## Agenda

<table>
<thead>
<tr>
<th>Session</th>
<th>Topic</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Introduction &amp; Overview</td>
</tr>
<tr>
<td>2</td>
<td>Economic Effect and Substantiality</td>
</tr>
<tr>
<td>3</td>
<td>Partner’s Interest in the Partnership (“PIP”)</td>
</tr>
<tr>
<td>4</td>
<td>Formation of a Partnership</td>
</tr>
<tr>
<td>5</td>
<td>Liabilities</td>
</tr>
<tr>
<td>6</td>
<td>Partnership Operations</td>
</tr>
<tr>
<td>7</td>
<td>Partnership Basis</td>
</tr>
<tr>
<td>8</td>
<td>Contributed Property Allocations</td>
</tr>
<tr>
<td>9</td>
<td>Disguised Sales</td>
</tr>
<tr>
<td>10</td>
<td>Allocation of Partnership Liabilities</td>
</tr>
</tbody>
</table>
Agenda

Session

11 – Partnership Distributions: Current and Liquidating
12 – Sale or Exchanges of Partnership Interests
13 – Events Resulting in Termination of a Partnership
14 – Summary / Wrap-Up
Purpose of the Seminar

• Gain an understanding of how MLPs differ from other partnerships.

• Review and refresh on various tax technical items critical to all partnerships.

• Discuss how MLPs interact with these partnership provisions.
Module I

Introduction & Overview
Overview

Partnership Taxation

• No federal income tax
• Income/deduction items pass-through to owners
• Character retained
• Aggregate vs. entity
**Aggregate vs. Entity**

What does A own?

A capital asset?

Half of each asset?
Overview: Getting in to a partnership

Purchase - §742
Contributions - §721

• Tax free, except:
  - Liabilities > basis
  - Services
  - Disguised sale
Overview: Operating a partnership

Partner-level Tax -- §702
Partnership-level Computations -- §703
Partner’s Distributive Share -- §704
Tax Year of the Partnership -- §706

• Partners are liable for tax on their distributive share of income calculated at the partnership-level.
• The distributive share is generally governed by the partnership agreement using section 704(b) accounting; not GAAP or tax accounting.
Overview: Getting out of a partnership

Sale -- §§741 & 751
Redemption -- §§731 & 736
Distributions - §731

• Tax free, except:
  - Cash received > basis
  - Disguised sale
  - Special rules: §704(c)(1)(b) & §737
Overview: Basis

Increases
• Contributions
• Income
• Increase in liabilities

Decreases
• Distributions
• Losses
• Decrease in liabilities
Overview: Inside vs. Outside Basis

- A&B each contribute $100
- AB purchases an asset worth $200
- Inside basis (basis in assets) = Outside basis (basis in interest)
Overview: Inside vs. Outside Basis (continued)

- C Purchases A’s Interest for $110
- Total Outside Basis is $210
- Total Inside Basis $200
Overview: Importance of Outside Basis

• Calculation of gain or loss on sale of partnership interest
• Tax consequences of distributions of money (cash, marketable securities, relief of debt)
• Limitation on deductibility of losses under § 704(d)
Overview: Capital Accounts versus Basis

A partner’s capital account is not the same as their outside tax basis.

Three sets of Capital Accounts:

- §704 (b)
- Tax
- GAAP

Examples of differences between Tax Capital and Tax Basis:

- Liabilities
- Depletion
- IDC
Overview: Master Limited Partnerships (MLPs)

- MLP is a common name for publicly traded partnerships (PTPs).
- Generally, MLPs are subject to the same rules that apply to all other partnerships.

PTPs

- Traded on a securities (or similar) exchange
- Involve a large number of partners and transfers of interests
- Fungibility
- Section 7704 & Qualifying Income and
- the use of certain conventions
PTP IPOs by Year

Source: Alerian as of September 30, 2016
MLPs by Industry

Source: Master Limited Partnership Association
MLPs by Industry

Source: Master Limited Partnership Association
MLP Market Capitalization by Industry

Market Capital on 6/8/2016

Source: Master Limited Partnership Association
Overview: Fungibility

Fungibility is not an income tax concept.

- The concept that something is interchangeable with other property of the same type (i.e., mutual substitution)
- Examples: gold, WTI Crude, Cash
- Necessary to allow the trading of securities on a national exchange
- Because MLPs are flow-through entities, the tax consequences to the investors must be considered in evaluating fungibility
- MLP fungibility requires a combination of section 743(b) adjustments and section 704(c) remedials
Defining Publicly Traded Partnerships

A Domestic or Foreign partnership is a PTP if:

1) Interests in the partnership are traded on an **established securities market**; or

2) Interests in the partnership are readily tradable on a **secondary market or the substantial equivalent thereof**
Established Securities Market

Treas. Reg. §1.7704-1(b) defines “established securities market” to include:

- A national securities exchange registered under section 6 of the Securities Exchange Act of 1934;
- A national securities exchange exempt from registration under section 6 of the Securities Exchange Act of 1934 because of the limited volume of transactions;
- A foreign securities exchange that, under the law of the jurisdiction where it is organized, satisfies regulatory requirements that are analogous to the regulatory requirements under the Securities Exchange Act of 1934 described in the two preceding bullets;
- A regional or local exchange; and,
- An inter-dealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise. Neither the statute nor the regulations define the term "traded" or contemplate any specific volume of trading as a prerequisite to finding that an interest is "traded" on an established market. If an interest is listed or otherwise available for trading on such a market, the interest is "publicly traded" regardless of how thin or inactive the market may be.
Secondary Market  
(or the Substantial Equivalent thereof)

A "secondary market or the substantial equivalent thereof" exists when the partners are "readily able to buy, sell, or exchange their membership interests in a manner that is economically comparable to trading on an established securities market....“

Treas. Reg. §1.7704-1(c)(2) provides that the secondary market test is satisfied if:

i. Interests in the partnership are regularly quoted by any person, such as a broker or dealer, making a market in the interests;

ii. Any person regularly makes available to the public (including customers or subscribers) bid or offer quotes with respect to interests and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others;

iii. The holder of an interest has a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell, or exchange the interests; or,

iv. Prospective buyers and sellers otherwise have the opportunity to buy, sell, or exchange the interests in a time frame and with the regularity and continuity that is comparable to that described in the three previous bulleted items.
Safe Harbors

- Essentially private transfers;
- Transfers pursuant to certain redemption or repurchase agreements;
- Transfers that are part of a qualified matching service;
- Issuance of interests in connection with certain specified private placements; and,
- Transfers constituting a minor volume of trading.
Overview: Section 7704 and Qualifying Income

• As a general rule, PTPs are taxed as corporations
• To avoid corporate status, the partnership must generate 90% of its gross income from qualified sources (i.e., the Qualifying Income Exception)
• Qualifying Income includes:
  • Interest
  • Dividends
  • Rents from, or gains from the sale of, Real Property
  • Income from the exploration, development, mining, production, refining or transportation of a natural resource, including gain on property used in such business and
  • Regulated Investment Company income
Qualifying Income

- Statute – mineral or natural resource includes fertilizer, geothermal energy, and timber as well as any product of a character with respect to which a deduction for depletion is allowable
  - Does not include soil, sod, dirt, turf, water, mosses or minerals from seawater, the air, or similar inexhaustible sources

- Legislative History (1987 Conference Committee Report) - mineral or natural resource includes "oil, gas or products thereof" which means "gasoline, kerosene, number 2 fuel oil, refined lubricating oils, diesel fuel, methane, butane, propane and similar products which are recovered from petroleum refineries or field facilities."

- Legislative History (1987 Conference Committee Report) – "Oil, gas, or products thereof are not intended to encompass oil or gas products that are produced by additional processing beyond that of petroleum refineries or field facilities, such as plastics or similar petroleum derivatives."
Qualifying Income

- Legislative History (1988 Senate Report) – "qualifying income does not include, for example, income from fishing, farming (including the cultivation of fruit or nuts), or from hydroelectric, solar, wind, or nuclear power production"

- Most of the authority regarding Qualifying Income is in the form of Private Letter Rulings (“PLRs”)

- On May 5, 2015, the IRS and Treasury Department issued proposed regulations addressing qualifying income under section 7704(d)(1)(E). (REG-132634-14).

- On January 19, 2017, the IRS and Treasury Department issued final regulations addressing qualifying income under section 7704(d)(1)(E).
The Final Regulations – Qualifying Activities

Scope

• The final regulations removed the exclusive list of qualifying activities that appeared in the proposed regulations.

• In response to comments received on the proposed regulations, many of the definitions of section 7704(d)(1)(E) activities were revised.

