a sale."

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- a liability that was not incurred in anticipation of the transfer of the property to a partner, but that was incurred in connection with a trade or business in which the property transferred to the partner was used or held, but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business.[35]

Hence, a partner can eliminate its negative equity basis without implicating the disguised sale rules by receiving from the terminating partnership a distribution of property encumbered by a qualified liability that equals or exceeds the partner's negative equity basis. This should allow the partnership to terminate without gain recognition (1) under section 731 on account of the negative equity basis, and (2) under reg. section 1.707-6 on account of a disguised sale of property.

***b. Partner's assumption of its share of partnership liability.***

Generally, a partner's assumption of partnership liability may be treated as consideration transferred by the partner to the partnership that may be stepped together with the terminating partnership's subsequent distribution of property to the partner and treated as a partnership's taxable sale of property under the disguised sale rules.[36] However, there is an exception under which a partner's assumption of its share of partnership liability is not treated as consideration paid by the partner in exchange for the partnership's sale of property under the disguised sale rules. Reg. section 1.707-6(b)(1) provides the following rule (the section 707 netting rule): "If the partner assumes or takes subject to a liability that is not a qualified liability, the amount treated as consideration transferred to the partnership is the amount that the liability assumed or taken subject to by the partner exceeds the partner's share of that liability . . . immediately before the transfer. [And] if more than one partner assumes or takes subject to a liability pursuant to a plan, the amount that is treated as a transfer of consideration by each partner is the amount by which all of the liabilities (other than qualified liabilities) assumed or taken subject to by the partner pursuant to the plan exceed the partner's share of all of those liabilities immediately before the assumption or taking subject to."

Hence, a partner's assumption of its share of partnership liability is not taken into account for purposes of the disguised sale rules. Thus, a partner can eliminate its negative equity basis without implicating the disguised sale rules by assuming its share of partnership liabilities in an amount that equals or exceeds its negative equity basis. This should allow the partnership to terminate without gain recognition (1) under section 731 on account of the negative equity basis, and (2) under reg. section 1.707-6 on account of the disguised sale of property.

Further, in certain cases, a partner with a negative equity basis might not be allocated the partnership liability that it wants to assume for purposes of eliminating its negative equity basis, and hence the partner's assumption of that partnership liability would not qualify under the section 707 netting rule. In that case, arguably, before the partnership termination, the partner can guarantee the partnership liability so that the liability is allocated to the partner.[37] Then, upon the partnership termination, the partner can assume that partnership liability and qualify for the section 707 netting rule, under which that assumption of partnership liability should not be taken into account under the disguised sale rules.

[35] Reg. section 1.707-5(a)(6); reg. section 1.707-6(b)(2)(iii). If the liability is a recourse liability, the amount of the liability does not exceed the FMV of the transferred property.

[36] Reg. section 1.707-6(a); reg. section 1.707-3(b).

[37] The regulatory history of the section 707 netting rule demonstrates that Treasury thought about revising (but decided not to revise) the rule so that partnership liabilities allocated to a partner shortly before they were assumed by the partner would not be taken into account for purposes of the section 707 netting rule. *See* REG-119305-11, 79 F.R. 4826-4839; T.D. 9787, 81 F.R. 69291-01; William S. McKee, William S. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, para. 14.02 ("The amount treated as consideration transferred to the partnership arising from the assumption of (or taking subject to) a nonqualified liability is the amount by which the assumed (or 'taken subject to') liability exceeds the partner's share of the liability immediately before the transfer. Reg. section 1.707-6(b)(1) (third sentence). *In the context of recourse debt, the partners can presumably make the distributee-partner fully liable for the assumed debt prior to the distribution, thereby making the amount of consideration arising from the assumption zero.* This suggests that the primary application of the disguised sale rules to partnership-to-partner transactions involving liabilities will be in the context of nonrecourse debt. Consistent with this suggestion, the relevant example deals with nonrecourse debt. See Reg. section 1.707-6(d) Example (2).").

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### 3. Nonrecognition transfer termination.

A corporate group can terminate a partnership, without having a partner recognize gain under section 731 on account of its negative equity basis, by having all the partners effectuate asset reorganizations (under section 368(a)(1)(A), (C), or (D)), or section 332 liquidations, into another old and cold corporation (including one of the partners).[38] Moreover, the partners that may not want (or be able) to effectuate an asset reorganization or section 332 liquidation into the old and cold corporation may be redeemed out of the partnership by having the partnership distribute assets to those partners in liquidation of their partnership interests.

For example, a partnership can completely redeem all the partners except for a corporate partner with a negative equity basis (Partner N) and another corporate partner that does not have a negative equity basis (Partner P) and that will retain all the partnership's assets and liabilities after its termination. Then Partner N can effectuate an asset reorganization under section 368(a)(1)(A), (C), or (D) into Partner P.[39]

In determining Partner N's tax consequences, Partner N should be treated as transferring its partnership interest to Partner P in exchange for Partner P stock in the asset reorganization. Under section 752(d), upon the transfer of a partnership interest, partnership liabilities must be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.[40] Despite the fact that Partner N's basis in the partnership interest is less than its share of partnership liabilities, under section 361(a), Partner N should not recognize any gain or loss on the transfer of the partnership interest to Partner P in exchange for Partner P shares and Partner P's assumption of Partner N's share of partnership liabilities. Thus, Partner N should not recognize section 731 gain on account of its negative equity basis.

In determining Partner P's (the transferee's) tax consequences, if the taxpayer applies the Rev. Rul. 99-6 approach (which the IRS believes applies), then the partnership should be treated as liquidating and transferring all its assets and liabilities to Partner N and Partner P, and then Partner N should be treated as contributing its assets and liabilities (which the partnership is deemed to have distributed to Partner N) to Partner P in exchange for Partner P shares. Thus, Partner P also should not recognize gain under section 731 on account of Partner N's negative equity basis. Alternatively, if the taxpayer applies the single-partner approach, then Partner N should be treated as transferring its partnership interest to Partner P, followed by the partnership liquidating and distributing all its assets and liabilities to Partner P. Because Partner P should be treated as being assigned all the partnership's liabilities, it should not recognize section 731 gain on account of Partner N's negative equity basis.

Thus, a partnership can terminate, without having a partner recognize section 731 gain on account of its negative equity basis, by having the partners effectuate asset reorganizations (under section 368(a)(1)(A), (C), or (D)), or section 332 liquidations, into an old and cold corporation (including one of the partners).

### 4. Combine a negative equity basis partnership interest with a positive equity basis partnership interest.

Before the partnership termination, a negative equity basis in a partnership interest can be eliminated by combining it with a partnership interest that has a positive equity basis. A negative equity basis in a partnership interest can be eliminated by either (1) having the partner with the negative equity basis transfer its partnership interest to another partner (with a positive equity basis that exceeds the transferring partner's negative equity basis) via an asset reorganization or a section 332 liquidation, or (2) having a partner

[38] If a partner with a negative equity basis contributes its partnership interest to a corporation under section 351, then the partner should recognize gain under section 357(c) equal to the amount of its negative equity basis. *See* sections 751(d) and 357(c). Rev. Rul. 80-323, 1980-2 C.B. 124 (a partnership interest that is transferred in a section 351 transaction is treated as transferred subject to its share of partnership liabilities for purposes of sections 357(c) and 358(d)). However, section 357(c) does not apply if a partner that is a member of a consolidated group contributes its partnership interest to a corporation that is also a member of the consolidated group under section 351. *See* reg. section 1.1502-80(d).

[39] A reorganization under section 368(a)(1)(A) may be effectuated by merging under state law Partner N into Partner P. A reorganization under section 368(a)(1)(C) or (D) may be effectuated by (1) contributing all the stock of Partner N to Partner P, followed by liquidation of Partner N via check-the-box election under reg. section 301.7701-3 or an actual liquidation, or (2) having Partner N contribute all (or substantially all) its assets to Partner P in exchange for Partner P shares, and then liquidating.

[40] *See* Rev. Rul. 80-323 (a partnership interest that is transferred in a section 351 transaction is treated as transferred subject to its share of partnership liabilities for purposes of sections 357(c) and 358(d)).



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(with a positive equity basis that exceeds the other partner's negative equity basis) transfer its partnership interest to the partner with the negative equity basis in a section 351 contribution, asset reorganization, or section 332 liquidation. Thereafter, the partnership can terminate using any method described above without having the partners recognize section 731 gain on account of a negative equity basis.

## V. Section 731 Gain Resulting From Partnership Distribution of Money

Upon a partnership termination, a partner may recognize section 731(a) gain to the extent that it is treated as distributed money by the partnership exceeding its basis in the partnership interest. Thus, in terminating a partnership, it is important to determine whether any partner will be treated as having been distributed money exceeding its basis in the partnership interest, and, if so, to structure the partnership termination in a manner that eliminates or reduces gain recognition.

