NEW YORK STATE BAR ASSOCIATION

One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

Report No. 1432
January 17, 2020

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1432 – Report on Partnership Terminations Following the Tax Cuts and Jobs Act*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1432 commenting on the application of Section 708(b)(1) of the Internal Revenue Code after the enactment of the Tax Cuts and Jobs Act.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

Cc:

Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury

John Cross
Associate Tax Legislative Counsel
Department of the Treasury

Michael Novey
Associate Tax Legislative Counsel
Department of the Treasury

Erika Nijenhuis
Senior Counsel
Department of the Treasury

Holly Porter
Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Thomas Moffitt
Deputy Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Clifford Warren
Senior Level Counsel to the Associate Chief Counsel (Passthroughs & Special Industries)
Internal Revenue Service

Report No. 1432

New York State Bar Association Tax Section

REPORT ON PARTNERSHIP TERMINATIONS FOLLOWING THE TAX CUTS AND JOBS ACT

January 17, 2020

TABLE OF CONTENTS

Page

I. Background

This report ("Report")[1] of the New York State Bar Association Tax Section comments on the application of section 708(b)(1)[2] following the Tax Cuts and Jobs Act (the "TCJA").[3]

Section 708 governs whether a partnership is treated as continuing or as terminating for U.S. federal income tax purposes. Section 708(a) provides that "an existing partnership shall be considered as continuing if it is not terminated."[4] Under section 708(b)(1), "a partnership shall be considered as terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership."[5]

Before the TCJA was enacted, former section 708(b)(1)(B) further provided that a partnership would be terminated if "within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits" (the "technical termination provision"). Thus, pre-TCJA, a partnership would terminate if a transaction fell within the black-and-white contours of the technical termination provision—and taxpayers could structure their transactions to ensure that a partnership would terminate (or continue) for tax purposes.[6]

Congress raised concerns about taxpayers "electively [changing] partnership-level elections and attributes in a way which otherwise would not be permitted," and the repeal of the technical termination provision specifically targeted taxpayers' ability to structure into a

---

1 The principal authors of this Report are Amanda H. Nussbaum and Janicelynn Asamoto Park. Helpful comments were received from Kimberly Blanchard, Andrew H. Braiterman, Robert Cassanos, Peter Connors, Phillip J. Gall, Steven J. Lorch, Michael Mollerus, Deborah L. Paul, Jennifer Ray, Yaron Reich, Richard L. Reinhold, Michael Schler, Eric B. Sloan, David H. Schnabel, Shun Tosaka, Dina A. Weisen, Christine N. Younger and Sara B. Zablotney. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

2 Except as otherwise noted, all section (and §) references are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury Regulations promulgated thereunder.

3 Pub. L. 115-97, § 13504(a)(1)-(2).

4 *See also* Treas. Reg. § 1.708-1(a) ("For purposes of subchapter K, chapter 1 of the Code, an existing partnership shall be considered as continuing if it is not terminated.").

5 *See also* Treas. Reg. § 1.708-1(b)(1) ("A partnership shall terminate when the operations of the partnership are discontinued and no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership."). Section 708(b)(1), formerly section 708(b)(1)(A), was re-designated without any changes to its text pursuant to the TCJA.

6 Some limitations applied to a taxpayer's ability to structure a transaction. For example, in non-precedential authority, the Internal Revenue Service (the "IRS") concluded that the technical termination provision did not apply when a partner was transferring partnership interests to a transferee who was the sole remaining partner of the partnership. Instead, the IRS concluded that section 708(b)(1)(A) applied to the transaction. *See* TAM 6309249300A (Sept. 24, 1963) ("Section 708(b)(1)(A) was intended to apply primarily to the case where all business operations of the partnership are discontinued. It also applies where all but one of the partners retire with the result that thereafter the business is conducted by a proprietorship and not a partnership."). Although the partnership was considered terminated, the fact that the termination was governed by section 708(b)(1)(A) meant that the carryover holding period provided by section 735(b) would apply to the assets attributable to the deceased partner's interest.

termination.[7] Nothing, however, suggests that Congress considered the collateral implications of that repeal. As explained in this Report and depicted in the examples herein, removing the technical termination provision may have eliminated one form of electivity but many others remain.

Under current law, and outside of the partnership merger and division context, partnership terminations are now governed by section 708(b)(1) alone. In light of the TCJA's changes to section 708, taxpayers must reconsider the tax treatment of transactions that, historically, would have been governed by the technical termination provision. For example, consider the following fact pattern:

> *Example 1. Partnership interest sale, no continuing partners*: A and B are 50/50 partners in AB Partnership. A sells its 50 percent interest to C, and B sells its 50 percent interest to D. Does AB Partnership continue for tax purposes?

All of the interests of AB Partnership are transferred. Thus, under the technical termination provision, AB Partnership (in the hands of C and D) would have been treated as a new partnership, not a continuation of AB Partnership (in the hands of A and B), which would have terminated.

Under current law, and under the facts above, the "business, financial operation, or venture of [AB Partnership] continues to be carried on" in the form of a partnership. However, taxpayers disagree as to whether it follows that the partnership continues. The central disagreement arises out of three different interpretations as to the scope of section 708(b)(1).

First, section 708(b)(1) can be viewed as a general rule that applies under all circumstances, and to all partnerships, and incorporates a historic partner requirement (the "<u>overlap rule</u>"). This rule requires overlap among the partners of the partnership whose interests or assets are being transferred (the "<u>target partnership</u>") and the partners of the partnership that is being tested under the statute (the "<u>tested partnership</u>").[8] Applying the overlap rule, AB Partnership in Example 1 terminates upon the transfers of the interests in AB Partnership.

Second, the IRS could provide guidance that a narrow exception to the overlap rule applies when the legal entities of the target and tested partnerships are the same (the "<u>legal entity exception</u>"). However, when the legal entities of the target and tested partnerships differ, the overlap rule would continue to apply. We refer to the legal entity exception, together with the overlap rule, as the "<u>modified overlap rule</u>." Applying the modified overlap rule, AB Partnership continues in Example 1 on the basis that the legal entity constituting AB Partnership is one and the same before and after the transfers of its interests.