• Also, the final regulations provide a uniform framework for determining whether oilfield services are qualifying activities. These rules are similar to the framework of the proposed regulations but were modified in response to certain comments received.

• The final regulations are to apply to income earned by a partnership in a taxable year beginning on or after January 19, 2017.

• 10 year transition period through the last day of the partnership’s taxable year that includes January 19, 2027.
Qualifying Activities

• Instead of an exclusive list, the final regulations provide a general definition of the 8 listed activities followed by non-exclusive examples.

• Qualifying activities include:
  1. The exploration, development, mining or production, processing, refining, transportation, or marketing of minerals or natural resources (section 7704(d)(1)(E) activities), and
  2. Certain limited support activities that are intrinsic to section 7704(d)(1)(e) activities (an “intrinsic activity”).
Qualifying Activities

• Exploration
  - An activity performed to ascertain the existence, location, extent, or quality of any deposit of mineral or natural resource before the beginning of the development stage of the natural deposit.

• Development
  - An activity performed to make minerals or natural resources accessible.

• Mining or production
  - An activity performed to extract minerals or other natural resources from the ground.

• Transportation
  - The movement of minerals or natural resources and products produced from mining or production, processing, and refining, including by pipeline, marine vessel, rail, or truck.

• Marketing of minerals or natural resources
  - Bulk sale of minerals or natural resources, and products from mining and production, processing, or refining of the final regulations.
Qualifying Activities

• Processing
  - An activity that is performed to convert raw mined or harvested products or raw well effluent to substances that can be readily transported or stored.
  - The final regulations provide a list of products that would be considered refining minerals and other natural resources when produced as a result of qualified processing activities. Products not included on the list will not be considered as a product of refining minerals and other natural resources.

• Refining
  - Includes the further physical or chemical conversion or separation process of products from processing activities, and the blending of petroleum hydrocarbons, to the extent they produce items listed in the final regulations under § 1.7704-4(c)(5)(i)(A).
**Qualifying Activities**

- Certain limited support activities that are intrinsic to section 7704(d)(1)(E) activities (an “intrinsic activity”)
  - Three requirements for a support activity to be intrinsic:
    1. The activity is specialized to support the section 7704(d)(1)(E) activity,
    2. The activity is essential to the completion of the section 7704(d)(1)(E) activity; and,
    3. The activity requires the provision of significant services to support the section 7704(d)(1)(E) activity.

- Additional Activities
  - Cost Reimbursement
  - Passive Interest
  - Blending and Additization
Effective Date

• The regulations are to apply to income earned by a partnership in a taxable year beginning on or after January 19, 2017.

• The final regulations also provide for a Transition Period, which ends on the last day of the partnership’s taxable year that includes the date that is ten years after the date that includes January 19, 2027.
Transition Rules

• The proposed regulations provide that a partnership may treat income from an activity as qualifying income during the Transition Period if:
  - The partnership received a private letter ruling from the IRS holding that income from the activity is qualifying income.
  - Prior to May 6, 2015 the partnership was publicly traded, engaged in the activity and treated the activity as giving rise to qualifying income under the statute as reasonably interpreted.
  - Prior to May 6, 2015 the partnership was publicly traded, entered into a binding agreement for construction of assets to be used in such activity that would give rise to qualifying income under the statute as reasonably interpreted.
  - The partnership is publicly traded and engages in the activity after May 6, 2015 but before January 19, 2017 and the income from the activity is qualifying income under the proposed regulations.
*Transition Period – Technical Termination*

- In the event of a technical termination, under section 708(b)(1)(B), of a publicly traded partnership that satisfied the transition period requirements, the resulting publicly traded partnership will be treated as the publicly traded partnership that satisfies the transition period requirements.
Module II

Economic Effect and Substantiality
Economic Effect
Economic Effect: In General

- Allocations under a partnership agreement comply with the §704(b) regulations if the allocations have:
  - Economic effect
  - Economic effect is substantial
- Economic effect is determined based on an objective test
- The regulations provide two safe harbors for economic effect:
  - Economic effect safe harbor
  - Alternative economic effect safe harbor


**Economic Effect Safe Harbor**

- Capital accounts maintained in accordance with § 704(b)
- Capital accounts control liquidating distributions
- Partnership agreement contains a Deficit Restoration Obligation ("DRO")
  - A DRO is an obligation to restore deficit capital accounts on liquidation
Alternative Economic Effect Safe Harbor

• Capital accounts maintained in accordance with § 704(b)
• Capital accounts control liquidating distributions
• Partnership agreement contains Qualified Income Offset (“QIO”) provision
  - QIO requires an immediate income allocation to restore a partner’s negative capital account caused by an unexpected distribution
§ 704(b) Capital Account Maintenance Rules

Increase

• $ contributed
• FMV property (net of liabilities) contributed
• Allocable income
• Tax-exempt income

Decrease

• $ distributed
• FMV property (net of liabilities) distributed
• Allocable losses
• Non-deductible/capitalizable expenditures
§ 704(b): Waterfall Agreements

- The purpose of § 704(b) is to ensure capital accounts reflect liquidation rights
- Historically partnership agreements were drafted under the §704(b) safe harbors (i.e., liquidation by capital account)
  - Targeted capital accounts determine liquidation rights first then allocate profits and losses accordingly
§ 704(b): Waterfall Agreements (continued)

- Typical structure for a targeted capital account
  - Calculate distribution rights on hypothetical liquidation ("waterfall")
  - Allocation of profits and losses to force capital account to equal liquidation rights

Is this safe harbor compliant?
Incentive Distribution Rights

Overview of IDRs

- While the ability to distribute pre-tax cash flow is typically the driving factor behind value creation from contributing assets to an MLP, characteristics of the MLP structure provide incentives to the Parent or Sponsor
  - If the GP operates the business in a manner which results in distributions paid per common unit surpassing specified target levels, then the GP receives an increasingly higher percentage of the incremental cash distributions
- The tax-advantaged structure creates a more competitive financing vehicle for both acquisitions and growth capital expenditures, which benefits the Sponsor through its general partner interest via the IDRs

Illustrative GP IDR Schedule

- A common arrangement provides that the GP can reach a tier where it receives 50% of every incremental dollar paid to common and subordinated unit holders
- There is not one standard for MLPs in terms of how many IDR tiers an MLP has, what percentage the top tier is, and at what per unit distribution each level begins

Illustrative MLP Distribution Split Between GP’s & LP’s

<table>
<thead>
<tr>
<th>Level</th>
<th>MQD</th>
<th>LP</th>
<th>GP</th>
<th>Distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>MQD</td>
<td>0-15%</td>
<td>98%</td>
<td>2%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Tier 1</td>
<td>15-25%</td>
<td>85%</td>
<td>15%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Tier 2</td>
<td>25-50%</td>
<td>75%</td>
<td>25%</td>
<td>8.1%</td>
</tr>
<tr>
<td>Tier 3</td>
<td>50% +</td>
<td>50%</td>
<td>50%</td>
<td>8.1-50%</td>
</tr>
</tbody>
</table>
**§ 704(b): IDR Agreements Example**

- Common contributes $2,000 of cash and property, and IDR contributes services with FMV $0.

**Distributions:**

1\textsuperscript{st} - Common’s initial purchase price is returned.

2\textsuperscript{nd} - Common receives 2.5% minimum quarterly distribution (the “MQD”).

3\textsuperscript{rd} - IDR’s receives 33% of all distributions in excess of the MQD.
**IDR Agreements Example – Year 1**

Assume $200 of income and $200 of distributions to the Common.

<table>
<thead>
<tr>
<th>Distribution of Hypothetical Liquidation</th>
<th>Com</th>
<th>IDR</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong> § 704(b)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
<td>0</td>
<td>1,000</td>
</tr>
<tr>
<td>Property</td>
<td>1,000</td>
<td>0</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>2,000</td>
<td>0</td>
<td>2,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Distribution Allocation</th>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Total Distribution</td>
<td>200</td>
<td></td>
<td>200</td>
</tr>
<tr>
<td>MQD</td>
<td>200</td>
<td></td>
<td>200</td>
</tr>
<tr>
<td>IDR Splits (33 / 67)</td>
<td>0</td>
<td></td>
<td>0</td>
</tr>
</tbody>
</table>

**Contributions:**

- **Cash** 1,000 0 1,000
- **Property** 1,000 0 1,000

**Beginning Capital** 2,000 0 2,000

**Year 1 Net Income** 200 0 200

**Distribution** (200) 0 (200)

**Ending Capital** 2,000 0 2,000
IDR Agreements Example – Year 2

Assume $500 of income and $500 of total distributions.