For purposes of section 731, money includes not only cash but also marketable securities (as defined in section 731(c)(2)).[41] Also, a decrease in a partner's share of partnership liabilities is treated as a distribution of money.[42] Upon a partnership termination, a partner's share of partnership liabilities decreases to zero, and thus the partner is treated as receiving a distribution of money equal to its share of partnership liabilities (minus any partnership liabilities that the partner assumes).[43]

As noted above, a partner is treated as having been distributed money to the extent that it is distributed marketable securities (as defined in section 731(c)(2)).[44] The term "marketable securities" is defined to include several assets, including under section 731(c)(2)(B)(ii) "any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities."[45] In FSA 200219008, the IRS concluded that notes with a nine-month term constituted marketable securities under section 731(c)(2)(B)(ii) because the notes were quickly paid off after being distributed. Similarly, in CCA 200250013, the IRS concluded that certain notes distributed by a partnership constituted marketable securities under section 731(c)(2)(B)(ii) even though they were not actively traded because an investment banker who arranged the creation of the notes stood ready to buy the notes from the holder. The Tax Court, however, rejected a similar argument in a comparable transaction.[46] Short-term notes and cash pool receivables should be carefully reviewed before a partnership termination because the IRS may contend that they constitute money under section 731(c).

Thus, upon a partnership termination, a partner may recognize gain under section 731(a) to the extent that it is distributed money exceeding its basis in the partnership interest. Below we describe possible techniques to eliminate or reduce the amount of gain recognized under section 731.

### A. Techniques to Eliminate Gain Under Section 731

To the extent that a distributee partner's basis in the partnership interest is less than the amount of money that would be distributed to it upon a partnership termination (a low-basis partner), consider whether the terminating partnership could instead distribute to the low-basis partner nonmoney assets and have some of the money be distributed to the other partners. Tax practitioners must also ensure that those selective distributions do not trigger gain under section 751(b).

Alternatively, the low-basis partner may assume its share of partnership liabilities or qualified liabilities, which should increase its basis in the partnership interest without implicating the disguised sale rules as explained in Section IV.A.2.[47] The increase in the partner's basis in the partnership interest should eliminate

[41] Section 731(c)(1)(A).

[42] Section 752(b).

[43] Section 752(a) and (b); reg. section 1.752-1(f).

[44] Section 731(c)(1)(A).

[45] Section 731(c)(2)(B)(ii).

[46] *See Countryside LP v. Commissioner*, T.C. Memo. 2008-3 (a mere right to renegotiate a note did not evidence an arrangement to readily exchange the note for cash).

[47] Section 752(a); reg. section 1.707-6(b)(1) and (2); reg. section 1.707-3(b).



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or reduce the amount of section 731 gain that the partner recognizes on the partnership termination without implicating the disguised sale rules.

Further, to the extent that there is a concern that a partnership holds a short-term note, demand note, or cash pool receivable that may be treated as money, that instrument may be refinanced into a longer-term instrument that is not treated as money.[48] The distribution of that longer-term instrument should not trigger gain recognition under section 731, but the basis in the instrument may be reduced under section 732(b), and subsequent repayment thereon may result in gain recognition.

Also, a partnership can terminate without causing the low-basis partner to recognize section 731 gain by first redeeming certain partners by distributing assets to them in liquidation of their partnership interests, and then effectuating an interests-over incorporation.[49] Under the interests-over incorporation, the partners are treated as contributing their partnership interests to the corporation in exchange for corporation stock,[50] and thus the partners should not be treated as receiving any distribution that may result in section 731 gain.

Also, in the case of a low-basis partner, the partnership can completely redeem out all the partners except for the low-basis partner and another partner with a high basis in its partnership interest. Then, the partnership can terminate by having the low-basis partner transfer its partnership interest to the other partner in a section 351 contribution, asset reorganization, or section 332 liquidation.[51] The low-basis partner would be treated as transferring its partnership interest to the other partner and thus should not be treated as receiving a distribution of money that results in section 731 gain recognition. The transferee partner should not recognize any section 731 gain to the extent that the Rev. Rul. 99-6 approach applies, insofar as the transferee would be treated as receiving a distribution from the terminating partnership only of its share of the partnership's money. Further, if the single-partner approach applies, the transferee partner should not recognize any section 731 gain to the extent that its basis in all the partnership interests exceeds the amount of money it is treated as being distributed upon the partnership termination.

Moreover, even before the partnership termination, the low-basis partnership interest can be combined with a high-basis partnership interest so that upon the subsequent partnership termination the basis in the combined partnership interest exceeds the amount of money distributed for that partnership interest. In particular, the low-basis partnership interest and high-basis partnership interest can be combined by having either partner transfer its partnership interest to the other via a section 351 contribution, asset reorganization, or section 332 liquidation. Tax practitioners must ensure that the combination of the partnership interests results in the transferee

[48] The terms of the note must be analyzed to determine whether it may be refinanced, and whether the refinancing would be respected as an arm's-length transaction. *See* section 482. The refinancing may be treated as a significant modification under reg. section 1.1001-3, and thus the note with the old terms (old note) would be deemed to be exchanged for a note with the new terms (new note) in a taxable exchange. Often, the deemed exchange of an old note for a new note results in no gain or loss recognition. More specifically, usually, the debtor's adjusted issue price in the note and the creditor's basis in the note equal the amount due under the note. And, in the deemed exchange that occurs as a result of the significant modification, the new note's issue price usually equals the amount due under the old note. *See* sections 1273(b)(4) and 1274. As such, in the deemed exchange, because the issue price of the new note equals the creditor's basis in the old note, the creditor does not recognize any gain or loss. *See* reg. section 1.1001-1(g). Also, because the debtor's issue price in the old note equals the issue price in the new note, the debtor does not recognize any cancellation of debt income or a repurchase premium deduction. Reg. section 1.61-12(c); section 108(e)(10); reg. section 1.163-7(c).

[49] Under the assets-over incorporation, the partnership is treated as contributing all its assets and liabilities to a new corporation and distributing the corporation stock to its partners in liquidation of the partnership. Each partner should be treated as receiving a distribution of money equal to its share of partnership liabilities, insofar as those liabilities are assumed by the corporation. Further, the partnership's distribution of corporation stock may be treated as a distribution of a marketable security or money, insofar as the terms "marketable security" and "money" also include "interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of marketable securities, money, or both." Section 731(c)(2)(B)(v); reg. section 1.731-2(c)(3). Thus, to the extent that the newly formed corporation is treated as a marketable security, tax practitioners must ensure that the partnership's distribution of the corporation stock does not trigger gain under section 731.

[50] Rev. Rul. 84-111, Situation 3.

[51] However, if a partner with a negative equity basis contributes its partnership interest to a corporation under section 351, the partner should recognize gain under section 357(c) equal to the amount of its negative equity basis. *See* sections 751(d) and 357(c). Rev. Rul. 80-323 (a partnership interest that is transferred in a section 351 transaction is treated as transferred subject to its share of partnership liabilities for purposes of sections 357(c) and 358(d)). However, section 357(c) does not apply if a partner that is a member of a consolidated group contributes its partnership interest to a corporation that is also a member of the consolidated group under section 351. *See* reg. section 1.1502-80(d).



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partner's basis in the partnership interest exceeding the amount of money that will be distributed to it upon the partnership termination. Thereafter, the partnership can terminate using any method.

This shows that section 731 gain attributable to distributions of money can frequently be avoided through careful planning. ■

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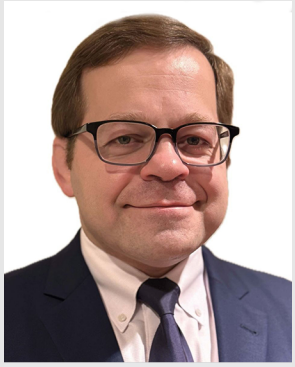
# A Guide for Corporate Groups on Structuring Tax-Efficient Partnership Terminations, Part 2

by Oleg Polyatskiy

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# A Guide for Corporate Groups on Structuring Tax-Efficient Partnership Terminations, Part 2

by Oleg Polyatskiy



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Oleg Polyatskiy is a partner at McDermott Will & Schulte. He thanks David D. Sherwood for his thoughtful comments and assistance with this report.

This two-part report is designed to be a guide for corporate groups on structuring a tax-efficient partnership termination.

In this final installment, Polyatskiy analyzes in detail potential gain recognition upon a partnership termination under sections 751(b), 707, 704(c), 737, 732(f), 721(c), and 367; reg. sections 1.337(d)-3 and 1.1502-13(g)(5); and debt rules. He also explores planning techniques that can eliminate or reduce that gain.