---

[7] H.R. Rep. No. 115-409, at 273 (2017) (further noting that the repeal of the technical termination provision would "improve tax administration and increase taxpayer compliance"). *See also* JCT, Gen. Explanation of Pub. L. 115-97 (JCS-1-18), at 225 (2018); H.R. Rep. No. 115-409, 115th Cong., 1st Sess., at 415 (2017).

[8] For purposes of this Report, we have assumed that all entities that are tested under section 708(b)(1) are treated as partnerships for tax purposes, unless specified otherwise.

Third, section 708(b)(1) can be viewed as an entity activity rule, pursuant to which if, immediately after a transaction, the entity-level activities of a target partnership continue in a tested partnership (whether the same legal entity or not), the tested partnership is a continuation of the target partnership (the "entity activity rule").[9] The support for this alternative is that pre-TCJA, this provision, which arguably reflects an entity view of partnerships, had been paired with the technical termination provision, which was an aggregate rule that focused on transfers at the partner level. The entity view of partnerships arguably supports the entity activity rule. These alternative theories are discussed further in Part III below.

We acknowledge that the legal question raised by Example 1 is a very narrow one. If the partners of the target and tested partnerships overlap, the tested partnership should be viewed as a continuation of the target partnership under any of the three alternatives. Accordingly, the legal question arises only under a fact pattern in which none of the partners of the target and tested partnerships overlap. Furthermore, from a practical standpoint, in our experience, outside of related party transactions, it is uncommon (though not without precedent) that a transaction is structured as described in Example 1. Rather, more frequently, either the partners of the target partnership would sell the target partnership interests, or the target partnership would sell its assets, to a single entity formed by the acquiring group, or the partners of the target partnership would sell their partnership interests at different times. As a result, clarifying the answer to this narrow legal question is unlikely to have broad ramifications in practice.

Nevertheless, the value of resolving the issue raised in Example 1 is to inform the tax treatment of the other fact patterns described below, many of which are widespread in practice. As the IRS considers how best to resolve the issues described herein, it may also want to consider the expectations of taxpayers (especially if the tax treatment of a specified transaction would run counter to its form).

II. Tax Consequences of Partnership Terminations

Before further discussing the alternative interpretations of section 708(b)(1), it is worth noting that the differing views have real consequences for target and tested partnerships. A number of tax consequences hinge on whether a partnership has terminated for tax purposes.[10] These are briefly discussed below.

A. Closing of Partnership's Taxable Year

The taxable year of a partnership that terminates closes on its termination date (*i.e.*, the date on which the winding up of the partnership affairs is completed).[11] If the taxable years of a

[9] Partnership taxation has long been complicated by the presence of two conflicting views as to the treatment of partnerships – the aggregate view and the entity view. Under the aggregate view of partnerships, each partner is treated as directly owning an undivided interest in the partnership's assets. Under the entity view of partnerships, the partnership is viewed as an entity distinct from its partners so that a partner's investment represents an investment in the partnership interest and not an investment in the partnership's assets.

[10] In addition to the following discussion, in certain circumstances, the form of a transaction can altogether change depending on whether the tested partnership is determined to be a continuation of the target partnership (*i.e.*, from a partnership interest purchase to an asset purchase). Please see the discussion following Examples 2A and 2B.

[11] Treas. Reg. § 1.708-1(b)(3).

partnership and any of its partners differ, the partner will report more than twelve months' worth of partnership taxable income in a single tax return.

B. Tax Elections and Accounting Methods

Under section 703(b), a partnership is generally entitled to make partnership-level tax elections. Accordingly, although a tested partnership that is treated as a continuing partnership would generally be bound by the elections previously made by a partnership, if a partnership is treated as terminated, then the tested partnership is not bound by the elections of the terminated partnership.

C. Depreciation of Partnership Property

If certain depreciable property is transferred in a section 721 transaction, a taxpayer generally steps into the shoes of the transferor for purposes of depreciating that property.[12] Prior to the TCJA, section 168(i)(7)(B) further provided that the above rule "shall not apply in the case of a termination of a partnership under section 708(b)(1)(B)." Rather, the new partnership in such case would treat such depreciable property as newly placed in service.

The preamble to proposed regulations under section 708(b)(1)(B) confirmed that those proposed regulations—since finalized—"will not change the effect of a termination on the depreciation of partnership property by the new partnership."[13] The preamble further noted that the contributed property would be subject to the anti-churning rules, and the result described in the preamble "is required by statute and is not affected by the specific mechanics of a termination under section 708(b)(1)(B)."[14] Given the repeal of the specific cross references to section 708(b)(1)(B) in section 168(i)(7)(B), it is unclear whether these provisions extend to terminations outside of the technical termination context (although we cannot identify policy reasons that would justify treating terminations pursuant to section 708(b)(1) any differently).

Furthermore, under section 168(k), certain qualified property that is acquired by a taxpayer and placed in service before January 1, 2027 is eligible for accelerated depreciation.[15] If a buyer that is a partnership intends to acquire all of the assets of another partnership's business, that buyer generally would be able to immediately depreciate any qualified property acquired. If, by contrast, the buyer is treated as a continuation of the target partnership, the buyer and its partners do not appear to be eligible for accelerated depreciation under section 168(k). The buyer's partners should be treated as acquiring target partnership interests from the partners of the target partnership (rather than assets from the target partnership); accordingly, the applicability of section 168(k) would turn on whether the target partnership had a section 754

[12] *See* section 168(i)(7)(A) (applying to modified accelerated cost recovery system and accelerated cost recovery system property).

[13] Termination of a Partnership Under Section 708(b)(1)(B) Background, 61 Fed. Reg. 21985, 21986 (proposed May 13, 1996) (codified at TD 8717).

[14] *Id.*

[15] Generally, bonus depreciation applies at a 100 percent rate for qualified property placed in service before January 1, 2023, and will phase down for property placed in service between 2023 and 2026. Section 168(k)(6)(A). Certain long-production period property and aircraft are eligible for 100 percent bonus depreciation if placed in service before January 1, 2024, and will phase down beginning in 2024. Section 168(k)(6)(B).

election in place (or the buyer, as a continuation of the target partnership, makes one in the year of the transaction). This unintuitive result could surprise a buyer and materially affect its economic position. A potential buyer is likely to price in the value of any expected deductions when determining the purchase price for the target; an inability to take these deductions could affect the buyer's expected return on its investment, as well as its cash flow in respect of the business acquired.