<table>
<thead>
<tr>
<th>Distribution of Hypothetical Liquidation</th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td><strong>§ 704(b)</strong></td>
<td><strong>Com</strong></td>
<td><strong>IDR</strong></td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
<td>2,000</td>
<td>0</td>
</tr>
<tr>
<td>Property</td>
<td>1,000</td>
<td>400</td>
<td>*100</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>2,000</td>
<td>(400)</td>
<td>(100)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Distribution Allocation</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Distribution</td>
<td>500</td>
<td>2,000</td>
</tr>
<tr>
<td>MQD</td>
<td>200</td>
<td>0</td>
</tr>
<tr>
<td>IDR Splits (33/67)</td>
<td>300</td>
<td>0</td>
</tr>
<tr>
<td>IDR Holder’s Share</td>
<td>100</td>
<td>0</td>
</tr>
</tbody>
</table>

* Gross Income Allocation
**IDR Agreements Example – Year 3**

Assume $200 of income and $500 of total distributions.

<table>
<thead>
<tr>
<th>Distribution of Hypothetical Liquidation</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>§ 704(b)</td>
</tr>
<tr>
<td>Cash</td>
<td>700</td>
</tr>
<tr>
<td>Property</td>
<td>1,000</td>
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<tr>
<td><strong>Total Assets</strong></td>
<td><strong>1,700</strong></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Distribution Allocation</th>
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</thead>
<tbody>
<tr>
<td>Total Distribution</td>
<td>500</td>
</tr>
<tr>
<td>MQD</td>
<td>200</td>
</tr>
<tr>
<td>IDR Splits (33/67)</td>
<td>300</td>
</tr>
<tr>
<td>IDR Holder’s Share</td>
<td>100</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Com</th>
<th>IDR</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning Capital</strong></td>
<td>2,000</td>
<td>0</td>
<td>2,000</td>
</tr>
<tr>
<td><strong>Year 1 Net Income</strong></td>
<td>100</td>
<td>*100</td>
<td>200</td>
</tr>
<tr>
<td><strong>Distribution</strong></td>
<td>(400)</td>
<td>(100)</td>
<td>(500)</td>
</tr>
<tr>
<td><strong>Ending Capital</strong></td>
<td>1,700</td>
<td>0</td>
<td>1,700</td>
</tr>
</tbody>
</table>

* Gross Income Allocation
§ 704(b): Capital Account Revaluations

• Generally partnerships do not adjust capital accounts for unrealized appreciation or depreciation

• Upon partner contribution or distribution, partnership can revalue capital accounts

• Revaluations require a book up of partnership property to fair market value to ensure that prior appreciation does not shift
§ 704(b): Capital Account Revaluations Example

- MLP uses the $100 to purchase a pipeline.
- When the pipeline is worth $150 NP contributes $75 for a 1/3 interest.

Pre-Contribution Capital Account

<table>
<thead>
<tr>
<th></th>
<th>GP</th>
<th>LP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>$50</td>
<td>$50</td>
</tr>
</tbody>
</table>
§ 704(b): Capital Account Revaluations Example

Post-Contribution Capital Account

<table>
<thead>
<tr>
<th></th>
<th>GP</th>
<th>LP</th>
<th>NP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>$50</td>
<td>$50</td>
<td>-</td>
</tr>
<tr>
<td>Book-up</td>
<td>$25</td>
<td>$25</td>
<td>-</td>
</tr>
<tr>
<td>Contribution</td>
<td></td>
<td></td>
<td>$75</td>
</tr>
<tr>
<td>Total</td>
<td>$75</td>
<td>$75</td>
<td>$75</td>
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**IDR Agreements Example – Year 4**

The MLP issues common units in public offering for $1,000 at a time when the MLP is valued at $4,000.

### Distribution of Hypothetical Liquidation

<table>
<thead>
<tr>
<th>Enterprise Value</th>
<th>§ 704(b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>700</td>
</tr>
<tr>
<td>Property</td>
<td>3,300</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>4,000</strong></td>
</tr>
</tbody>
</table>

### Waterfall Distributions

1. Common’s IPO Price 2,000
2. MQD 200
3. IDR Splits (33/67) 1,800

IDR Holder’s Share 600

<table>
<thead>
<tr>
<th></th>
<th>Com</th>
<th>IDR</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Beginning Capital</strong></td>
<td>1,700</td>
<td>0</td>
<td>1,700</td>
</tr>
<tr>
<td><strong>Unrealized Income</strong></td>
<td>1,700</td>
<td>600</td>
<td>2,300</td>
</tr>
<tr>
<td><strong>Contribution</strong></td>
<td>1,000</td>
<td>0</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>Ending Capital</strong></td>
<td>4,400</td>
<td>600</td>
<td>5,000</td>
</tr>
</tbody>
</table>
Substantiality
Substantiability: Generally

- Recap: § 704(b) requires allocations to have both economic effect and substantiability
- Substantiability is determined based on a subjective test
- Substantiability requires a reasonable possibility that the allocations will affect substantially the dollar amounts the partners will receive independent of tax consequences
Substantiality: Generally (continued)

- There are three (3) tests applied to determine substantiality
  - Are the allocations transitory?
  - Are the allocations shifting?
  - Is the overall tax effect test satisfied?
Substantiality: Transitory Allocations (Interyear)

- Special allocations in one year are transitory if another allocation is likely to offset it in a later year
  - Strong likelihood that offsetting allocations will not materially affect capital account
  - Partner total tax liability reduced
Substantiality: Transitory Allocations (Interyear) (continued)

Safe Harbor – “5 Year Rule”

• Allocations are not transitory if offsetting allocations are made after 5 years. Treas. Reg. § 1.704-1(b)(2)(iii)(c)
Substantiality: Shifting Allocations (Intra-year)

• Special allocations in the same year will not be respected if:
  
  - Strong likelihood that the allocations will not materially affect capital account
  
  - Partner total tax liability reduced
Substantiality: Overall Tax Effect Rule

The overall tax effect rule strikes down any allocation if:

- the after-tax economic consequences of at least one partner may, in present-value terms, be enhanced, and

- a strong likelihood exists that the after-tax consequences of no partner will, in present value terms, be substantially diminished.
Module III

Partner’s Interest in the Partnership ("PIP")
§ 704(b): PIP

- Partnership income and loss allocated “in accordance with the partner’s interest in the partnership” unless the partnership agreement provides for an allocation which has “substantial economic effect”

- Indicia of PIP
  - Relative contributions
  - Interest in economic profit and loss
  - Interest in cash flow
  - Right to distributions on liquidation
Module IV

Formation of a Partnership
Contribution of Property
Contributions of Property General Rules

§721(a)
• No gain or loss
• Property contributed
• Partnership interest received (profits and capital)

§722
• Substituted basis

§723
• Carryover basis
Contributions of Property: Exceptions To The General Rule

§ 731: assumptions of liabilities in excess of tax basis
  • Receipt of boot = disguised sale

§ 721(b): investment company
  • Must recognize gain
Property Contribution: Effect on Contributor

Generally nonrecognition treatment – § 721(a)
Exception - § 731(a) gain

- § 752(b) treats liabilities reallocated to other partners as cash distribution
- Liabilities assumed by the partnership exceed tax basis of assets
Property Contribution: Effect on Contributor (cont’d)

Basis in Partnership Interest Received § 722

- Plus: Money contributed
- Plus: Tax basis of property contributed
- Plus: Partnership Liabilities allocated to contributor
- Less: Liabilities Assumed by partnership
Contribution of Services
Contributions of Services

- § 721 does not apply to contributions of services
- § 61 and § 83 apply to services in exchange for capital interest
Non-elective Changes: DE to Partnership

Rev. Rul. 99-5:

Scenario 1

Scenario 2
Revenue Ruling 2004-77

- OP cannot be classified as a partnership
- OP is a DE (default) or corporation
Module V

Liabilities
§752 - Liabilities

• §752(a) - Increase in share of partnership liabilities = cash contribution
• §752(b) - Decrease in share of partnership liabilities = cash distribution
Example - Liability Shifts

FACTS

- Mike (M) + Leigh (L) = MLP a general partnership
- M contributes $10,000 cash for 50% interest
- L contributes property: basis = $4,000 and FMV = $20,000
- Property is subject to a $10,000 liability
- Partnership assumes liability
- Partners are to share liabilities equally under § 752
## Answer - Liability Shifts

### L’s Basis in MLP

<table>
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<tr>
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<td>Basis of property contributed</td>
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<tr>
<td>-L’s liabilities assumed by MLP</td>
<td>-$10,000</td>
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<tr>
<td>+MLP liabilities allocated to L</td>
<td>+(50% x $10,000)</td>
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<tr>
<td>Gain</td>
<td>(1,000)</td>
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<td>L’s basis in MLP</td>
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### M’s Basis in MLP