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## VI. Gain Under Section 751(b)

A partnership termination may trigger gain under section 751(b) if the liquidating distributions alter the partners' relative interests in hot assets and cold assets. Thus, it is important to analyze the implications of section 751(b) and, if necessary, structure the termination in a way that eliminates or reduces gain recognition.

Section 751(b) applies if the distributee partner receives either (1) unrealized receivables or substantially appreciated inventory items (hot assets) in exchange for all or a part of its interest in other partnership property, including money (cold assets); or (2) cold assets in exchange for all or a part of its interest in hot assets.[1] Section 751(c) defines the term "unrealized receivables," and section 751(d) defines "inventory." Unrealized receivables are defined broadly to include several assets the sale of which would result in ordinary income, including section 1245 property (that is, depreciable property) to the extent of the amount that would be treated as ordinary income under section 1245 (depreciation recapture) upon sale of the property. Substantially appreciated inventory is inventory with a fair market value that exceeds 120 percent of its basis.[2] Generally, any partnership property that, on the sale by the partnership, would result in ordinary income or loss is treated as either an unrealized receivable or inventory.

Section 751(b) and the current regulations do not provide any detailed guidance on how a distributee partner's interest in hot or cold assets should be measured. The principal regulatory example — reg. section 1.751-1(g), Example (2) — illustrates what has become known as the "gross value" approach. Under this approach, each partner's interest in hot and cold assets is determined by reference to the gross value of each category of partnership assets rather than the amount of unrealized gain or loss inherent in those assets. Reg. section 1.751-1(g), Example (2), involves a three-person partnership in which partner C receives a liquidating distribution of cash and other cold assets in exchange for C's one-third interest in the partnership. In the example, C's share of hot and cold assets is calculated as equal to one-third of the amount of each asset. Because this is a very simplified example, in which no mention is made of waterfall distributions, preferred returns, other special allocations, or section 704(c) property, it provides no direct insight into how a partner's interest in partnership property should be measured in more complicated circumstances.

The preamble to the proposed regulations under section 751(b) states that Example (2) applies the gross value approach.[3] "The examples in the current regulations under section 751(b) determine a partner's interest in section 751 property by reference to the partner's share of the gross value of the partnership's assets (the 'gross value' approach), not by reference to the partner's share of the unrealized gain or loss in the property."[4]

The application of the approach can be demonstrated with the following example. Partnership AB is a general partnership with two equal partners, A and B, and no special allocation provisions. Partnership AB has a hot asset with an FMV of $100 and a basis of $0, and a cold asset with an FMV of $100 and a basis of $0. Partnership AB terminates by distributing the hot asset to partner A and the cold asset to partner B. Before the liquidating distributions, each partner held a 50 percent interest in the hot asset and a 50 percent interest in the cold asset, and after the distributions, partner A holds 100 percent of the hot asset and partner B holds 100 percent of the cold asset. Under the gross value approach, partner A is treated as exchanging the 50 percent interest in the cold asset for the 50 percent interest in the hot asset, and partner B is treated as exchanging the 50 percent interest in the hot asset for the 50 percent interest in the cold asset. Thus, the partners and partnership are treated as exchanging the 50 percent interest in the cold asset for the 50 percent interest in the hot asset, resulting in $50 of gain recognition on 50 percent of the hot asset and $50 of gain recognition on 50 percent of the cold asset.

[1] Section 751(b)(1)(A) and (B).

[2] Section 751(b)(3).

[3] Preamble to proposed regulations, REG-151416-06, 79 F.R. 65151.

[4] *Id.*



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Therefore, a terminating partnership's distribution of assets may result in section 751(b) recharacterizing the distribution as a taxable sale of those assets between the partnership and the distributee partner. Possible techniques that may be used to eliminate or reduce the gain recognized under section 751(b) follow.

## VII. Techniques to Eliminate Gain Under Section 751(b)

### A. Hypothetical Sale Approach

Although the IRS is of the view that current regulations apply section 751(b) under the gross value approach,[5] prop. reg. section 1.751-1 generally allows taxpayers to apply section 751(b) under the "hypothetical sale" approach.[6]

Rather than comparing gross asset values, the hypothetical sale approach compares the ordinary income each partner would recognize if the partnership sold all its assets immediately before the distribution with the ordinary income the partner would recognize if it sold those assets immediately after receiving them. When a terminating partnership distributes all its assets to the partners, each distributee partner would recognize ordinary income equal to the excess of (1) the amount of ordinary income from hot assets that would be allocated to the partner if the partnership, immediately before the distributions, sold all its assets for FMV, over (2) the amount of ordinary income from hot assets that would be recognized by that partner if, immediately after the distribution, the partner sold the distributed hot assets for FMV.[7]

In certain scenarios, the hypothetical sale approach eliminates or reduces section 751(b) gain, as demonstrated in the following example. Partnership AB is a general partnership with two equal partners, A and B, and assets with an FMV of $200. The only hot asset consists of depreciable property with an FMV of $100 and a basis of $0, with all the built-in gain allocated to partner A as a result of a previous reverse section 704(c) allocation or special allocations. Partnership AB terminates by distributing the hot asset to partner A, and all the other assets to partner B. Under the gross value approach, each partner had a 50 percent interest in the hot asset and a 50 percent interest in the cold assets, and after the liquidating distributions, partner A would hold all of the hot asset and partner B would hold all of the cold assets. Partner A would be treated as exchanging its 50 percent interest in the cold assets for the 50 percent interest in the hot asset, and partner B would be treated as exchanging its 50 percent interest in the hot asset for the 50 percent interest in the cold assets. Consequently, $50 of gain would be recognized on 50 percent of the hot asset. However, under the hypothetical sale approach, there would be no gain recognition insofar as the amount of ordinary income from the hot asset that would be allocated to the partners if the partnership, immediately before the distributions, sold all its assets for FMV ($100 of ordinary income to A, and $0 to B) would equal the amount of ordinary income from the hot asset that would be recognized by those partners if, immediately after the distribution, the partners sold the distributed hot asset for FMV ($100 of ordinary income by A, and $0 by B).

As a result, a terminating partnership's distribution of assets to partners can result in gain recognition under section 751(b) to the extent any distributee partner receives more or less than its share of the partnership's hot or cold assets. Before terminating a partnership, it is prudent to consider whether gain under section 751(b) may be eliminated or reduced by applying the gross value approach or hypothetical sale approach.

### B. Incorporation

Gain under section 751(b) generally may be avoided by incorporating the partnership through either an interests-over incorporation or an assets-over incorporation.

Under the interests-over incorporation, the partners are treated as contributing their partnership interests to the corporation in

[5]Reg. section 1.751-1(g), Example (2).

[6]*See, e.g.*, *Rauenhorst v. Commissioner*, 119 T.C. 157, 170-171 (2002); *Dixon v. Commissioner*, 141 T.C. 173, 188 (2013); *Dover Corp. v. Commissioner*, 122 T.C. 324, 350 (2004); *Walker v. Commissioner*, 101 T.C. 537, 550-551 (1993); *Phillips v. Commissioner*, 88 T.C. 529, 534 (1987); *Byrne v. Commissioner*, T.C. Memo. 2002-319; *Burleson v. Commissioner*, T.C. Memo. 1994-364. *Dixon*, which involved binding the IRS to positions in the Internal Revenue Manual and a revenue procedure as well as revenue rulings, used the term "published administrative positions" to encompass all three. *Dixon*, 141 T.C. at 188. *See also Dover* (general counsel memorandum).

[7]REG-151416-06; prop. reg. section 1.751-1(b)(2) and (3).



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exchange for corporation stock,[8] and, thus, the partners should not be treated as receiving any distribution, and there should not be any gain recognition under section 751(b).[9]

Under the assets-over incorporation, the partnership should be treated as contributing all of its assets to a new corporation in exchange for stock, and then distributing the new corporation stock to the partners.[10] Immediately before the partnership distributes all the new corporation stock to its partners, the partnership holds only cold assets (shares in the new corporation),[11] and thus each partner should be treated as receiving its share of cold assets and hot assets, resulting in no gain recognition under section 751(b).

### C. Nonrecognition Transfer Termination

Gain under section 751(b) may be eliminated or reduced by having all the partners transfer their partnership interests to a single corporation (including one of the partners) in section 351 contributions, asset reorganizations, or section 332 liquidations.

In determining the tax consequences for the transferor partners, they should be treated as transferring their partnership interests to the transferee corporation,[12] and because the transferor partners are not treated as receiving distributions from the partnership, section 751(b) should not apply.