D. Partnership Audits and Litigation under the Bipartisan Budget Act of 2015

Under section 6225, a partnership is liable for "imputed underpayments"—generally, an approximation of the tax liability owed by the partners in the partnership in a reviewed year as a result of incorrectly reported income for that reviewed year (assuming all partners are taxable at the highest rate in effect for that year). Although the Code and regulations allow for alternative methods of satisfying the liability, given a number of well-documented administrative challenges relating to those methods, particularly in tiered partnership arrangements, in many cases, the partnership will end up paying the imputed underpayment. And, as a practical matter, a tax liability paid by the partnership will be borne by the partners in the year the audit is settled, even if the imputed underpayment related to a tax liability for a prior year, in which the identity of the partners was entirely different.

If section 708(b)(1) applies more broadly—and more transactions are viewed as continuations—acquirers of partnership assets or interests in transactions that were historically viewed as terminations may now be burdened by tax liabilities attributable to a business or venture that they had nothing to do with.[16]

However, this may be the case even if a partnership terminates. Under regulations, if a partnership terminates <u>and</u> the IRS has determined that the partnership "ceases to exist" before a partnership adjustment takes effect, then the partnership is not liable for any unpaid tax liabilities associated with that adjustment.[17] The former partners of the partnership are responsible for that liability, and under the tax law, the acquirer of the partnership's assets or partnership interests should not be exposed to this liability. In light of the conjunctive requirement, if a target partnership has terminated for tax purposes but has not received an IRS determination that the partnership has "cease[d] to exist," the possibility remains that partners of the acquiring entity may still be subject to the historic liabilities of the target.

E. Section 163(j) and Limitations on the Deductibility of Interest

Generally, under section 163(j), a taxpayer's deduction for business interest expense is limited to the sum of (i) business interest income, (ii) 30 percent of its adjusted taxable income, and (iii) floor plan financing interest expenses. For partnerships, the limitation is applied at the partnership level; the disallowed business interest expense (as determined at the partnership level) is allocated to the partners and carried forward by the partners.

---

16 In situations where a significant portion of the assets of a business is transferred, a transferee may be subject to the pre-transfer liabilities of that business based on the theory of successor or transferee liability.

17 Treas. Reg. § 301.6241-3(a).

Under section 163(j)(4)(B)(iii), when a partner disposes of its partnership interest (whether by sale, exchange, or redemption), the partner's outside basis immediately before the disposition is increased by the amount of any losses suspended under section 163(j).[18] Proposed regulations further provide that the basis adjustment is only permitted for dispositions of the entire partnership interest; if a partner disposes of less than substantially all of its partnership interests, the excess business interest expense is carried forward indefinitely until it can be offset by excess taxable income or business interest income allocated to the partner from the same partnership.[19]

This issue can be implicated in certain transactions where the partners of the target and tested partnerships overlap. Taxpayers with large suspended deductions could be motivated to structure transactions as terminations of the target partnership so as to unlock the immediate benefit of the suspended deductions (even at the cost of a character mismatch).[20]

III. Section 708(b)(1): Alternative Interpretations and their Application to Example 1

The tax consequences described above demonstrate the administrative and economic drivers that can motivate taxpayers to structure their transactions as a continuation or termination of the target partnership. As noted above, the target partnership terminates, and the tested partnership is viewed as a continuation of the target partnership, "only if no part of any business, financial operation, or venture of *the partnership* continues to be carried on by *any of its partners* in a partnership."[21] If, as in Example 1 above, (1) all of the target partnership's business has been transferred, and (2) the tested partnership continues the same business, we have identified three potential interpretations of section 708(b)(1): (i) an overlap rule that applies to all partnerships and under all circumstances, and incorporates a historic partner requirement, when evaluating whether a partnership has terminated or continues, (ii) the modified overlap rule, which generally applies that same overlap rule, except in cases in which the legal entities of the target and tested partnerships are the same, and (iii) the entity activity rule, which only considers whether the activities continue to be conducted in partnership form.

A. The Overlap Rule

First, section 708(b)(1) could, for the reasons described below, require overlap among the partners of the target and tested partnerships. This interpretation turns on the meaning of the phrase "any of its partners" in the statute.

Under a natural reading of the statute, the "it" in "any of *its* partners" refers to the partnership twice referenced earlier in the statute—*i.e.*, the target partnership that had previously conducted the business, financial operation, or venture. Under this reading, the target partnership terminates (and the tested partnership is not treated as a continuation of the target partnership) only if none of the partners of the tested partnership are historic partners of the

---

18 *See also* Prop. Treas. Reg. § 1.163(j)-6(h)(3)(i).

19 Section 163(j)(4)(B)(ii)(I); Prop. Treas. Reg. § 1.163(j)-6(h)(3)(ii).

20 We acknowledge that the same issue would apply in the context of transfers that do not implicate section 708(b)(1).

21 Section 708(b)(1) (emphasis added).

target partnership. Given, in particular, the continuing liabilities and the inability to make new tax elections and determinations if one partnership is a continuation of another, it is logical to require, in addition to continuity of a business venture, an overlap of partners who conduct that venture.[22] Accordingly, under this reading of the statute, a partner in the tested partnership must be a historic partner of the target partnership to conclude that a tested partnership is a continuation of the target partnership.