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<tr>
<td>$ contributed</td>
<td>$10,000</td>
</tr>
<tr>
<td>+ MLP liabilities allocated to M</td>
<td>+(50% x $10,000)</td>
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<tr>
<td>M’s basis in MLP</td>
<td>$15,000</td>
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Module VI

Partnership Operations
Partnership Allocations
Allocations overview

Step 1: Calculation 704(b) Income
Step 2: Determine each partner’s distributive share (704(b) allocations)
Step 3: Determine how taxable income is allocated (704(c) allocations)
Calculating § 704(b) income and loss

Begin with taxable income
Add back tax amount for § 704(c) items
• Inventory
• Depreciation and Amortization
• Gain / Loss on Sale of Assets
• Contingent Liabilities (i.e., non-tax liabilities)

Add / Subtract § 704(b) amount for § 704(c) items
• Depreciation and Amortization
• Gain / Loss on Sale of Assets
• Revaluation Gain

Add / Subtract Tax-Exempt Income and Nondeductibles
Allocation Periods
Modified Rules Controlling How a Partnership Determines its Taxable Year

• To determine a taxable year, partnerships are first required to adopt the majority partner’s tax year-end; and if there are no majority partners then the tax-year end of principal partners; and if there are no principal partners then the tax year-end that results in the least aggregate deferral of income

• A foreign partner’s interest will generally be disregarded in the determination unless the foreign partner is allocated ECI

• An exception to that general rule exists when regarded partners hold only a minority partnership interest

• A regarded partner is any partner that is not a disregarded foreign partner

• A minority interest previously was defined as each regarded partner holding an interest of less than 10% of capital or profits, and all regarded partners in aggregate holding interests of less than 20%

• Final Regulations replaced “capital or profits” with “capital and profits” for partnerships formed on a prospective basis

• Significant impact on reporting for partnerships with foreign partners and large profits interests, such as many investment partnerships
10-step Approach to Determining Varying Interests in Distributive Share Under § 702(a)

Steps:

1: Apply exceptions
2: Special rules for extraordinary items
3: Select method: interim closing or proration
4: Apply convention to determine timing of each variation
5: Apply any partner agreement to perform regular monthly or semi-monthly interim closings, regardless of whether any variation closes
6: Identify segments (specific periods created by interim closings)
7: Apportion items among segments
8: Determine proration periods within each segment (based on variations within each segment)
9: Prorate partnership items among each segment
10: Aggregate each partner’s items during each segment and proration period to determine their distributive share for the year
**Example Under Reg. sec. 1.706-4(a)(4)**

**Facts:**

- At the beginning of 2015, PRS, a calendar year partnership, has three equal partners, A, B, and C.
- On April 16, 2015, A sells 50% of its interest in PRS to new partner D.
- On August 6, 2015, B sells 50% of its interest in PRS to new partner E.
- During 2015, PRS earned $75,000 of ordinary income, incurred $33,000 of ordinary deductions, earned $12,000 of capital gain in the ordinary course of its business, and sustained $9,000 of capital loss in the ordinary course of its business.
- Within that year, PRS earned $60,000 of ordinary income, incurred $24,000 of ordinary deductions, earned $12,000 of capital gain, and sustained $6,000 of capital loss between January 1, 2015, and July 31, 2015.
- PRS earned $15,000 of gross ordinary income, incurred $9,000 of gross ordinary deductions, and sustained $3,000 of capital loss between August 1, 2015, and December 31, 2015.
- No extraordinary items exist.
- Capital is a material income-producing factor for PRS.
Example Under Reg. sec. 1.706-4(a)(4)

Proration Period 1

4/16
Select Proration
Must use Calendar Day Convention

Proration Period 2

7/31
8/6
Default Interim Closing
Select Semi Monthly Convention
NOTE: 8/6 Date would push back to 7/31

SEGMENT 1

SEGMENT 2
Example Under Reg. sec. 1.706-4(a)(4)

**SEGMENT 1**

- $60K Ordinary Income, $24K Ordinary Deductions
- $12K Capital Gain, $6K Capital Loss

**Proration Period 1**

- $30K Ordinary Income, $12K Ordinary Deductions
- $6K Capital Gain, $3K Capital Loss

- A: 33.33%
- B: 33.33%
- C: 33.33%

**SEGMENT 2**

- $15K Ordinary Income, $9K Ordinary Deductions
- $3K Capital Loss

**Proration Period 2**

- $30K Ordinary Income, $12K Ordinary Deductions
- $6K Capital Gain, $3K Capital Loss

- A: 16.67%
- B: 16.67%
- C: 33.33%
- D: 16.67%
- E: 16.67%

**Dates**

- 4/16
- 7/31
- 8/6
Publicly Traded Partnership Rules

- **Timing of extraordinary items**: PTPs may, but are not required to, apply their selected convention in determining who held publicly traded units.
  - E.g., a PTP may treat all variations occurring during each month as occurring at the end of the last day of that calendar month if it uses the monthly convention.
  - PTPs must use the same convention for all variations during the taxable year.
- **PTPs utilizing the Proration Method are not required to use calendar day convention for allocations to publicly traded units** – monthly convention is permissible.
  - For allocations associated with variations in non-publicly traded units, the PTP must use the calendar day convention.
- **Exception for Admission to and Exit From the Partnership Within a Convention Period**: For administrative convenience, partners in PTPs may be deemed to enter and exit from a partnership on the same day, thereby avoiding allocations.
- **The selected method and convention must be documented**.
Publicly Traded Partnership
Extraordinary Items

• Gain on the sale of asset is treated as an Extraordinary Item under the regulations.

• Consider implications on depreciation allocations as non-extraordinary items.

• **Proposed Regs:** PTPs may choose to treat certain amounts subject to foreign withholding requirements as extraordinary as long as the PTP has a regular practice of making at least four distributions to its partners during each taxable year

• Income treated as an extraordinary item under this provision must be allocated to the next date of determination for partners who will receive the subsequent quarter’s distribution.

• Helpful for financial PTPs – how will other industries in the asset class treat income that is not ECI going forward?
Module VII

Partnership Basis
Partnership Basis

- Importance of Basis
  - Calculation of gain or loss on sale of interest
  - Limitation on deductibility of losses under §704(d)
  - Tax consequences of distributions of money (cash, marketable securities, relief of debt)
- Inside Basis is separate from Outside Basis
Partnership Basis (continued)

- Adjusted basis determined under §722 (or §742) and adjusted under §705
- Impact of Liabilities on Basis (§752)
  - General Partners
  - Limited Partners
  - LLC Members
**Partnership Basis (continued)**

- Increases to Basis - §705(a)
  - Taxable income
  - Tax-exempt income
  - Depletion in excess of basis - non oil and gas
  - Contributions of money or property
  - Increase in share of liabilities
Partnership Basis (continued)

• Why include tax exempt income in basis?
• Assume the following:
  - Partner A contributes $100 to AB for a 50% interest
  - AB earns $20 of tax exempt interest
  - Partner A sells its interest in AB for $110
  - Should Partner A recognize gain on the sale?
**Partnership Basis (continued)**

- Decreases to Basis - §705(a)
  - Taxable losses
  - Non-deductible expenses (e.g., M&E)
  - Depletion on oil and gas wells to extent of basis
  - Distributions from partnership
  - Decrease in share of liabilities
**Partnership Basis**  
**Ex: Calculation of Basis**

Joe Public's basis in MLP partnership interest at 1/1/2014 $48,000  
Joe's percentage ownership of MLP 25%  
MLP's 2014 partnership net operating loss ($200,000)  
MLP's 2015 partnership net profit $16,000

How much loss, if any, may Joe recognize for 2014?

- §704(d) limits a partner's distributive share of partnership loss to the extent of such partner's basis in the partnership at the end of the partnership year in which such loss occurred. However, partnership losses may by carried forward by the partner and utilized against future income generated by the partnership.