In determining the transferee corporation's tax consequences, if the single-partner approach applies, the transferee corporation should be treated as receiving all the partnership interests, and then, while the transferee corporation is the sole owner, the partnership liquidates by distributing all its assets and liabilities to the transferee corporation. Because the transferee corporation would be treated as owning 100 percent of the partnership interests as of the time the terminating partnership distributes all its assets, the transferee corporation should be treated as receiving its 100 percent share of hot and cold assets, and, thus, no gain should be recognized under section 751(b).

If the Rev. Rul 99-6 approach applies, however, and the transferee corporation is not one of the old partners, then the partnership should be treated as having liquidated and distributed all of its assets to the partners, followed by the partners transferring the assets to the transferee corporation. Because the transferee corporation is not receiving a distribution from the partnership, section 751(b) should not apply. If the transferee corporation is one of the old partners, then the partnership should be treated as having liquidated and distributed all of its assets to the partners, and because the transferee corporation is treated as receiving a liquidating distribution from the partnership of its share of assets, there could be some gain recognition under section 751(b) to the extent the transferee corporation is not distributed its share of hot and cold assets.

### D. Other Potential Solutions

Further, section 751(b) does not apply to a partnership's distribution of property to a partner that previously contributed that property to the partnership.[13] Thus, a terminating partnership may distribute certain property back to the contributing partner without implicating section 751(b).

As a result, section 751(b) should be analyzed whenever a partnership termination changes the partners' economic interests in hot and cold assets. Depending on the facts, taxpayers may significantly reduce or eliminate section 751(b) gain by applying the hypothetical sale approach, incorporating the partnership, effectuating a

[8] Rev. Rul. 84-111, 1984-2 C.B. 88, Situation 3.

[9] Regardless of whether the single-partner approach or the Rev. Rul. 99-6 approach applies in determining the partners' tax consequences, the partners should not be treated as receiving a distribution of assets from the partnership, and, thus, section 751(b) should not apply. Moreover, under the single-partner approach, the transferee corporation should be treated as the sole partner in the partnership for a moment in time, and, thus, should be attributed 100 percent of the partnership's hot and cold assets and treated as receiving a distribution of those assets. Therefore, the transferee corporation should not recognize gain under section 751(b).

[10] Rev. Rul. 84-111, Situation 1.

[11] Only stock in a foreign corporation may be treated as a hot asset, and only to the extent of the amount that would be treated as gain to which section 1248(a) would apply if it were sold by the partnership at its FMV. *See* section 751(c). However, a newly formed foreign corporation that receives assets in a section 351 contribution should not have any earnings and profits, and, thus, section 1248 should not apply to the stock of that corporation. Consequently, the stock in the foreign corporation should not be treated as a hot asset.

[12] Rev. Rul. 84-111; Rev. Rul. 99-6, 1999-1 C.B. 432.

[13] Reg. section 1.751-1(b)(4)(i).

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nonrecognition transfer termination, or modifying the liquidating distributions.

## VIII. Gain Under Section 707 (Disguised Sale Rules)

A terminating partnership's distribution of assets may be recharacterized as a taxable sale of those assets to a distributee partner under the disguised sale rules under section 707. Thus it is important to analyze the implications of the disguised sale rules and, if necessary, structure the termination in a manner that eliminates or reduces gain recognition under section 707.

The disguised sale rules are intended to prevent taxpayers from achieving sale treatment indirectly through a combination of partnership contributions and distributions. As a result, transactions that are formally structured as contributions followed by liquidating distributions may still be recharacterized as taxable sales if the requirements of reg. section 1.707-6 are satisfied. In particular, if a partner contributed money or property to a partnership that later terminates and distributes property to that partner, the contribution and distribution may be stepped together to be treated as a taxable sale of property by the partnership to the partner under the disguised sale rules. Those rules provide that a transfer of money or other consideration (including assumption of liability) by a partner to a partnership and a transfer of property (excluding money) by the partnership to the partner constitute a sale of property by the partnership to the partner if, based on all the facts and circumstances, (1) the transfer of money or other consideration would not have been made but for the transfer of property (referred to herein as the but-for test); and (2) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.[14] Also, a partner's assumption of partnership liability may be treated as consideration transferred by the partner to the partnership that may be stepped together with the partnership's distribution of property to the partner and treated as a partnership's taxable sale of property under the disguised sale rules.[15]

The regulations establish two important presumptions. A contribution and a distribution occurring within two years generally are presumed to be a disguised sale unless the facts clearly establish otherwise.[16] Conversely, transfers occurring more than two years apart generally are presumed not to be a disguised sale unless the facts clearly establish otherwise.[17]

The disguised sale rules generally should not apply if a partner makes a partnership contribution (or assumes a partnership liability) before there is any intention or plan for the partnership to make a liquidating or nonliquidating distribution, insofar as the but-for test should not be satisfied. Moreover, although a partnership's distribution of property back to the partner that contributed it is not an exception to the disguised sale rules, the fact that the property is being distributed back to the partner that contributed it would be an important fact in establishing that there is no disguised sale under all the facts and circumstances.

## VIX. Techniques to Eliminate Gain Under Section 707

As stated, a partner's assumption of partnership liability in connection with the partnership termination may be treated as consideration transferred by the partner to the partnership that may be stepped together with the terminating partnership's subsequent distribution of property to the partner and treated as a partnership's taxable sale of property under the disguised sale rules.[18] However, a partner's assumption of partnership liability is not subject to the disguised sale rules if the partner is distributed property subject to a qualified liability that the partner assumes, or the partner assumes

[14] Reg. section 1.707-6(a); reg. section 1.707-3(b)(1); reg. section 1.707-3(b)(2)(i)-(x).

[15] Reg. section 1.707-6(a).

[16] Reg. section 1.707-3(c)(1).

[17] Reg. section 1.707-3(d).

[18] Reg. section 1.707-6(a).

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its share of partnership liabilities, as explained in Section IV.A.2 of Part 1 of this report.[19] Thus, structuring a partnership termination in a manner that results in partners being distributed property that is encumbered only by qualified liabilities and assuming only their share of partnership liabilities should not implicate section 707.

Another effective planning technique is to terminate the partnership via an interests-over incorporation or a nonrecognition transfer termination. Even if a partner made a contribution that may be subject to the disguised sale rules when the terminating partnership distributes its assets to the partner, the disguised sale rules might not apply if (1) the partnership redeems out any partner other than the contributing partner that wants to be redeemed out, by distributing assets to that partner in liquidation of its partnership interest, and (2) the partnership terminates via interests-over incorporation or a nonrecognition transfer termination. In these situations, the contributing partner and other transferor partners should be treated as transferring their partnership interests to the transferee corporation,[20] and, thus, the transaction does not involve the type of contribution and distribution sequences required for the disguised sale rules to apply.

Disguised sale concerns can frequently be eliminated by modifying the form of the partnership termination. A partner's assumption of qualified liabilities or its share of partnership liabilities, an interests-over incorporation, and a nonrecognition transfer termination may provide effective alternatives for terminating the partnership without triggering gain under the disguised sale rules.

## X. Gain Under Sections 704(c)(1)(B) and 737 (Mixing-Bowl Rules)

A partnership termination may trigger gain under the mixing bowl rules if appreciated property contributed by one partner is distributed to another partner, or if the contributing partner receives different property in liquidation. It is therefore important to determine whether any contributed property remains subject to sections 704(c)(1)(B) or 737 and, if so, to structure the termination in a manner that eliminates or reduces gain recognition.

A terminating partnership's distribution of assets may result in a partner recognizing gain under sections 704(c)(1)(B) and 737 (collectively, the mixing bowl rules) if that partner contributed appreciated property (section 704(c) property) to the partnership within seven years of the distribution and (1) the contributed section 704(c) property is distributed to another partner,[21] or (2) the contributing partner is distributed property other than the property it contributed.[22]

In particular, under section 704(c)(1)(B), if any section 704(c) property is distributed by the partnership to other than the contributing partner within seven years of its being contributed, the contributing partner recognizes the precontribution built-in gain by treating the section 704(c) property as if it were sold at its FMV at the time of the distribution.

Section 737 addresses the converse situation. Rather than receiving its contributed property back, the contributing partner receives other property in liquidation. Under section 737(a), in that situation, the contributing partner recognizes gain in an amount equal to the lesser of:

- the excess if any of the FMV of property (other than money) received in the distribution over the adjusted basis of that partner's interest in the partnership as of immediately before the distribution, reduced (but not below zero) by the amount of any money received in the distribution; or
- the partner's net precontribution gain; that is, the net gain if any that would be recognized under section 704(c)(1)(B) if all property contributed by the partner to the partnership within seven years of the distribution and still held by the partnership were distributed to another partner.[23]

[19] Polyatskiy, "A Guide for Corporate Groups on Structuring Tax-Efficient Partnership Terminations, Part 1," *Tax Notes Federal*, Oct. 19, 2026, p. 487. Section 752(a); reg. section 1.707-6(b)(1) and (2); reg. section 1.707-3(b).