Moreover, the history of section 708(b)(1) further supports the overlap rule. Prior to the TCJA, section 708(b)(1) was often viewed as a general rule, subject to the more specific technical termination provision. Thus, if taxpayers transferred 50 percent or more of the interests of the target partnership in connection with a transaction, as in Example 1, then, by operation of the technical termination provision, the target partnership terminated, regardless of the presence of a historic partner. The technical termination provision might have been interpreted as a historic determination as to a threshold of transfers that justified terminating the target partnership, irrespective of whether any historic partner of the target partnership was also a partner in the tested partnership. With the repeal, under this reading, the current statutory mandate seems to be that any overlap among the partners of the target and tested partnerships, however small and irrespective of the magnitude of transfers at the partner level, justifies treating a tested partnership as a continuation of the target partnership.[23] That overlap is absent in Example 1. Accordingly, AB Partnership (*i.e.*, the target partnership) would not be treated as continuing under the overlap rule.[24]

B. The Modified Overlap Rule

A second view of section 708(b)(1) is that the overlap rule applies , subject to an exception in cases where the legal entities of the target and tested partnerships are the same. In those cases, drawing on IRS authorities and case law that both pre- and post-date the codification of section 708(b)(1), one could argue that the tested partnership in those circumstances should always be treated as continuing, without regard to whether any partners overlapped. These authorities conclude that, despite changes in the composition of the partners of a partnership, when that partnership continued to conduct the same business as before, the partnership continues for U.S. federal income tax purposes.[25] Thus, under this view, if evaluating a

---

22 As further discussed below in Part IV.B., practical questions arise around the margins of that requirement (*e.g.*, the extent of overlap, indirect or remote continuity, and the types of interests (profits interests, capital interests, or profits and capital interests) that justify treating a partnership as continuing based on the presence of a historic partner).

23 Without a materiality threshold for overlap in this context, we would expect more continuations after the TCJA's repeal of the technical termination provision. That said, we are not aware of any authority prior to the 1954 enactment of section 708(b)(1)(B) where a partnership with more than two partners was treated as continuing with less than 50 percent overlap of its historic partners.

24 Had A and B sold their partnership interests to C and D, respectively, in non-simultaneous transfers that were not pursuant to a plan, a transaction that may well be more likely in practice, then either C or D would have been a historic partner and AB Partnership would not have been treated as terminating.

25 Rev. Rul. 144, 1953-2 C.B. 212 ("Ordinarily, a partnership will be treated as continuing where the business of the partnership, or a substantial portion thereof, is continued."). *See, e.g.*, *Tooke v. Comm'r*, 17 B.T.A. 690 (1929) (dissolution of two-partner partnership and reincorporation of same in corporate form did not end the partnership's accounting year until the year in which the partnership's accounting period would have ended), *acq'd* 1930 IX-1 C.B. 54; *Reynolds v. Comm'r*, 17 B.T.A. 693 (1929) (same), *acq'd* 1930 IX-1 C.B. 46.

transaction where the legal entities of the target and tested partnerships differ, the overlap rule would apply. By contrast, if the legal entities of the transaction in question were one and the same, then section 708(b)(1) would, effectively, be deemed satisfied (*i.e.*, without regard to whether there were any overlapping partners).

This interpretation of former section 708(b)(1)(A) would be consistent with the conclusion in Revenue Ruling 144, a ruling issued just one year before the 1954 Code and section 708(b)(1) were enacted. That Revenue Ruling concluded that "[a] change in the membership of a partnership resulting from the death, withdrawal, substitution, or addition of a partner, or a shift of interest among exiting partners does not, in itself, effect a termination of a partnership for Federal income tax purposes."[26] We acknowledge that Revenue Ruling 144, as well as case law before and after the codification of section 708(b)(1), did not explicitly focus on the legal entity of the target partnership; however, as the ruling and these cases addressed two-person partnerships that terminated under state law upon the death,[27] retirement,[28] or withdrawal of one partner,[29] these courts and the IRS reached their respective conclusions in situations where the legal entity of the target and tested partnerships were the same. In these authorities, a partnership that would have been treated as terminating under state law but continues to undertake the minimal activities associated with the wind-up process is treated as a continuing partnership.[30] By extension, the holdings and ruling that affirm a historic emphasis on

---

[26] 1953-2 C.B. 212.

[27] *See, e.g.*, *Guaranty Trust Co. v. Comm'r*, 303 U.S. 493 (1938) (death of partner, which caused partnership to dissolve under state law, did not cause partnership to terminate, and tax year for surviving partners continued after state law dissolution); *Walsh v. Comm'r*, 7 T.C. 205 (1946) (same). *See also* Treas. Reg. § 1.708-1(b)(1)(i) ("Upon the death of one partner in a 2-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business."); Treas. Reg. § 1.736-1(a)(6) ("[I]f a partner in a 2-man partnership dies, and his estate or other successor in interest receives payments under section 736, the partnership shall not be considered to have terminated upon the death of the partner but shall terminate as to both partners only when the entire interest of the decedent is liquidated"); *Skaggs v. Comm'r*, 672 F.2d 756 (9th Cir. 1982) (per curium) (affirming Tax Court ruling that, although partnership had dissolved upon death of partner in two-partner partnership, partnership continued until windup was completed). *Cf. McCauslen v, Comm'r*, 45 T.C. 588 (1966) (two-person partnership terminated when one partner acquired decedent partner's interest in partnership, resulting in short-term capital gain upon the sale of an asset six months after purchase of decedent's partnership interest); Rev. Rul. 67-65, 1967-1 C.B. 168 (two-person partnership terminated when sole remaining partner acquired deceased partner's interest pursuant to a pre-existing buy-sell agreement).

[28] *Cf.* Treas. Reg. § 1.708-1(b)(1)(ii) (cross-referencing Treas. Reg. § 1.736-1(a)(6) for "the continuation of a partnership where payments are being made under section 736 (relating to payments to a retiring partner . . .)"); Treas. Reg. § 1.736-1(a)(6) ("[I]f one of the members of a 2-man partnership retires under a plan whereby he is to receive payments under section 736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time.").

[29] *Cf. Fensel v. United States*, 617 F.Supp. 22 (W.D. Pa. 1985) (two-partner partnership did not terminate where one partner alleged that the partnership had terminated "by mutual agreement" and he had "ceased activities" with the partnership, where other partner continued to be involved with the business); *Fuchs v. Comm'r*, 80 T.C. 506 (1983) (taxpayer's withdrawal from two-partner partnership did not terminate partnership and, accordingly, section 1033(a) election (relating to nonrecognition of gain on replacing condemned property) must be made by partnership).