2014 Recognized Loss = $48,000.
**Partnership Basis**

**Ex: Calculation of Basis (continued)**

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<td>Operating loss in 2014 ($200,000 x 25%)</td>
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<td>Loss disallowed § 704(d)</td>
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<tr>
<td>Loss recognized</td>
<td>(48,000)</td>
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<tr>
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<td>2015 Operating Income</td>
<td>4,000</td>
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<tr>
<td>2014 suspended loss § 704(d)</td>
<td>(2,000)</td>
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<td>Reportable income 2015 &amp; Basis at 12/31/2015</td>
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Partnership Basis (continued)

- Basis is determined as of date of sale or exchange or termination of partnership interest
- Alternative rule of calculation of basis
- Relationship between ‘basis’ and ‘capital account’
- Partners can never have negative basis
  - Partners may have negative capital accounts
Module VIII

Contributed Property Allocations
§ 704(c)

- Original § 704(c) – Contributed property with built-in gain or loss
- Reverse § 704(c) – new partner contributes cash to partnership and partnership’s property has built-in gain or loss
- Tax allocations must take into account variation between tax basis and fair market value of property at time of contribution
- Tax gain or loss on disposition of contributed property allocated to contributing partner
- Tax depreciation/amortization with respect to contributed property allocated to take into account built-in gain or loss
§ 704(c)

Use reasonable method to allocate tax amounts for § 704(c) items

Apply methods on an asset by asset basis
• E.g., use traditional method for goodwill, but remedial for machinery

Three Reasonable Methods Provided in Treas. Reg. § 1.704-3
• Traditional – Ceiling Rule limit
• Curative – Cure the ceiling rule limit with items of similar character (e.g., other depreciation)
• Remedial – use notional items of income and deduction to give the “non-contributing” partner tax amounts equal to its share of § 704(b) amounts
**Five step approach**

**Step One**: Compute tax item

**Step Two**: Compute book item

**Step Three**: Allocate book item

**Step Four**: Allocate tax to noncontributing partner to the extent of its share of the book item

**Step Five**: Allocate residual tax, if any, to contributing/ § 704(c) partner
§ 704(c): Example

Assume: Subsequent Sale of Land by AB for $80

- Tax gain = $40 (80-40=40)
- § 704(b) gain = $30 (80-50=30)
- § 704(b) gain is allocated 15 to each A and B
- Without § 704(c) tax gain is allocated 20 to each A and B but § 704(c) requires tax to follow § 704(b) – 15 to A and 25 to B
Public

Cash $100

Sponsor

Property
FMV $100
Basis $60

MLP

Assume: 10 year remaining life of Property contributed
• Annual Tax Depreciation = $6
• Annual 704(b) Depreciation = $10
### Without § 704(c) Allocation

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<th>Public (non-contributing partner)</th>
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## Traditional Method

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**Traditional Method (continued)**

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Assume: Sale of Asset in Year 2 for $100

- Tax Gain = $46 ($100 - $54)
- Book Gain = $10 ($100 - $90)

Book / Tax capital account disparity disappears on sale of asset
Assume: 20 year asset with 10 year remaining life of Property contributed
- Annual Tax Depreciation = $2
- Annual § 704(b) Depreciation = $10
Ceiling Rule (continued)

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Ceiling Rule: Public’s tax allocation < § 704(b) allocation
### Ceiling Rule (continued)

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<td>80</td>
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§ 704(b) / Tax Capital Account Disparity remains.
Traditional Method with Curative Allocations

- Allocate other partnership item to the non-contributor
  - Same type
- Allocated for tax purposes only
- If insufficient items (amount or type) then make allocation in next year with sufficient items
Remedial Method

- Offsetting tax allocations are created to match book allocations to the noncontributing partner
  - These offsetting allocations are notional and only exist for tax purposes

- Bifurcate Asset
  - Step in the shoes rules for tax basis
  - Excess § 704(b) is depreciated using any method for newly purchased placed in service asset
**Remedial Method – Bifurcating the Asset**

- $100 FMV, $20 ATB, $80 BIG
- 20 year life, 10 years remaining

<table>
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<th>Partnership Depreciation per Year</th>
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<td>New BIG Asset</td>
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# Remedial Method - Example

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# Remedial Method – Systematic Example

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* 704(b) Depreciation 60

<p>| | |</p>
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<tr>
<td>Tax Depreciation</td>
<td>20</td>
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<tr>
<td>Built-in Gain / Remedial</td>
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<td>Noncontributor Ownership %</td>
<td>50%</td>
</tr>
<tr>
<td>Remedial Allocation to Noncontributor</td>
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</table>
Distributions of § 704(c) Property

• § 704(c)(1)(B): Built-in gain or loss must be recognized by the contributing partner if the contributed property is distributed to another partner within 7 years of the asset’s contribution.

• § 737: Built-in gain must be recognized by a contributing partner when it contributes property to a partnership and receives a distribution of other property from such partnership within 7 years of original contribution.
“Reverse” § 704(c) Allocations

• § 704(c) applies to eliminate the § 704(b)/tax disparity created when a partnership revalues its assets (i.e. book-up)
You may be asking....

How does this work in the MLP world?
Module IX

Disguised Sales
§707 - Disguised Sales of Property

General Rules – Nonrecognition

• No gain on contribution of property to partnership
• No gain on distribution of property to partner
**Disguised Sale of Property - Gain Recognition**

- Contribution of property or services and related distribution of money or property
- More properly characterized as:
  - Transaction between partnership and non-partner
  - Sale or exchange of property between 2 partners
§ 707 - Disguised Sales of Property

Presumptions in regulations:

- **Within 2 years** - presumption of sale unless facts and circumstances clearly establish not sale
- **More than 2 years** - presumed not to be sale unless facts and circumstances clearly establish sale
Disguised Sales of Property

- Transfers treated as a sale
- Facts & circumstances determination
- Transaction treated as a sale only if based on all the facts and circumstances:
  - The transfer of money or other consideration would not have been made but for the transfer of property, and
  - In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership operations
Disguised Sales of Property: Example

- Sale of 75% of property
  - Sale: $30
  - Basis: 9 \( (12 \times \frac{3}{4}) \)
  - Gain: $21

- Contribution of 25% of property
  - FMV: $10
  - ATB: 3
Safe Harbors for Distributions Within 2 Years

• Reasonable guaranteed payments
• Reasonable preferred returns
• Operating cash flow distribution
  - (net cash flow x partner’s profits %)
• Reimbursement of Pre-formation expenditures
• Debt financed distributions
Reimbursement of Preformation Expenditures

- Treas. Reg. §1.707-4(d) provides an exception to the normal disguised sale rules for the reimbursement of certain expenditures.
- The reimbursement must be for:
  - Capital expenditures,
  - Made by the partner within the 24 month period preceding the contribution, and
  - Relate to either (i) the organization and syndication (i.e., §709) costs, or (ii) the property contributed to the partnership.
- If related to a property contribution, a FMV limitation test applies.
  - If the FMV of the property is > 120% of the tax basis,
  - The eligible cap ex is limited to 20% of the property’s FMV
Preformation Expenditures: Treas. Reg. §1.707-4(d)

(d) Exception for reimbursements of preformation expenditures.

A transfer of money or other consideration by the partnership to a partner is not treated as part of a sale of property by the partner to the partnership under section 1.707-3(a) (relating to treatment of transfers as a sale) to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that--

(1) Are incurred during the two-year period preceding the transfer by the partner to the partnership; and

(2) Are incurred by the partner with respect to--

(i) Partnership organization and syndication costs described in section 709; or

(ii) Property contributed to the partnership by the partner, but only to the extent the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the contribution. However, the 20 percent of fair market value limitation of this paragraph (d)(2)(ii) does not apply if the fair market value of the contributed property does not exceed 120 percent of the partner's adjusted basis in the contributed property at the time of contribution.
Preformation Expenditures: Treas. Reg. §1.707-4(d)

- Fair Market Value test must be applied on a property by property basis (subject to certain de minimus exceptions)

- Step in the shoes rules for non-recognition transfers and tiered partnerships

- Qualified liabilities – NO DOUBLE DIP!
The 2016 Step-in-the-Shoes Rule

A contributes property capital expenditure property to LTP

A then contributes its interest in LTP to UTP

LTP can reimburse UTP for A’s capital expenditures and UTP can reimburse A
Leveraged Partnership Structure (before 2016 temporary and final regulations)

**Step 1:** A contributes assets; B contributes strategic assets/cash

**Step 2:** LLC borrows from Bank, secured by LLC’s assets

**Step 3:** LLC distributes the cash to A, reducing its common interest

A guarantees note
Leveraged Partnership Distributions (after 2016 temporary and final regulations)

Guarantee disregarded
If A and B split profits 50/50, A likely recognizes gain under disguised sale rules equal to 50% of the liability (the portion allocated to B)
Leveraged Partnership Distributions (2016 temporary regulations)

2016 temporary disguised sale regulations

• Treats all partnership liabilities as excess nonrecourse liabilities for purposes of section 707
• No longer any concept of “economic risk of loss” for contributing partner
• Final section 752 regulations: for purposes of section 707, excess nonrecourse liabilities allocated in accordance with profit %
• Amount of liabilities allocated to other partners likely = disguised sale proceeds
• Contributing partner not allocated liabilities to the extent another party bears the “economic risk of loss”
• Effective for transactions entered into on or after January 3, 2017
Leveraged Partnership Distributions (Comparison)

Old section 707 rules
• Liabilities for section 707 purposes tied to section 752 rules
• Possible to allocate 100% of liabilities to one partner if that partner bears all the risk of loss
• Several potential methods for allocating excess nonrecourse liabilities

New rules
• Liabilities for section 707 purposes treated as excess nonrecourse liabilities
• Allocate in accordance with profit %—likely not possible to allocate 100% of liabilities to one partner
Disguised Sales with Encumbered Property

- Liability shifts away from contributing partner
- Nonqualified – shift = proceeds
- Qualified – shift is proceeds only if partner received cash proceeds ("tainted qualified liabilities")
- Contributing partner receives loan proceeds and liability allocated to other partners
Nonqualified vs. Qualified Liabilities

Nonqualified

• Liabilities incurred within 2 years of transfer presumed to be incurred in anticipation of transfer unless facts and circumstances establish otherwise.