[20] Rev. Rul. 84-111, Situation 3.

[21] Section 704(c)(1)(B).

[22] Section 737.

[23] Section 737(b).



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A partnership's distribution of 704(c) property back to the contributing partner is not taken into account for purposes of computing gain under section 737.[24]

## XI. Techniques to Eliminate Gain Under Sections 704(c)(1)(B) and 737

The simplest planning technique is to distribute the contributed section 704(c) property back to the contributing partner, because neither section 704(c)(1)(B) nor section 737 generally applies in that case.[25]

When a partner contributes multiple section 704(c) properties, the partnership need not necessarily return every one of them back to the contributing partner. Instead, the partnership may avoid section 704(c)(1)(B) if the contributed property returned to the contributing partner preserves sufficient built-in gain under reg. section 1.704-4(c)(2). In particular, if a partner contributed multiple appreciated properties and upon its termination the partnership distributes only some of them to the contributing partner and the remaining section 704(c) properties to the other partners, the contributing partner does not recognize gain under section 704(c)(1)(B) to the extent that (1) it receives only its previously contributed section 704(c) properties (and no other property), and (2) the built-in gain in the section 704(c) properties distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the built-in gain on the section 704(c) properties that would have been allocated to the contributing partner under section 704(c)(1)(A) on a sale of the contributed section 704(c) properties to an unrelated party immediately before the distribution.[26]

Another effective planning technique is to incorporate the partnership through either an interests-over or an assets-over incorporation. Except in the case of an assets-up incorporation, the mixing bowl rules do not apply to partnership incorporations.[27] Before incorporating the partnership, some partners other than the contributing partner can be redeemed out by having the partnership distribute assets (other than section 704(c) property) to those partners in liquidation of their partnership interests.

A nonrecognition transfer termination likewise may avoid the mixing bowl rules. Gain would not be recognized under the rules if the partnership terminates by having all the partners, including the contributing partner, transfer the partnership interests to another corporation (including one of the partners other than the contributing partner) in section 351 transfers, asset reorganizations, or section 332 liquidations. In determining the tax consequences of the contributing partner, the partner should be treated as transferring its partnership interest to the transferee corporation, and, thus, there should not be any partnership distribution that would trigger gain recognition under the mixing bowl rules.[28] Moreover, the transferee corporation should not recognize gain under the mixing bowl rules, insofar as under the Rev. Rul. 99-6 approach it should not be treated as receiving a distribution from the partnership and under the single-partner approach it should be treated as a successor to the contributing partner that is distributed back its section 704(c) property.[29] Also, arguably, the incorporation exception should apply to a nonrecognition transfer termination.[30]

Before terminating the partnership, some partners (other than the contributing partner) may also be redeemed out of the partnership by having the partnership distribute assets (other than 704(c) property) to those partners in liquidation of their partnership interests.

[24] Reg. section 1.737-2(d)(1).

[25] Section 704(c)(1)(B); reg. section 1.737-2(d)(1).

[26] Reg. section 1.704-4(c)(2).

[27] Reg. section 1.737-2(c); reg. section 1.704-4(c)(5).

[28] Rev. Rul. 99-6; Rev. Rul. 84-111, Situation 3.

[29] Reg. section 1.704-4(d)(2); section 704(c)(1)(B); reg. section 1.737-2(d)(1); reg. section 1.737-1(c)(2)(iii). Note that reg. section 1.737-1(c)(2)(iii) provides an explicit successor rule for purposes of attributing the transferor's net precontribution gain to the transferee partner, but there is no explicit successor rule that allows a transferee partner to reduce the net precontribution gain on account of the partnership's distribution of property to the successor of the partner that contributed that property to the partnership (*i.e.*, the transferee partner). Nevertheless, arguably, reg. section 1.737-1(c)(2)(iii) should be read broadly so as to treat the transferee partner as stepping into the transferor partner's shoes for purposes of applying section 737, including the previously contributed property exception. *See* William S. McKee, William S. Nelson, and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, para. 19.08 (2026), "Distributions of Property to Partners Who Contributed Other Property: Section 737."

[30] Reg. section 1.737-2(c); reg. section 1.704-4(c)(5).

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Thus, gain under sections 704(c)(1)(B) and 737 often can be avoided through careful planning. Returning contributed 704(c) property to the contributing partner, incorporating the partnership, or effectuating a nonrecognition transfer termination may allow the partnership to be terminated without triggering gain under the mixing bowl rules.

## XII. Gain Under Reg. Section 1.337(d)-3 (May Co. Regulation)

Under reg. section 1.337(d)-3, gain can be recognized when a partnership, either directly or indirectly, owns, acquires, or distributes stock of a corporate partner.[31] For these purposes, stock of a corporate partner also includes other equity interests, including options, warrants, and similar interests, in the corporate partner, or stock or other equity interests in a corporation that controls the corporate partner within the meaning of section 304(c), except that sections 318(a)(1) and (3) do not apply.[32] By turning off the application of section 318(a)(3) (attributing stock ownership from a shareholder to a corporation it controls), the concept of control is generally limited to situations in which the corporation whose stock is transferred is a direct or indirect parent of one of the corporate partners.

This regulation rarely applies because a partnership usually does not hold stock of its corporate partner. However, upon a partnership termination, it is prudent to confirm that reg. section 1.337(d)-3 does not apply to trigger gain.

## XIII. Section 732(f) Triggering Gain Recognition or Basis Reduction in Assets Held by a Partnership's Subsidiary Corporation

A partnership termination may implicate section 732(f) if the partnership distributes stock of a subsidiary corporation to a corporate partner that controls the subsidiary after the distribution. In that circumstance, section 732(f) may require a reduction in the subsidiary's asset basis and, in some cases, may result in gain recognition. Therefore, practitioners should determine whether any distribution of subsidiary stock could implicate section 732(f).

Section 732(f) sets forth special basis adjustments to assets of a distributed corporation controlled by a corporate partner. Section 732(f)(1) provides that if: (1) a corporation (the corporate partner) receives a distribution from a partnership of stock in another corporation (the distributed corporation), (2) the corporate partner has control of the distributed corporation immediately after the distribution or at any time thereafter,[33] and (3) the partnership's adjusted basis in that stock immediately before the distribution exceeds the corporate partner's adjusted basis in the stock immediately after the distribution, an amount equal to that excess will be applied to reduce the basis of property held by the distributed corporation at that time.[34] In other words, to the extent that basis in the stock of a distributed corporation controlled by a corporate partner is reduced under section 732(b), the basis of the distributed corporation's property is also reduced.

However, the required basis reduction cannot exceed the amount by which the sum of the aggregate adjusted bases of the property and the amount of money of the distributed corporation exceeds the corporate partner's adjusted basis in the stock of the distributed corporation.[35]

Also, if the required basis reduction exceeds the subsidiary's aggregate basis in its assets, the excess is recognized by the distributee corporate

[31] Reg. section 1.337(d)-3(c)(2)(ii) ("Stock of the corporate partner does not include any stock or other equity interests held or acquired by a partnership if all interests in the partnership's capital and profits are held by members of an affiliated group as defined in section 1504(a) that includes the corporate partner.").

[32] Reg. section 1.337(d)-3(c)(2)(i).

[33] For purposes of section 732(f), the term "control" means ownership of stock meeting the requirements of section 1504(a)(2). Section 732(f)(5). However, section 732(f) does not apply to any distribution of stock in the distributed corporation if (1) the corporate partner does not have control of that corporation immediately after the distribution, and (2) the corporate partner establishes to the satisfaction of the secretary that the distribution was not part of a plan or arrangement to acquire control of the distributed corporation. Section 732(f)(2).

[34] The basis of the corporation's property is reduced "in accordance" with section 732(c). Under section 732(f)(7), if the property held by a distributed corporation is stock in a corporation that the distributed corporation controls, section 732(f) applies to reduce the basis of the property of that controlled corporation. This rule is applied successively down the chain of lower-tier controlled corporations.

[35] Section 732(f)(3).



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partner as long-term capital gain, and the corporate partner's basis in the subsidiary stock is increased by the amount of the recognized gain.[36]

Further, special rules apply in the consolidated return context. In determining whether a corporate partner that is a member of a consolidated group has control of a distributed corporation, the stock in the distributed corporation owned by all other members of the consolidated group is taken into account.[37] Moreover, if the following two conditions are met, then section 732(f) applies only to the extent that the partnership's basis in the distributed stock immediately before the distribution exceeds the aggregate basis of the stock of the distributed corporation in the hands of corporate partners that are members of the same consolidated group immediately after the distribution: (1) two or more of the corporate partners receive a distribution of stock in another corporation; and (2) the corporation, the stock of which was distributed by the partnership, is or becomes a member of the distributee partners' consolidated group after the distribution.[38]

Practitioners should therefore evaluate section 732(f) whenever a partnership distributes subsidiary stock, particularly in connection with an assets-over incorporation, when the partnership distributes the stock of the newly formed corporation to its partners.