[30] *See, e.g.*, Revenue Ruling 144 ("[T]he term 'partnership' for tax purposes is broader than the term under common law, the Uniform Partnership Act, or individual State laws."); *Baker Commodities, Inc. v. Comm'r*, 415 F.2d 519 (9th Cir. 1969) (complete cessation of business required for partnership to terminate); *Ginsburg v. United States*,

partnership continuations for federal tax purposes arguably support a conclusion that a partnership should continue when its business continues to be operated in the same legal entity's partnership form.[31] However, no authorities explicitly endorse this approach and an exception is not directly supported by the statutory text, suggesting that, if the IRS were to apply a legal entity exception in practice, it should issue guidance to the effect that, where the target and tested partnerships are the same legal entity, section 708(b)(1) would be deemed satisfied without regard to the presence of a historic partner (and the tested partnership would be treated as a continuation of the target partnership).

Applying the modified overlap rule to Example 1, because A and B transferred their respective partnership interests to C and D, the legal entities of the target and tested partnerships are one and the same. Accordingly, the legal entity exception to the overlapping partner requirement would apply, and section 708(b)(1) would be deemed satisfied. If, by contrast, the legal entities of the target and tested partnerships were different, then the overlap rule would determine whether the tested partnership is a continuation of the target partnership.

Strong policy reasons favor the modified overlap rule. It has the benefit of simplicity, administrability, and an intuitive conclusion and is arguably supported by a legislative policy tilt in favor of continuations, evidenced by the repeal of former section 708(b)(1)(B). As a practical matter, immediately after the transfer of AB Partnership interests to C and D, AB Partnership conducts its business in the exact same entity as it did before the transfer, AB Partnership is continuing in partnership form, and therefore, treating AB Partnership in the hands of C and D as a continuation is justified.

C. The Entity Activity Rule

The third interpretation of section 708(b)(1)—the "entity activity rule"—focuses on whether, in substance, the business of the target partnership is continuing in partnership form (or, phrased differently, whether the tested partnership is continuing any part of the business of the target partnership), without regard to which partners continue that business and without regard to whether the business continues in the same legal entity as before. This interpretation views the statute as the remaining prong of what, prior to the TCJA, was a two-prong rule for partnership terminations. Under the first prong, in former section 708(b)(1)(A), a target partnership would terminate if it carried on "no part" of its business (and a tested partnership that conducted any part of that target partnership's business would be treated as continuing). Under the second prong, the technical termination provision in former section 708(b)(1)(B) provided an aggregate rule for partnership terminations if more than 50 percent of the partners in a target partnership

---

396 F.2d 983 (Ct. Cl. 1968) (abandoning "primary purpose" of business insufficient to terminate partnership under section 708, further suggesting that holding property for investment might be enough to overcome termination); *Yagoda v. Comm'r*, 39 T.C. 170, 183 (1962) (partnership was not terminated on dissolution, but only after final distribution of partnership assets), *aff'd* 331 F.2d 485, 491 n.5 (2d Cir. 1964). *Cf. Harbor Cove Marina*, 123 T.C. 64 (2004) (holding that, where partner challenged managing partner's distribution of all partnership assets in purported liquidation of partnership, resulting litigation prevented termination of partnership under former section 708(b)(1)(A)).

[31] *See, e.g., Neubecker v. Comm'r*, 65 T.C. 577, 582 (1975) (holding that where some partners retained clients and cases of the partnership "the continuity of operation contemplated in section 708(b)(1)(A) is clearly established," despite some indication of physical interruption of business operations by relocating offices).

transferred their partnership interests within a 12-month period. Whether the target and tested partnerships are the same legal entity, and whether the partners of the target and tested partnerships overlap, are not relevant to the analysis under the entity activity rule.

Under this approach, in Example 1, AB Partnership (in the hands of C and D) would be treated as a continuation of AB Partnership (in the hands of A and B). The distinction between the entity activity rule, and the modified overlap rule described above, is that the entity activity rule applies irrespective of whether the tested partnership is the same legal entity or a different legal entity than the target partnership since, in all cases, the focus is on the activities conducted in partnership form (rather than by the same legal entity).

The authorities discussed above in the context of the legal entity exception to the statute could also be interpreted as supporting the entity activity rule. First, as discussed above, the precedents established in the case law—that a partnership should be treated as continuing even as it continues the wind up process and the entity has terminated for state law purposes—are consistent with viewing a partnership as terminating only if "no part" of the partnership's business continues. Second, Congress purported to make no change to the "present-law rule of section 708(b)(1)(A)".[32] The TCJA only repealed the technical termination rule. Inasmuch as the technical termination rule looked at the aggregate amount of partnership interests transferred in a 12-month period, the technical termination rule was an aggregate rule for partnership terminations. Thus, Congress may have intended to leave only the entity-based rule behind (i.e., the entity activity rule). Finally, the policy reasons discussed in connection with the modified overlap rule are equally relevant here.

The drawback in the entity activity rule, however, lies in the statutory text of section 708(b), which, as discussed above seems to contemplate a historic partner requirement. The application of the entity activity rule does not hinge on whether a partner in the tested partnership was a historic partner of the target partnership. Practitioners who support the entity activity rule have interpreted the phrase "any of its partners" as part of the single phrase "any of its partners in [any] partnership," reading out the historic partner requirement. Under this reading "its partners" refers to the partners of the tested partnership. Thus, the tested partnership could be a continuation of the target partnership even absent any historic partner. The primary weakness of this reading is that it seems to render the words "any of its partners" in the statute meaningless. If no historic partner is required for a partnership to continue, the words "any of its partners" in section 708(b)(1) are superfluous. But, a statute should generally not be interpreted so as to render portions of the statute meaningless, especially if another reading would give meaning to those words.[33]

Nevertheless, given subchapter K's long tradition of incorporating rules that treat partnerships as both an entity and an aggregate of its partners, and the logical juxtaposition of the entity and aggregate termination rules in former section 708(b), it seems reasonable to view section 708(b)(1) as an entity activity rule.

---

[32] *See* supra note 7.

[33] *See, e.g.*, *United States v. Menasche*, 348 U.S. 528, 538-39 (1955) (statutory construction requires "giv[ing] effect, if possible to every clause and word of a statute" (quoting *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1882)).