Qualified

• Normal Business Liabilities
Nonqualified Liabilities

If partnership assumes nonqualified liability –

• Partnership treated as transferring money to contributing partner to extent nonqualified liability greater than contributing partner’s share of that liability after transfer

Allocation - Contributing partner’s share

• Recourse - Risk of Loss
• Nonrecourse - Profits interest
Module X

Allocation of Partnership Liabilities
Nonrecourse vs. Recourse Liabilities

- **Recourse**
  - Partner or related person has “economic risk of loss”
    - Payables
    - Debt guaranteed by a partner

- **Nonrecourse**
  - Any debt not considered recourse
  - Debt typically secured by property only
Allocations of Recourse Liabilities – Economic Risk of Loss

Recourse Liabilities – allocated under “atom-bomb” approach:

- All partnership liabilities become payable in full
- All partnership assets, including cash, are deemed worthless
- The partnership disposes of all its assets in a fully taxable transaction for no consideration (except relief from nonrecourse liabilities; i.e., minimum gain)
- The partnership allocates items of income, gain, loss, or deduction among the partners
- The partnership liquidates
- Recourse liabilities are allocated to the partner(s) that bear the obligation to satisfy the debt
- Special situations:
  - GP is a SMLLC
  - Partner Nonrecourse Debt
**Exception – Qualified Lender**

A partner is not treated as bearing the economic risk of loss if:

1. The partner in the business of lending money and whose relationship to the partnership is primarily that of a lender and

2. The partner owns 10% or less in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership
Final, Temporary and Proposed Regulations-Section 752

New section 752 rules, with non-disguised sale implications

- Backing away from the 6 enumerated factors proposed in 2014
- “Bottom Dollar Payment Obligations” not respected, but vertical slice guarantees and joint and several liabilities can be respected
- New proposed anti-abuse rule with six factors
- New proposed rules for deficit restoration obligations
- Non-Recourse Liabilities: Partnerships can continue to use significant item method; proposed “liquidation value method” dropped

Implications

- Existing special allocations of non-recourse items still work
- Gain deferred as part of legacy property/debt still deferred, provided grandfather rules followed
Allocations of Nonrecourse Liabilities

Nonrecourse Liabilities – allocated under a three tier approach:

• Tier 1: to the extent of § 704(b) minimum gain
  Nonrecourse debt less § 704(b) value

• Tier 2: to the extent of § 704(c) minimum gain
  Nonrecourse debt less tax basis

• Tier 3a: to the extent of excess § 704(c) built-in gain
  §704(b) value less tax basis less Tier 2

• Tier 3b: excess nonrecourse debt allocated based on share of profits
  Nonrecourse debt less Tiers 1, 2, and 3a
Minimum Gain

Minimum gain is the amount that would be recognized if the assets were exchanged for the debt.

<table>
<thead>
<tr>
<th>Nonrecourse Debt</th>
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</thead>
<tbody>
<tr>
<td>- Basis of Property</td>
</tr>
<tr>
<td>Minimum Gain</td>
</tr>
</tbody>
</table>
## Allocations of Nonrecourse Liabilities (continued)

### Asset
- FMV = $150
- Basis = $80
- Debt = $100

### Cash $50

<table>
<thead>
<tr>
<th>Tier</th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1 ($100-150)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Tier 2 ($100-80)</td>
<td>0</td>
<td>20</td>
</tr>
<tr>
<td>Tier 3a ($150-80-20)</td>
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<td>50</td>
</tr>
<tr>
<td>Tier 3b ($100-20-50)</td>
<td>15</td>
<td>15</td>
</tr>
</tbody>
</table>

**Total**
- A: 15
- B: 85
Module XI

Partnership Distributions: Current and Liquidating
Consequences to Partner
Partnership Distributions

TYPES OF DISTRIBUTIONS

• Current: Any distribution that does not liquidate a partner’s interest in capital and profits
  - Draw / Operating Distribution
  - Partial liquidation

• Liquidating: A distribution (or series of distributions) that liquidates a partner’s entire interest in a partnership
  - Ongoing partnership (§736)
  - Liquidating partnership
**Partnership Distributions (continued)**

General Rule: There is no gain or loss on distributions from a partnership to a partner.
Partnership Distributions (continued)

Gain recognized when:

- Money (including Marketable Securities, debt relief) is distributed in excess of a partner’s basis in its partnership interest (outside basis)

Loss recognized only on Liquidating Distributions and only if:

- only Cash, Marketable Securities, Receivables, and/or Inventory distributed, and
- Partner's outside basis > cash (including marketable securities) + partnership's adjusted basis in assets distributed
Partnership Distributions Basis Rules

Partner's basis in distributed property

- Current Distributions - §732(a)
  - Partnership basis carries over to partner
  - Exception: partnership's basis in assets exceeds partner's basis in partnership interest
    ◦ Basis limited to partner’s basis in partnership interest
- Liquidating Distributions - §732(b)
  - Basis = Partner’s Basis in Partnership Interest
Partnership Distributions Basis Rules

Partner’s Basis in Remaining Partnership Interest

• §733 - Partner's basis before distribution reduced by:
  - amount of money, and
  - basis to partner of property distributed as determined under §732
**Partnership Distributions Example**

Partner X receives a nonliquidating distribution from a partnership. His basis in the interest is $25,000. The distribution consists of:

- cash of $30,000 and
- land with an adjusted basis of $13,000 and a fair market value of $18,000

How much, if any, gain must Partner X recognize on the distribution?
Partnership Distributions Example (cont’d)

$5,000. Under § 731(a), X recognizes gain only to the extent that any money distributed exceeds X’s adjusted basis. X takes the land with $0 basis under § 732, and has $0 basis remaining in its interest under § 733.

Assume the same facts, but X has a basis of $35,000 in X’s interest?

What basis will Partner X have in the distributed land?
Partnership Distributions Example (cont’d)

X takes a basis of $5,000 in the land, recognizes no gain, and has $0 basis remaining in its interest
Partnership Distributions (cont’d)

Other Rules Affecting Distributee Partner

- § 735(b) - Holding Period
- § 735 - Gain or Loss on Distributed Assets
  - Unrealized Receivables: Ordinary
  - Inventory: Ordinary if sold within five years
- § 751(b) - Disproportionate Distributions
- § 731(c) – Distributions of Marketable Securities
§ 731(c): Marketable Securities

- Marketable securities treated as cash for purposes of § 731(a)
- Gain = FMV of security – tax basis of partnership interest
- Applies to actively traded financial instruments
- Distributee’s Basis = basis determined under § 732 + gain recognized by distributee partner
- Exceptions
  - Investment partnerships
  - Contributed securities
  - Security acquired in a nonrecognition transaction
  - Security not marketable at the time acquired by partnership
Consequences to Partnership
Property Distributions

- § 731(b) – No gain or loss recognized by the partnership
- § 751(b) – Deemed sale of assets to partner
Module XII

Sales or Exchanges of Partnership Interests
Sale or Exchange of Partnership Interests

§ 741. General Rule: Gain or loss is generally capital in nature.