## XIV. Technique to Eliminate Basis Reduction and Gain Under Section 732(f)

Section 732(f) only applies if the distribution of the stock of the distributed corporation results in a basis reduction in that stock in the hands of the distributee partner. Thus, if the terminating partnership distributes the stock of a subsidiary corporation to a partner with a high basis in its partnership interest that exceeds the basis in the assets that are distributed to that partner, there should not be any basis reduction in the distributed stock of the subsidiary corporation and section 732(f) should not apply.

If the partnership terminates via an interests-over incorporation (or a nonrecognition transfer termination) and the single-partner approach is applied, then the transferor partners should be treated as transferring partnership interests to a transferee corporation, and then, while the transferee corporation is a single owner, the partnership liquidates by distributing all of its assets to the transferee corporation. Generally, the transferee corporation's basis in 100 percent of the partnership interest should equal the partnership's aggregate basis in its assets.[39] Thus, there should not be any basis reduction in assets (including in stock of a distributed corporation) distributed by the partnership to the transferee corporation under section 732(b) and section 732(f) should not apply.

## XV. Debt Issues to Consider

### A. Gain as a Result of Debt Extinguishment

When a terminating partnership distributes its assets and liabilities to its partners, debt may be extinguished as a result of (1) the partnership distributing a note to a partner that is the debtor under the note, and (2) a partner assuming the partnership's debt that is owed to that partner. Thus, when terminating a partnership, it is important to analyze the implications of debt extinguishment and, if necessary, structure the partnership termination in a manner that eliminates or reduces that gain recognition.[40]

#### 1. Partnership distributing a note to the debtor partner.

If a partnership distributes to a partner the partner's own promissory note, the obligation is effectively extinguished. The resulting tax consequences depend on whether the note was originally issued by the partner to the partnership

[36] Section 732(f)(4).

[37] Reg. section 1.732-3(a); reg. section 1.1502-34(a).

[38] Reg. section 1.732-3(b).

[39] However, there are rare instances in which the aggregate amount of basis in 100 percent of the partnership interest does not equal the partnership's aggregate basis in its assets. In those circumstances, if the transferee corporation's basis in 100 percent of the partnership interest is less than the partnership's aggregate basis in its assets, there may be a basis reduction in the distributed stock of a subsidiary corporation and section 732(f) may apply.

[40] Debt extinguishment refers to extinguishment of debt for U.S. federal income tax purposes, regardless of whether that debt continues to be respected as debt for corporate purposes (*e.g.*, debt between a corporation and its disregarded entity may be treated as debt for corporate purposes but is disregarded for federal income tax purposes).

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or instead was acquired by the partnership from a third party. If a terminating partnership distributes a note to the debtor partner, the tax consequences will be governed by (1) reg. section 1.731-1(c)(2) if the debtor partner originally issued the note to the partnership, or (2) Rev. Rul. 93-7, 1993-1 C.B. 125, if the partnership purchased the note from a third-party creditor.

Reg. section 1.731-1(c)(2) provides that the debtor partner "will be considered to have received a distribution of money."[41] It does not specify whether the amount of money that the partnership is deemed to distribute to the debtor partner equals the amount due under the note or the FMV of the note. Certain secondary authorities provide that the partner should be treated as being distributed money equal to the amount due under the note,[42] while others provide that the partner should be treated as being distributed money equal to the FMV of the note.[43]

If reg. section 1.731-1(c)(2) is interpreted as the partnership distributing money equal to the amount due under the distributed note, no gain or loss will normally be recognized with respect to the note. Usually, the creditor partnership's basis in the note and the debtor partner's issue price in the note equal the amount due under the note. In that case, the creditor partnership should not recognize any gain or loss because the note should be treated as being satisfied for an amount equal to the creditor partnership's basis in the note.[44] Similarly, the debtor partner should not recognize any cancellation of debt (COD) income or repurchase premium deduction because it should be treated as having satisfied the note for an amount of money equal to its issue price.[45]

If reg. section 1.731-1(c)(2) is interpreted as treating the partnership as distributing money equal to the FMV of the distributed note, there will usually be gain or loss recognized for the note. The debtor partner should be treated as satisfying the note for an amount equal to the FMV of the note. Thus, the creditor partnership should recognize gain or loss equal to the difference between the note's FMV and basis.[46] And the debtor partner should recognize COD income or a repurchase premium deduction equal to the difference between the note's issue price and FMV.[47] If the partnership wants to avoid the risk of that gain recognition, before the distribution of the note, the partnership may consider refinancing the note so as to provide terms (an interest rate) that would result in the note having an FMV that equals its basis, issue price, and amount due.

If a terminating partnership distributes to the debtor partner a note the partnership purchased from a third party, under Rev. Rul. 93-7 (1) the partnership is treated as distributing property to the debtor partner, and, thus, the partnership does not recognize any gain or loss for the note; (2) the debtor partner is treated as taking the distributed note with a basis determined under section 732; (3) the debtor partner is treated as the holder of the note and recognizes gain or loss equal to the difference between the FMV of the note and the partner's basis in the note under section 732; and (4) the debtor partner recognizes COD income or a repurchase premium deduction equal to the difference between the note's issue price and FMV.

Thus, a terminating partnership's distribution of a note to the debtor partner may result in gain

[41] A partnership's distribution of a promissory note to the debtor partner is treated as a cancellation of that note. LTR 201314004. While not precedential, private letter rulings and technical advice memorandums tend to indicate the IRS's view on the issues under consideration.

[42] *See* Phillip Gall and Franny Wang, "The Mysterious Case of Disappearing Debt in Partnership Transactions," 90 *Taxes* 157 (Mar. 2012) ("Upon the cancellation of a direct loan by a partnership to a partner, we believe the better interpretation of Treas. Reg. section 1.731-1(c)(2) is that the amount of the deemed distribution under the regulation should be the outstanding amount of the debt, not the fair market value of the debt [the footnote acknowledges that the McKee treatise provides a contrary view]. We believe this is the better view even though it allows the debtor's embedded COD [cancellation of debt] income to be deferred and converted to capital gain.").

[43] *See* McKee, Nelson, and Whitmire, *supra* note 29, at para. 19.02, "Defining the Distribution" ("Regulations section 1.731-1(c)(2) does not specify the amount of the deemed money distribution. Conceptually, the amount should be equal to the fair market value of the debt at the time it is canceled, rather than its face amount, its adjusted issue price, or any similar amount. This conceptual framework assures that the tax consequences of a cancellation are the same as those that occur if a partner receives a distribution of money from the partnership and acquires his debt by purchasing it from the partnership for its fair market value. Moreover, this analysis is mandatory if the other partners are to share in the burdens and benefits of the loan transaction, as is presumably required for the loan transaction to be respected in the first place.").

[44] *See* sections 1271 and 1001.

[45] Reg. section 1.61-12(c); reg. section 1.163-7(c).

[46] *See* sections 1271 and 1001.

[47] Reg. section 1.61-12(c); reg. section 1.163-7(c).



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recognition. Therefore, it is prudent to consider whether there will be extinguishment of debt and whether gain will be recognized. The partnership may avoid adverse tax consequences by distributing the note to a non-debtor partner or incorporating the partnership. Also, if the debtor partner originally issued the note to the partnership, the partnership may consider refinancing the note as described above.

#### 2. Partner assuming the partnership's debt that is owed to that partner.

If a terminating partnership distributes to a partner property that is subject to debt owed to that partner, the debt is extinguished. Although there is no direct authority that provides for the tax treatment of that debt extinguishment, arguably the transfer of property should not be viewed as a repayment of the debt that triggers recognition of any built-in gain in that property under section 1001, and the transfer should be treated as a distribution that is provided tax-free treatment under section 731(a) and (b).[48] However, the partnership potentially may recognize COD income or a repurchase premium deduction equal to the difference between the note's issue price and FMV, and the distributee partner may potentially recognize gain or loss equal to the difference between the FMV of the note and the partner's basis in the note.[49] If the partnership wants to avoid the risk pertaining to that gain recognition, before distributing the note, the partnership may consider refinancing the note so as to provide terms (an interest rate) that would result in the note having an FMV that equals its basis, issue price, and amount due.[50]

### B. Partnership Termination May Result in Basis Reduction in a Distributed Note Under Section 732(b), Resulting in Gain Recognition on Its Repayment

A terminating partnership's distribution of a note to its partner can result in a reduction in the basis in the note in the hands of the partner, requiring the partner to later recognize gain upon the (actual or, in the case of an intercompany obligation, deemed) repayment of the note.

Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's partnership interest will be an amount equal to the adjusted basis of that partner's partnership interest reduced by any money distributed in the same transaction.

Section 732(c) provides rules on allocating basis among the distributed property. Of relevance, the basis of distributed property starts with its adjusted basis in the hands of the partnership.[51] If the distributee partner's adjusted basis in the partnership interest exceeds the adjusted basis of the distributed property, to the extent of that difference, additional basis is allocated to the distributed property based on, and to the extent of, unrealized appreciation and then based on relative FMVs.[52] If the distributee partner's adjusted basis in the partnership interest

[48] *See Kniffen v. Commissioner*, 39 T.C. 553 (1962). *See* Gall and Wang, *supra* note 42.

[49] *Id.*

[50] The note's terms must be analyzed to determine whether it may be refinanced and if the refinancing will be respected as an arm's-length transaction. *See* section 482. The refinancing may be treated as a significant modification under reg. section 1.1001-3, and thus the note with the old terms would be deemed to be exchanged for a note with the new terms in a taxable exchange. Often, the deemed exchange of an old note for a new note results in no gain or loss recognition. Usually, the debtor's adjusted issue price in the note and the creditor's basis in the note equal the amount due under the note. And, in the deemed exchange that occurs as a result of the significant modification, the new note's issue price usually equals the amount due under the old note. *See* sections 1273(b)(4) and 1274. Thus, in the deemed exchange, because the issue price of the new note equals the creditor's basis in the old note, the creditor does not recognize any gain or loss. *See* reg. section 1.1001-1(g). Also, because the debtor's issue price in the old note equals the issue price in the new note, the debtor does not recognize any COD income or a repurchase premium deduction. Reg. section 1.61-12(c); section 108(e)(10); reg. section 1.163-7(c).

[51] Technically, basis is first allocated to unrealized receivables and inventory items. *See* section 732(c)(1)(A).

[52] Section 732(c)(2).



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is less than the adjusted basis of distributed property, to the extent of that difference, the basis of the distributed property is decreased based on, and to the extent of, unrealized depreciation and then in proportion to the adjusted basis of each asset distributed.[53]

Thus, when a terminating partnership distributes its assets to the partners, to the extent a distributee partner's basis in the partnership interest is less than the partnership's basis in the property distributed to that partner, the basis in the distributed property may be reduced under section 732(b) in the hands of the partner. If that basis reduction is allocated to a note distributed by the terminating partnership to a partner, then the partner will recognize gain upon the (actual or, in the case of an intercompany obligation, deemed) repayment of the note.[54]

If there is a basis reduction in a distributed note, the partnership may either distribute that note to another partner or, if possible, have the note repaid and distribute the cash (provided the distributee partner's basis in the partnership interest exceeds the amount of distributed cash). Alternatively, basis reduction in a partnership's note may also be avoided by incorporating a partnership via an assets-over incorporation, insofar as it results in the partnership contributing its assets, including the note, to a newly formed corporation and the corporation taking the note with a transferred basis.[55]

Debt issues should therefore be carefully analyzed in partnership terminations. The adverse tax consequences of extinguishing indebtedness and reducing note basis can often be avoided through careful planning.

## XVI. Consolidated Return Issue to Consider

A partnership termination may trigger gain or loss under the consolidated return regulations if a distributed debt instrument becomes an intercompany obligation. Thus, before implementing a partnership termination involving members of a consolidated group, practitioners should determine whether any distributed indebtedness will become an intercompany obligation and subject to reg. section 1.1502-13(g)(5).

An intercompany obligation is an obligation between members of a consolidated group.[56] If an obligation that is not an intercompany obligation becomes an intercompany obligation, it is treated, immediately after it becomes an intercompany obligation, as having been satisfied by the debtor for cash in an amount determined under the principles of reg. section 1.108-2(f), and then reissued as a new obligation for the same amount of cash.[57] Under reg. section 1.108-2(f)(2), the amount of cash for which the intercompany obligation is deemed satisfied generally equals its FMV, unless that obligation was acquired by purchase on or less than six months before.[58] Upon a deemed satisfaction of an intercompany obligation, the character of gain or loss recognized by the creditor and the debtor is determined on a separate-entity basis,[59] and there is often a mismatch between the debtor's ordinary income/deduction and the creditor's capital gain/loss upon the deemed satisfaction of an intercompany obligation.

Therefore, a terminating partnership's distribution of a note receivable or note payable to a corporate partner that is a member of a consolidated group of which the debtor or creditor of the note is also a member results in reg. section 1.1502-13(g)(5) applying to treat the note as being satisfied and reissued for its FMV, which may trigger gain or loss recognition with mismatched character.

If the partnership wants to avoid this, then some time before the distribution of the note the

[53] Section 732(c)(3).

[54] Section 1271.

[55] Rev. Rul. 84-111, Situation 1; section 362(a).

[56] Reg. section 1.1502-13(g)(2)(ii).

[57] Reg. section 1.1502-13(g)(5)(ii)(A).

[58] Under reg. section 1.108-2(f), indebtedness is acquired by purchase if the indebtedness in the hands of the holder is not transferred basis property. *See* reg. section 1.108-2(f)(1); section 7701(a)(42). Transferred basis property is property with basis "determined in whole or in part by reference to the basis in the hands of the . . . transferor." Section 7701(a)(43). In determining a distributee partner's basis in a distributed note, section 732(b) starts out with the partnership's basis in the note, and then adjusts that basis as necessary. Thus, the distributee partner's basis in the distributed note is "determined . . . in part by reference to the basis in the hands of the . . . transferor" (*i.e.*, the partnership), and, hence, the note should be treated as a transferred basis property and substituted basis property. Thus, in applying reg. section 1.108-2(f), the distributee partner should not be treated as having purchased the note upon it being distributed to the distributee partner.

[59] Reg. section 1.1502-13(g)(6)(B).



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partnership may refinance the note to provide an interest rate that would result in the note having an FMV that equals its basis, issue price, and amount due.[60] This should result in there being no gain or loss recognized on the deemed satisfaction and reissuance of the note.

It is therefore necessary to analyze whether any debt will become an intercompany obligation upon a partnership termination and, if so, consider whether that debt should be refinanced to avoid income and loss with mismatched character.

## XVII. International Issues to Consider

### A. Gain Under Section 721(c)

A termination of a section 721(c) partnership may trigger gain recognition. Thus, the partnership termination should be structured in a way that does not trigger gain recognition under the section 721(c) regulations.

Generally, a U.S. transferor recognizes gain on the contribution of section 721(c) property (that is, appreciated property) to a section 721(c) partnership, unless the partnership applies the gain deferral method.[61] A section 721(c) property is defined as property, other than certain excluded property,[62] that has an FMV exceeding the contributing partner's basis in the property at the time of the contribution.[63] A partnership is a section 721(c) partnership if there is a contribution of section 721(c) property to the partnership and, immediately after the contribution (and all transactions related to the contribution), (1) a related non-U.S. person with respect to the U.S. contributor is a direct or indirect partner in the partnership, and (2) the U.S. transferor and related persons own 80 percent or more of the interests in the partnership capital, profits, deductions, or losses.[64] A partnership is treated as applying the gain deferral method if it satisfies the five conditions set forth in reg. section 1.721(c)-3(b). Generally, a partnership satisfies the gain deferral method by, inter alia, adopting the remedial allocation method for the section 721(c) property and applying the consistent allocation method provided in reg. section 1.721(c)-3(c).[65]

Even if a section 721(c) partnership applies the gain deferral method, a U.S. transferor partner still has to recognize gain upon an acceleration event with respect to the section 721(c) property, which is any event that either would reduce the amount of remaining built-in gain that the U.S. transferor would recognize under the gain deferral method if the event had not occurred or could defer the recognition of the remaining built-in gain.[66] Also, a U.S. transferor has to recognize gain with respect to the section 721(c) property upon a partial acceleration event, which occurs if there is a distribution of other property by the section 721(c) partnership that results in a positive basis adjustment to the section 721(c) property under section 734.[67]

Further, if a section 721(c) partnership transfers a section 721(c) property (or a U.S. transferor transfers an interest in a section 721(c) partnership that owns a section 721(c) property) to a foreign corporation in a transaction described in section 367, the property will no longer be subject to the gain deferral method.[68] The U.S. transferor will be treated as having transferred a proportionate share of that property (or partnership's property) in an exchange described in section 367(a)(1), and with respect to the remaining portion of that property the U.S. transferor must recognize an amount of gain equal to the remaining built-in gain that would have been allocated to the U.S. transferor if the section 721(c) partnership had sold that portion of

[60] *See supra* note 50.

[61] Reg. section 1.721(c)-2(b).