D. Application of Alternative Interpretations

Each of the foregoing alternative approaches is supported by a plain reading of the statute, historic or legislative context, first principles established by early case law, or some combination of the foregoing. As a result, the IRS has a number of rationales at its disposal to deal with the facts described in Example 1. In furtherance of the foregoing, it would be helpful for the IRS to issue guidance that affirms, in general, the IRS's understanding of the scope of section 708(b)(1) in general, or, more specifically, the tax treatment of Example 1.[34]

As noted in the discussion above, under the overlap rule, CD Partnership would not be treated as a continuation of AB Partnership in Example 1. However, we understand that this is inconsistent with the goals and current expectations of the IRS.[35]

One way to reconcile the natural reading of the statute with the case law, legislative history, and policy arguments in respect of section 708(b)(1) would be to apply either the modified overlap rule or the entity activity rule. Under either of these approaches, AB Partnership would be treated as a continuing partnership.

Further, if the IRS concludes that Example 1 results in the termination of AB Partnership (and CD Partnership is treated as a new partnership), we recommend that the IRS provide guidance on the tax treatment of such transaction. Specifically, the IRS should confirm that such transfer would be treated as a sale of partnership interests (rather than as an asset sale) for tax purposes. To do otherwise would unsettle expectations as to the tax treatment of many transactions that have taken place, as taxpayers generally treated Example 1 as involving a sale of partnership interests. The tax consequences attributable to the sale of partnership interests in Example 1 could be the same as those that would have applied under the former section 708(b)(1)(B) technical termination provision.[36]

Moreover, as further discussed in Part IV.B, related party taxpayers in particular have opportunities to structure into and out of terminations.[37] Accordingly, we further recommend that, if the IRS concludes that, in Example 1, AB Partnership terminates (and CD Partnership is treated as a new partnership), the IRS give due consideration to special rules that would

---

[34] In public comments, Treasury representatives have indicated that they view the transaction described in Example 1 as a continuation for tax purposes. *See, e.g.*, Eric Yauch, "IRS Plans to Clarify Partnership Technical Termination Changes," *Tax Notes*, June 10, 2019, p. 1704 (quoting remarks by Holly Porter, IRS associate chief counsel, and Clifford Warren, special counsel to the IRS associate chief counsel, at the Practising Law Institute meeting in San Francisco on June 5, 2019). In particular, Warren noted, "there's a pretty strong case that the partnership is still carrying on business through its partners, even without the historic partners." *Id*.

[35] *Id*.

[36] Specifically, under Treasury regulations section 1.708-1(c)(4), the partnership that is being terminated under former section 708(b)(1)(B) (i.e., the target partnership) would be treated as contributing all of its assets and liabilities to a new partnership (i.e., the tested partnership) in exchange for an interest in that new partnership. Immediately thereafter, the terminated partnership would make a liquidating distribution of the interests in the new partnership to the other remaining partners in proportion to their respective interests in the terminated partnership and to the purchasing partner. Accordingly, in an Example 1 scenario, AB Partnership would be treated as contributing all of its assets and liabilities to New AB Partnership, and would then make a liquidating distribution of the New AB Partnership interests to C and D (i.e., the purchasing partners).

[37] The threshold could be determined by reference to the existing rules in section 267 and section 707.

recharacterize CD Partnership as a continuation of AB Partnership if the transaction involved related parties. In the alternative, rather than recharacterizing related-party transactions in all cases, the IRS could also consider an anti-abuse rule that would apply to related-party transactions where the tested partnership is not treated as a continuation of the target partnership. In either case, the IRS should consider the extent to which step transaction principles would be relevant in determining whether a transaction should be recast.

This guidance could be provided pursuant to the IRS's regulatory authority (or by issuing a notice or revenue ruling). However, as the below discussion demonstrates, notwithstanding any guidance that the IRS may provide on this point, absent significant alterations to the statute, taxpayer electivity as to partnership terminations will remain widespread.

IV. The Challenges of Extending the Modified Overlap Rule and the Entity Activity Rule to Other Scenarios

A. Limitations of the Modified Overlap Rule and the Entity Activity Rule

Both the modified overlap rule and the entity activity rule permit a conclusion that the tested partnership is a continuation of the target partnership in Example 1. This is true, even though there is no overlap among the partners of the target and tested partnerships. The principles behind these approaches—a bias against partnership terminations and a renewed focus on the legal entity of the partnership—are hard to apply consistently. As the following sets of examples show, in some cases, the application of these approaches leads to unexpected results that are not justified by law or policy, and continue to allow taxpayers to easily structure around undesirable tax consequences.[38]

1. Examples 2A and 2B: Partnership interest sale; buyer is newly formed

For example, consider the following fact pattern:

> *Example 2A. Partnership interest sale, no continuing partners, buyer is a newly formed partnership.* A and B are 50-50 partners in AB Partnership. C and D form new CD Partnership. CD Partnership purchases all of A's and B's interests in AB Partnership. Is CD Partnership a continuation of AB Partnership?

This fact pattern parallels that in Revenue Ruling 99-6 (Situation 2)—a single unrelated buyer acquires 100 percent of the interests in a target partnership.[39] Under the ruling, for

---

[38] Electivity is present in other areas of the Code and approved by the IRS. For example, Revenue Ruling 84-111 sets forth three methods whereby a partnership may be incorporated, each of which leads to different tax results. 1984-2 C.B. 88. The IRS expressly acknowledged that the form chosen by the taxpayer to incorporate partnership assets is the form that will govern the tax consequences of the incorporation. This authority approved of electivity in general and the ability of taxpayers to "structure around undesirable tax consequences." *Id.*

[39] 1999-1 C.B. 432. While Rev. Rul. 99-6 only specifies that the buyer is an "unrelated person," the IRS has applied Rev. Rul. 99-6 to fact patterns in which the buyer is a partnership. *See, e.g.*, PLR 200807005 (Feb. 15, 2008) (buyer is disregarded entity owned by partnership).

purposes of determining the tax consequences to the buyer, AB Partnership is deemed to make a liquidating distribution of its assets to A and B, after which CD Partnership is deemed to acquire, in a taxable sale, all of those assets from A and B;[40] consequently, AB Partnership would terminate under former section 708(b)(1)(A). The recharacterization under this ruling should also apply to Example 2A. Indeed, under the modified overlap rule, because there is no overlap among the partners in AB Partnership and CD Partnership, CD Partnership would not be a continuation of AB Partnership, and AB Partnership would terminate.[41]

By contrast, under the entity activity rule—and contrary to Revenue Ruling 99-6—the emphasis on the continuing business in any partnership would result in CD Partnership being treated as a continuation of AB Partnership. But, perhaps the entity activity rule should have an exception for transactions to which the Revenue Ruling applies.