- Gain or loss is the difference between the partner’s adjusted basis and the sales price
- Liabilities are included in amount realized
- Example: A has $50 basis in A’s partnership interest, reflecting A’s $10 share of partnership liabilities. A sells his interest for $75
Sale or Exchange of Partnership Interests

A’s amount realized

<table>
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<tr>
<th>Description</th>
<th>Amount</th>
</tr>
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<tbody>
<tr>
<td>Cash</td>
<td>75</td>
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<tr>
<td>Liabilities relieved</td>
<td>10</td>
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</table>

Total amount realized 85

A’s basis in partnership interest (50)

Gain (loss) recognized 35

Liabilities relieved and liabilities included in basis are usually the same amount, so net effect of liabilities on gain is usually zero.
Sale or Exchange of Partnership Interests
§ 751(a)

• Requires ordinary income treatment for seller’s share of partnership’s ordinary income assets (“hot assets”)
• Purpose: To ensure that seller recognizes his share of ordinary income
• Sales Proceeds allocated between § 751 “hot assets” and other property
• Separate gain / loss calculated on each class of property
  - Can have ordinary income and a capital loss
  - Can have ordinary income even if an overall loss results
• § 751(a) applies to Inventory and Unrealized Receivables
  - Includes 1245 and 1250 recapture
  - Inventory is defined as any property that is not capital in nature or defined under § 1231
§ 751(a) Example

A sells his interest to C for $100

A's Amount Realized $100
A's Basis = (65)
Overall Gain 35

A's share of FMV of Inventory $50
A's basis in Inventory (25)
A's share of ordinary income 25
A's Capital Gain 10
§751(a) and MLPs

Depreciation recapture is the most common “hot asset”

- Recapture calculations are based upon the following:
  - A unit trading price convention;
  - Asset FMVs calculated; and
  - The amount of recapture items previously allocated to the unitholder.

- Frequently, MLPs use the “High Close” convention.

- Asset FMVs are dependent on C&CE and other information provided.

- Generally, a FIFO method is applied regarding previously allocated items.
You may be asking....

How does this work in the MLP world?
## Sales Schedule

<table>
<thead>
<tr>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
<th>(7)</th>
<th>(8)</th>
<th>(9)</th>
<th>(10)</th>
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<tbody>
<tr>
<td>UNITS DISPOSED</td>
<td>ACQUISITION DATE</td>
<td>DISPOSITION DATE</td>
<td>SALES PROCEEDS</td>
<td>PURCHASE AMOUNT</td>
<td>CUMULATIVE ADJUSTMENTS TO BASIS</td>
<td>TOTAL GAIN/LOSS (-)</td>
<td>GAIN OR LOSS CLASSIFICATION</td>
<td>ORDINARY GAIN/LOSS (-)</td>
<td>CAPITAL GAIN/LOSS (-)</td>
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<td>FORM 4797, PART II, LINE 10</td>
<td>FORM 1040, FORM 8949</td>
<td>FORM 6251, LINE 17</td>
</tr>
</tbody>
</table>

---

**NOTE:** If you disposed of units during 2015, you must include the following statement in your income tax return:

**IRC SECTION 751 STATEMENT**

The taxpayer has reported ordinary income upon the disposition of units in Spectra Energy Partners LP, as provided by the Tax Matters General Partner. The amount was determined in accordance with Internal Revenue Code Section 751 and the detailed information is available in the offices of the Tax Matters General Partner upon request.
**Sale or Exchange of Partnership Interests**

**Other Issues**

- Partnership year does not close, but partner’s year does (§ 706).
  - Generally, MLPs use a monthly convention described in treasury regulations.
  - The typical monthly convention allocates income/loss to partners who were owners on the first day of the month.

- Partial Sales
  - Unitary basis - allocate basis on relative FMV of interest sold
  - Consider calculations of section 751(a) on Sales Schedule.

- Holding period - look to how long interest is held; asset holding period not relevant.
§754 Basis Adjustment
**Basis**

- Entity-aggregate theory demands that a partner’s basis in its partnership interest equal its share of the partnership’s basis in its assets.
- However, this equality can be thrown off by the following:
  - Sale of a partnership interest
  - Distribution of cash in excess of basis
  - Distribution of property with different tax basis
- To cure disparities, Section 754 allows partnership to adjust the inside basis of partnership property.
§ 754 Election

- Inside and Outside basis differentials are created under the partnership rules

- Basis adjustments were created to cure differentials
  - § 734(b) Adjustment – adjustments on distribution
  - § 743(b) Adjustment – transfers by sale or exchange
§ 754 Election (cont.)

- Partnership rules try to keep outside and inside basis equal to prevent duplication of gains and losses
- Sale of a partnership interest may create inequality
- Optional 754 election allows purchaser to equalize outside and inside basis
Section 743(b) Adjustment

• § 743(b) allows basis of partnership property to be adjusted to reflect transferee partner’s outside basis
• Adjustment with regard to transferee partner only
• If the adjustment relates to depreciable asset then treat as new asset
**Computation of § 743(b) Adjustment**

- Buyer’s Outside Basis = Amount Paid + Liabilities
  - Buyer’s Inside Basis = Previously Taxed Capital + Liabilities
  = § 743(b) Adjustment

- Previously Taxed Capital = Cash on Liquidation*
  - Buyer’s Gain on Liquidation
  + Buyer’s Loss on Liquidation

*Based on a hypothetical sale and liquidation for FMV*
§ 743(b) Basis Adjustment-Example (cont’d)

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>ATB</th>
<th>BIG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>100</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Building</td>
<td>100</td>
<td>80</td>
<td>20</td>
</tr>
<tr>
<td>Total Assets</td>
<td>200/2 = 100</td>
<td>130/2 = 65</td>
<td>70/2 = 35</td>
</tr>
<tr>
<td>Capital A</td>
<td>100</td>
<td>65</td>
<td></td>
</tr>
<tr>
<td>Capital B</td>
<td>100</td>
<td>65</td>
<td></td>
</tr>
<tr>
<td>Total Liabilities &amp; Capital</td>
<td>200</td>
<td>130</td>
<td></td>
</tr>
</tbody>
</table>

- A recognizes gain of $35
- Without a § 743(b) basis adjustment, C’s outside basis would be $100 (the amount paid) and C’s inside basis would be $65.
- If ABC sold its assets, $35 of gain would be allocated to C
- $35 of gain would be taxed twice
Computation of § 743(b) Adjustment (cont’d)

C’s Outside Basis = $100 = $100 Paid + $0 Liabilities
- C’s Inside Basis = $65 = Previously Taxed Capital + Liabilities
  $65
  $0

= § 743(b) Adjustment $35

Previously Taxed Capital = $100 Cash on Liquidation*
  - $35 Buyer’s Gain on Liquidation
  + Buyer’s Loss on Liquidation
Allocation of the Basis Adjustment

§755

- The allocation of the basis adjustment generally reduces the difference between the FMV and basis of each asset adjusted
- Two-way basis adjustments permitted
**Allocation of § 743(b) Basis Adjustment (cont’d)**

- Separate the partnership property into capital/1231 and ordinary classes
- Allocate basis adjustment between and among classes using a hypothetical sale approach
- Allocate the basis adjustment first, to the ordinary income class, and the excess to the capital asset class
- Adjustments within a class determined by hypothetical sale approach
- Example:  
  - C’s share of gain in Inventory: $25 ($50 x 50%)
  - C’s share of gain in Building: $10 ($20 x 50%)
  - C’s § 743(b) basis adjustment: $35
Due to the size and complexity, conventions are required for MLPs.

§743(b) Basis Adjustments: MLP Considerations

• Exchange trading complicates matters:
  • §743(b) basis adjustments are specific to each partner and are technically calculated based upon each partner’s specific acquisition.
  • MLPs have thousands of exchanges per day at varying prices.
  • Conventions are used to calculate the purchasing partners’ §743(b) adjustment.
  • Example: “low-close” convention.
• Basis adjustments are dependent upon the FMV of properties kept in the MLP System.
Optional Basis Adjustments - Distributions of Property to Partners

Distributee recognizes §731(a)(1) gain

- Money > partner’s outside basis
- Partnership can increase basis in remaining assets by excess.
  §734(b)(1)(A)
**Optional Basis Adjustments - Distributions of Property to Partners**

**Distributee’s basis in distributed property is limited**

- Basis of property distributed > partner’s outside basis
- Partnership can increase basis in remaining assets by excess. §734(b)(1)(B)
- This rule does not apply if the distributed property is an interest in another partnership which does not have a §754 election in effect
Allocation of Basis Adjustment (continued)

§734(b) adjustments

- May be allocated only to property of a character similar to that of distributed property
- Use a §732(c) approach to allocate the adjustment to property within a class in proportion to, and to the extent of unrealized appreciation/depreciation, then in proportion to FMV/ATB
- Adjustment must be allocated to capital gain class where cause is §731(a)(1) gain or §731(a)(2) loss
Optional Basis Adjustments - Distributions of Property to Partners (continued)

Distributee recognizes loss under §731(a)(2)

- Partner’s outside basis > money, unrealized receivables and inventory received
- Partnership must decrease basis in remaining assets by loss recognized. §734(b)(2)(A)
Optional Basis Adjustments - Distributions of Property to Partners (continued)

**Distributee’s basis in distributed property increased**

- Partnership property received takes on basis > basis of property when distributed
- Partnership must decrease basis in remaining assets by the excess. §734(b)(2)(B)
Redemptions of MLP units can be problematic if done through the public markets.