[62] Excluded property is defined as (1) cash equivalents, (2) certain securities, and (3) any item of tangible property with a built-in gain of less than $20,000, and (4) an interest in a partnership if 90 percent or more of the value of the partnership's property consists of excluded property. Reg. section 1.721(c)-1(b)(6)

[63] Reg. section 1.721(c)-1(b)(15)(i).

[64] Reg. section 1.721(c)-1(b)(14). For this purpose, relatedness is measured under sections 267(b) and 707(b)(1). Reg. section 1.721(c)-1(b)(12).

[65] Reg. section 1.721(c)-3(b)(1).

[66] Reg. section 1.721(c)-3(b)(2); reg. section 1.721(c)-4(b)(1).

[67] Reg. section 1.721(c)-5(d)(3).

[68] Reg. section 1.721(c)-5(e).



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the section 721(c) property immediately before the transfer for FMV.[69]

Thus, upon a termination of a section 721(c) partnership, a U.S. transferor may recognize gain under the section 721(c) regulations to the extent (1) the section 721(c) property is distributed not to the U.S. transferor, (2) another partner receives a distribution (in redemption of its partnership interest or otherwise) that results in a positive basis adjustment to the section 721(c) property under section 734, (3) the partnership incorporates into a foreign corporation, or (4) the partnership incorporates via assets-up incorporation.[70]

### B. Techniques to Eliminate Gain Under Section 721(c)

The section 721(c) regulations provide that, inter alia, the following termination events with respect to a section 721(c) property do not constitute an acceleration event and will result in the section 721(c) property no longer being subject to the gain deferral method:

> (1) incorporation of a section 721(c) partnership into a domestic corporation by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners, followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction;
>
> (2) a section 721(c) partnership's distribution of section 721(c) property either to the U.S. transferor or, if the U.S. transferor is a member of a consolidated group (as defined in reg. section 1.1502-1(h)) at the time of the distribution and the distribution occurs outside the seven-year period described in section 704(c)(1)(B), to a member of the consolidated group; and
>
> (3) a section 721(c) partnership ceasing to have any direct or indirect partners that are related foreign persons to the U.S. transferor, provided there is no plan for a related foreign person to later become a direct or indirect partner in the partnership (or a successor).[71]

There are various ways to terminate a section 721(c) partnership without triggering gain under the regulations. First, a section 721(c) partnership can redeem out the foreign partners by distributing to them non-section 721(c) property in liquidation of their partnership interests, which should result in the section 721(c) regulations no longer applying, and, thus, subsequent termination of that partnership should not trigger gain under the section 721(c) regulations.[72] Second, the partnership can distribute the section 721(c) property back to the U.S. transferor.[73] Finally, the partnership can incorporate into a domestic corporation via either an assets-over or an interests-over incorporation.[74]

### C. Gain Under Section 367

Terminating a partnership by incorporating it into a foreign corporation may result in the domestic partners recognizing gain under section 367(a).

In particular, if a domestic partner transfers an interest in a partnership (whether foreign or domestic) to a foreign corporation in an exchange described in sections 351, 361, 332, 354, or 356, the domestic partner is treated as having transferred a proportionate share of the partnership's property to the foreign corporation in an exchange described in section 367(a)(1), which may trigger gain recognition.[75] Also, if a foreign or domestic partnership transfers property to a foreign corporation in an exchange described in sections 351, 361, 332, 354, or 356, then any domestic partner in the partnership is treated as having transferred a proportionate share of the

[69] *Id.*; reg. section 1.367(a)-1(c)(3)(ii); reg. section 1.367(a)-1T(c)(3)(i).

[70] Unlike section 704(c)(1)(B), which applies only to a distribution of property that occurs within seven years of the property being contributed, a distribution of section 721(c) property to a person other than the U.S. transferor may trigger gain under the section 721(c) regulations regardless of the time span between the contribution and the distribution of the property.

[71] Reg. section 1.721(c)-5(b).

[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] Reg. section 1.367(a)-1(c)(3)(ii).



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property in an exchange described in section 367(a)(1), which may trigger gain recognition.[76]

Thus practitioners should determine whether any domestic partner will recognize gain under section 367.

## XVIII. Opportunities for Loss Recognition on Partnership Interest

When structuring a partnership termination, a tax practitioner must also analyze potential opportunities for partners to recognize a loss on their partnership interests under sections 731 and 165.

### A. Loss Under Section 731

If a terminating partnership distributes solely money, inventory, and unrealized receivables to a partner in liquidation of the partner's partnership interest, the partner recognizes a capital loss under section 731 to the extent its basis in the partnership interest exceeds the sum of money distributed plus the partner's basis (determined under section 732) in the distributed inventory and unrealized receivables.[77]

Thus, if one of the partners has a built-in loss in its partnership interest, the tax practitioner must analyze whether the partner may recognize a loss by structuring the partnership termination in a way that results in the partner being distributed solely money, inventory, and unrealized receivables in liquidation of its partnership interest. However, the tax practitioner must also ensure that those selective distributions do not trigger gain under section 751(b).

Partnerships owned by corporate groups often do not hold large amounts of cash, but rather hold receivables and have payables. If a terminating partnership distributes a receivable to a partner, that partner would not be able to claim a loss under section 731. Thus, rather than distributing a receivable, the terminating partnership may be able to have its receivables repaid and use the received money to redeem out the partner, which should allow the partner to claim a loss under section 731 on account of its partnership interest.[78]

Thus, upon a partnership termination, a partner may be able to recognize a capital loss under section 731 to the extent it is distributed only money, inventory, and unrealized receivables in liquidation of its partnership interest. Alternatively, a partner may, arguably, be able to recognize an ordinary loss under section 165 to the extent it is not distributed anything in liquidation of its partnership interest.

### B. Loss Under Section 165

If a partnership terminates without distributing anything to one of the partners, that partner may recognize a loss on account of its worthless partnership interest under section 165, equal to the amount of the basis in its partnership interest. Arguably, the loss should be of ordinary character (not capital) insofar as the partner is not receiving any distribution in exchange for its partnership interest.[79] If a partnership has liabilities that are allocated to the partner, upon the termination, the partner may be deemed to be distributed money (as a result of its share of partnership liabilities decreasing to zero), which may preclude the partner from claiming an ordinary loss on its partnership interest under section 165, and result in the partner claiming a capital loss under section 731.[80] If a partnership has a liability, then a partner should be treated as being distributed money equal to the net amount of its share of partnership liabilities minus any partnership liabilities that the partner personally assumes.[81] The partner may avoid being treated as being distributed money by assuming its share of partnership liabilities. Thus, if a partner does not receive an actual distribution in liquidation of its partnership interest but it is allocated a share of partnership liabilities, arguably, the partner may

[76] Reg. section 1.367(a)-1T(c)(3)(i).

[77] Section 731(a)(2); reg. section 1.731-1(a)(3). Sections 267 and 707(b) should not prohibit or defer the recognized loss. Reg. section 1.267(b)-1(b); section 707(b)(1).

[78] In addition to the money actually distributed to a partner, the partner should also be treated as having been distributed money equal to the amount of its share of partnership liabilities (minus any partnership liabilities that the partner assumes, if any). Section 752(a) and (b); reg. section 1.752-1(f).

[79] Rev. Rul. 93-80, 1993-2 C.B. 239. *But see Pilgrim's Pride Corp. v. Commissioner*, 141 T.C. 533 (2013), *rev'd*, 779 F.3d 311 (5th Cir. 2015).

[80] Section 752(a); section 752(b); reg. section 1.752-1(f).

[81] Section 752(a); section 752(b); reg. section 1.752-1(f).

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still be able to claim an ordinary loss on its partnership interest under section 165 by assuming its share of partnership liabilities.[82]

Another requirement that must be satisfied to claim a section 165 loss is that the loss must be (1) demonstrated by a closed and completed transaction, fixed by identifiable events, and (2) actually sustained during the tax year.[83] A termination of a partnership should qualify as a completed transaction that is fixed by an identifiable event. The partner may have to establish that the loss was sustained in the year for which it was claimed, because, for example, the partnership interest was not worthless in prior years, insofar as there was a chance that the value of the partnership interest would rebound, or there was no identifiable event in prior tax years.

Upon a partnership termination, a partner may therefore be able to recognize an ordinary loss under section 165 to the extent it is not distributed anything in liquidation of its partnership interest.

## XIX. Conclusion

Structuring a partnership termination requires careful planning because the transaction may implicate tax rules that trigger gain recognition. This report provides a guide for corporate groups on structuring a tax-efficient partnership termination. ■

[82] *Echols v. Commissioner*, 935 F.2d 703, 705 (5th Cir. 1991); *In re Kreidle*, 146 B.R. 464 (Bankr. Dist. Colo. 1991).

[83] Reg. section 1.165-1(b) and (d)(1).

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