Assuming, however, that Example 2A should be viewed as a termination, it is difficult to reconcile the treatment of Example 2A (*i.e.*, CD Partnership operates AB Partnership business as a disregarded entity of CD Partnership) as a termination with the treatment of Example 1 (*i.e.*, C and D holding AB Partnership interests and operating the AB Partnership business) as a continuation. Furthermore, as transactions described in Example 2A are far more common than those in Example 1, the treatment of Example 2A as a termination undermines a possible policy goal of expanding the number of situations involving continuations.

Revenue Ruling 99-6 is not affected by the repeal of the technical termination provision. The ruling explicitly addressed a termination under former section 708(b)(1)(A) (and did not address the technical termination provision in former section 708(b)(1)(B)). Accordingly, under current law, Revenue Ruling 99-6 should continue to apply. The modified overlap rule reaches a result that is consistent with the Revenue Ruling.

Notwithstanding the foregoing, a minor change in the facts reveals a potential disconnect between Revenue Ruling 99-6 and the modified overlap rule. The following example, a variation on Example 2A, also opens the door to structuring into partnership continuations:

> *Example 2B. Partnership interest sale, a continuing partner, buyer is a newly formed partnership.* A and B are 50-50 partners in AB Partnership. A, C, and D form new ACD Partnership. ACD Partnership purchases all of A's and B's interests in AB Partnership. Is ACD Partnership a continuation of AB Partnership?

Although, facially, Example 2A and Example 2B look similar (in both cases, a single person (*i.e.*, the acquiring partnership) acquired 100 percent of the interests of the target partnership), in Example 2B, A's common ownership of both AB Partnership and ACD

[40] CD Partnership therefore acquires the assets with a cost basis and generally does not succeed to the former AB Partnership's holding period for those assets. *See also McCauslen v. Comm'r,* 45 T.C. 588 (1966) (purchase of deceased partner's interest by other partner in two-man partnership should be treated as purchase of assets attributable to purchased interest); Rev. Rul. 67-65, 1967-1 C.B. 168 (same).

[41] The legal entity exception to the overlap rule would not apply because CD Partnership is a different legal entity than AB Partnership. Accordingly, the overlap rule would apply, and AB Partnership would terminate because there is no overlap among the partners in AB Partnership and CD Partnership.

Partnership satisfies the overlap requirement, with the result that the buyer in Example 2B (ACD Partnership) is treated as a continuation of AB Partnership for tax purposes.[42] As a result, Revenue Ruling 99-6, which addresses the tax consequences to a partnership that has terminated under section 708(b)(1), is not implicated.

That said, many taxpayers might be surprised to find that the composition of the buyer's owners could alter the conclusion as to whether the tested partnership is treated as a continuation of the target partnership. We expect that many taxpayers would view both CD Partnership (in Example 2A) and ACD Partnership (in Example 2B) to be analogous to the buyer in Revenue Ruling 99-6 (Situation 2), with similar tax consequences.

Another dimension of the analysis is relatedness among the parties. Revenue Ruling 99-6 specifically noted that the buyer was an unrelated person (although the legal analysis never discussed this fact). Accordingly, by its terms, Revenue Ruling 99-6 would not apply if the buyer is related to the seller.[43] Neither Revenue Ruling 99-6 nor current authorities in the context of section 708(b)(1) define relatedness; prior to the TCJA, the technical termination provisions effectively established a 50 percent relatedness threshold. If the IRS were to conclude that taxpayers cannot rely on Revenue Ruling 99-6 (Situation 2) when the buyer is related to the target partnership, it could apply existing relatedness thresholds that apply to partnerships (or establish a new threshold for this specific purpose).[44] In the alternative, both the partnership merger and division rules, also included in section 708, set forth a 50 percent ownership threshold for the purpose of determining whether a resulting partnership is a continuation of a merging or dividing partnership.[45]

If the entity activity rule were to apply, ACD Partnership would be treated as a continuation of AB Partnership. This conclusion does not change relative to Example 2A because it is tied to the actual business being acquired and operated by ACD Partnership.

2. Examples 3A, 3B and 3C: Asset sale, buyer is newly formed, and old partnership liquidates

[42] The legal entity exception to the overlap rule would not apply because ACD Partnership is a different legal entity than AB Partnership. However, under the overlap rule, ACD Partnership would be treated as a continuation of AB Partnership because A is a partner in both AB Partnership and ACD Partnership.

[43] If the Revenue Ruling does not apply where the buyer is related to the seller, the IRS may also want to clarify how the relatedness test may impact, and consistently apply to, fact patterns analogous to Revenue Ruling 99-6 (Situation 2), including for buyers that are not partnerships (*e.g.*, where the buyer and the seller are members of a consolidated group).

[44] Section 707(b)(1) provides that (i) a person that owns, directly or indirectly, more than 50 percent of the capital or profits interest of a partnership is related to that partnership, and (ii) two partnerships are related if under common control (*i.e.*, the same persons own more than 50 percent of the capital or profits interests in those partnerships). In addition, section 267(b)(10) provides that a corporation and a partnership are related if they are under common control (*i.e.*, the same persons own both (i) more than 50 percent in value of the outstanding stock of the corporation, and (ii) more than 50 percent of the capital interest, or the profits interest, in the partnership).

[45] *See* Treas. Reg. § 1.708-1(c) (merger rules), (d) (division rules).

The modified overlap rule also yields inconsistent results in the following examples involving a partnership that sells all of its assets to another partnership and then liquidates. For example:

> *Example 3A. Asset sale, buyer is a new partnership, old partnership liquidates.* A and B are 50/50 partners in AB Partnership. C and D form new CD Partnership. CD Partnership purchases all of AB Partnership's assets and then AB Partnership liquidates. Is CD Partnership a continuation of AB Partnership?