§734(b) Basis Adjustments: MLP Considerations (cont.)

- The §754 election requires adjustments under both §743(b) and §734(b).
- §734(b) basis adjustments are based upon the consequences to the redeemed partner.
- In private redemptions, the MLP can identify and determine the consequences to the redeemed partner.
- A public redemption through a securities exchange results in untraceable redemptions.
- How does the MLP calculate its §734(b) adjustment?
Mandatory Basis Adjustments
§ 743 Mandatory Basis Adjustments

- Basis adjustments under § 743 are mandatory for transfers of partnership interests where there is a substantial built-in loss.
- Substantial built-in loss = partnership’s adjusted basis in its property > FMV of partnership property by more than $250,000.
- Exceptions:
  - Securitization Partnerships
  - Electing Investment Partnerships
§ 743 Mandatory Basis Adjustments

B transfers its interest to D for $100k when the FMV of the Asset is $200k.
**§ 743 Mandatory Basis Adjustments**

- **Whiteacre**
  - AB $1000k
  - FMV $1000k

- **Blackacre**
  - AB $500k
  - FMV $1000k

### Table

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
<th>ATB</th>
<th>BIG(L)</th>
<th>B’s Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>W</td>
<td>200</td>
<td>1000</td>
<td>(800)</td>
<td>(400)</td>
</tr>
<tr>
<td>B</td>
<td>1000</td>
<td>500</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>1200</td>
<td>1500</td>
<td>(300)</td>
<td>100</td>
</tr>
</tbody>
</table>

- Assume B contributed Blackacre with FMV of $1000k, Basis of $500k
- Assume that B transfers interest to C when FMV of Whiteacre is $200k and FMV of Blackacre is still $1000k
- Substantial built-in loss of partnership assets at time of transfer = $300k
- C has a net positive adjustment of $100k
- Increase to basis of Blackacre of $500 and decrease to basis of Whiteacre of $400 required
Electing Investment Partnership

• No adjustment to the basis of the partnership’s assets
• Partnership must meet nine criteria identified in Notice 2005-32 to make the election, including:
  - Never been engaged in a trade or business
    ◦ Uncertain how to apply to tiered partnerships
  - Substantially all assets held for investment
  - 95% of contributed assets consist of money
  - No contributed assets had built-in loss when contributed
  - Interests issued within 24 months after first capital contribution
Electing Investment Partnership

- Exception intended to apply to private equity funds, venture capital funds, and buy out funds
- The election continues after a 708(b)(1)(B) termination
- Special partner-level loss disallowance rule is imposed
  - Transferee partner’s share of loss from sale or exchange of partnership property disallowed except to the extent it exceeds transferor’s loss on transfer of interest
  - Includes losses recognized by prior transferors
  - Loss disallowed computed without regard to gains (gross losses) and does not reduce partner’s basis
    - New reporting disclosures on Schedule K-1’s
§ 734 Mandatory Basis Adjustments

Basis adjustments under § 734(b) required for distributions where there is a substantial basis reduction.

- A substantial basis reduction means a downward adjustment of more than $250,000 that would be made to the basis of partnership assets if a § 754 were in effect
- Exception for Securitization partnerships
- Effective date – Distributions occurring after date of enactment
§ 755: Mandatory Step Down

- Prohibits allocation of § 734 step-down to stock of a corporate partner

- Step-downs are allocated to other partnership assets or create gains if the amount of the step-down exceeds the tax basis of other assets

- Effective for distributions after date of enactment
Module XIII

Events Resulting in Termination of a Partnership
Types of Partnership Terminations

- § 708(b)(1)(A)
- § 708(b)(1)(B)
- Merger / Conversion
Partnership Terminations

• §708(b)(1)(A): No part of any business, financial operation or venture of partnership continues to be carried on by the partners

• One partner buys second partner’s interest: Rev. Rul. 99-6
  - Bifurcated treatment
    ◦ Sale of capital asset
    ◦ Liquidation & asset purchase

• Cessation of Business Activities
  - Liquidation under State Law
  - Winding up period
Non-elective Changes: Partnership to DE

Rev.Rul. 99-6:

Scenario 1

A -> B

50% LLC Int

$10,000

50%

Scenario 2

C <-> D

50% LLC Int

$10,000

50%

50% LLC Int

$10,000

50%
§708(b)(1)(B)

§708(b)(1)(B): Sale or exchange of ≥50% capital and profits within a 12-month period.

- Technical Termination
- Short Year Return
Form of Technical Termination

1. Contribution
2. Liquidation

Old Partnership \rightarrow New Partnership

Partners
**Partnership Terminations**

*What is a “Sale or Exchange”*

- Contribution of Partnership Interest to a Corporation
- Corporate or partnership distribution of partnership interests
- A § 368 reorganization (except ‘B’ or ‘F”)
- Contribution of a partnership interest to another partnership
- Sale or exchange of an interest in a lower-tier partnership if the upper-tier terminates
- Liquidation of a corporate partner
**Partnership Terminations**

*What is not “Sale or Exchange”*

“Sale or Exchange” does NOT include:

- Contributions to partnership for new interest
- Redemptions of a partner’s interest
- Sales of the same interest within 12 months
- Gifts, inheritances, or bequests; divorce settlements between spouses
- Partnership to partnership conversions
- For a lower-tier partnership, the sale of an interest in the upper-tier partnership if the sale does not cause the termination of the upper-tier partnership
Consequences of § 708(b)(1)(B) Terminations

- Restart depreciation
  - but, § 197 assets are not ‘newly acquired’
- Closing of the Partnership Tax Year
  - Short Year Return – end on date of termination
  - Due date 3.5 months after date of termination
- Elections (but not new EIN)
  - § 754 Election of old will apply to purchaser for old partnership
  - New Partnership must make all new elections including § 754, inventory methods, § 179 expensing of business assets
- Basis Rules
  - Capital Accounts carry over
  - Holding period will generally “tack”
**MLPs and Technical Terminations**

- Causes of technical terminations:
  - Only a few MLP technical terminations are solely the result of common unitholders trading on the exchange.
  - Most are the (direct or indirect) result of transactions by the sponsors.
- Impact of IDRs.
- Quantifying the change in ownership:
  - Private transaction must be calculated by the MLP.
  - Market transactions are based upon the information from brokers and measured by the movement in the prior twelve month’s Trade Groups.
MLPs and Technical Terminations

- The timing of obtaining data from the brokers creates a delay in the ability to evaluate for technical terminations.
  - Broker data is available in Jan/Feb of the following year.
  - Tax returns or extensions are due 3½ months after the tech term.
- IRS now has a formal policy in place for granting administrative relief to MLPs that have undergone a technical termination.
  - For MLP technical terminations after 2009.
  - Allows for filing a single combined Sch. K-1, but still requires two (or more) Form1065s.
  - Not automatic.


**Mergers**

**Merger:** The resulting partnership, for § 708 purposes, is treated as a continuation of the merging partnership whose members own more than 50% the capital and profits of the resulting partnership.

- If members of both merging partnerships own more than 50%, the resulting partnership treated as continuation of merging partnership with greater net asset value. If the resulting partnership is not owned more than 50% of capital and profits by one of the merging partnerships, then all of the partnerships are deemed to terminate and a new partnership is formed.
Partnership Mergers
Treas. Reg. §1.708-1(c)

- A and B merge into AB
- A continues
- B terminates
**Partnership Mergers**
**Treas. Reg. §1.708-1(c)**

- C and D merge into CD
- FMV of C’s net assets exceed D’s
- D terminates
- C continues

Diagram:

- **C**
  - Net Asset Val = 100

- **D**
  - Net Asset Val = 50

- **CD**
**Partnership Merger**  
*Treas. Reg. §1.708-1(c)*

2 Forms:

"Asset Over"
- Default

"Asset Up"
- §704(c)(1)(B) / §737 triggered
- §732 / §723 may change basis
- Transfer tax
- Form respected if partnership titles assets in partners' names
Partnership Conversions

Merger of Partnership into Corporation

- Rev. Rul. 2004-59: applies to state law formless conversions
- Check the box conversion regulation
- Treated as “assets over”
Module XIV

Summary & Wrap Up
Thank you

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