In form, Example 3A is simply an asset sale. Consistent with the form of the transaction (and taxpayers' expectation that the transaction is an asset sale) under the modified overlap rule, because CD Partnership is a different legal entity than AB Partnership, the overlap rule would apply.[46] Because there are no overlapping partners, AB Partnership would be treated as terminating for tax purposes.

The entity activity rule, however, would treat CD Partnership as a continuation of AB Partnership. This rule simply applies the entity approach to partnerships and, faced with a partnership transferee that continues the target partnership's business, the rule concludes that the transferee, or tested, partnership is a continuation of the target partnership.

However, a minor change in facts in what otherwise appears to be a very similar asset sale, muddies the tax treatment of the buyer partnership, at least under the modified overlap rule.

> *Example 3B. Asset sale, buyer is newly formed ACD partnership, old partnership liquidates.* A and B are 50/50 partners in AB Partnership. A, C, and D form new ACD Partnership. ACD Partnership purchases all of AB Partnership's assets and then AB Partnership liquidates. Is ACD Partnership a continuation of AB Partnership?

Under the modified overlap rule, the target and tested partnerships are different entities, so the legal entity exception does not apply. Then, applying the overlap rule, as a result of A's common ownership in both AB Partnership and ACD Partnership, ACD Partnership would be treated as a continuation of AB Partnership for tax purposes.

By contrast, the entity activity rule yields consistent results under both Example 3A and 3B, not due to any overlap but because the business of AB Partnership is continued when its assets are subsequently used in ACD Partnership.

These outcomes seem problematic. If ACD Partnership is a continuation of AB Partnership, the transaction is transformed; no longer is AB Partnership selling assets (with A and B receiving a liquidating distribution from AB Partnership), but instead A and B are each

[46] The legal entity exception to the overlap rule would not apply because CD Partnership is a different legal entity than AB Partnership.

treated as transferring their AB Partnership interests to C and D in a taxable partnership interest sale.

As unexpected as we believe this would be to taxpayers, there is some authority that supports this result. In Revenue Ruling 66-264, the IRS addressed the tax treatment of a court-ordered judicial sale of a partnership's assets to three of the partnership's five partners.[47] The two other partners received a share of the sales proceeds as liquidating distributions. The IRS noted that the partnership did not terminate under the provisions of section 708(b). Instead of treating the transaction as a sale of partnership assets to the three partners, the IRS concluded that the transaction should be treated "as a sale or liquidation of the partnership interests of the two withdrawing partners depending upon the facts and circumstances." Similarly, in *Neubecker v. Commissioner*,[48] a three-partner law practice dissolved, and two of the partners formed a new partnership, retaining certain clients and cases from the old partnership. The IRS concluded that the cases and clients were taken by the two partners prior to a complete cessation of the business of the old partnership, and found the new partnership conducted enough of the business previously conducted by the old partnership to be treated as a continuation of the old partnership.[49] These authorities support treating ACD Partnership as a continuation of AB Partnership in Example 3B.

A third variation of Example 3 raises questions as to whether section 708(b)(1) requires a business to be carried on by a partnership directly, and whether interposing corporate subsidiaries below a tested partnership would also cause AB Partnership to have terminated for tax purposes:

> *Example 3C. Asset sale, no continuing partner, buyer is a corporation.* A and B are 50-50 partners in AB Partnership, which owns solely Target (a corporate entity). C and D form new CD Partnership, which, in turn, forms a new corporation, CD Newco. CD Newco acquires all of the Target stock from AB Partnership, then AB Partnership liquidates. Does AB Partnership continue?

Section 708(b)(1) explicitly says that a partnership will terminate if no part of "any business, financial operation, or venture of the partnership continues to be carried on by any of its partners *in a partnership*" (emphasis added). When, as here, a corporate subsidiary of the tested partnership acquires the Target, it is unclear whether this requirement has been satisfied. On the one hand, as a substantive matter, there is no difference between the business of AB Partnership and that of CD Partnership; both entities hold corporate stock, including that of

---

47 1966-2 C.B. 248. *See also* NSAR 20132101F (Apr. 16, 2013).

48 65 T.C. 577 (1975). *See also* Rev. Rul. 66-264 (discussing same facts as *Neubecker*).

49 *Id.* at 582-83 (court's conclusion further supported by new partnership's use of same Employer Identification Number as prior partnership). *But see LaRue v. Comm'r*, 90 T.C. 465 (1988) (transfer of taxpayer's business in exchange for buyer's assumption of liabilities resulted in taxable sale of target partnership's entire business; court held that partnership had no business or assets despite partnership's ongoing activity of defending lawsuit, absence of formal dissolution, and financing agreement that required consent of specified parties to partnership to dissolve); *Barran v. Comm'r*, 39 T.C. 515 (1962) (when considering whether sale of most of partnership assets terminated selling partnership, suggesting that section 708(b) "has no application where assets only are sold, and not partnership interests" and holding that partnership continued).

Target (indirectly, in the case of CD Partnership). On the other hand, after the transfer, the business of holding Target stock is no longer being carried on "in a partnership"—at least not directly for federal income tax purposes.[50] CD Partnership holds its Target stock indirectly (through CD Newco). On that basis, some might argue that the statutory predicate for applying section 708(b)(1) does not apply here.[51]

B. Ongoing Opportunities for Electivity

The above sets of examples illustrated not only the limitations of applying the modified overlap rule, but also ways in which taxpayers might structure into or avoid a continuation determination. Also, with the exception of Example 3C where the buyer was a corporation, that determination turned on the mere presence of a historic partner. Thus, despite Congress's stated goal of eliminating taxpayers' ability to easily structure into a termination (or continuation), opportunities for doing so remain widespread.

Although, as discussed above, the more natural reading of section 708(b)(1) is that a tested partnership continues if a historic partner of the target partnership is also a partner of the tested partnership, very little guidance exists. As a result, nothing in section 708 (or the limited guidance promulgated thereunder) sheds any light as to whether some minimum threshold of overlap is required to treat a tested partnership as a continuation pursuant to section 708(b)(1). Absent that guidance, even a historic partner with a *de minimis* interest in the tested partnership (*e.g.*, A's interest in ACD Partnership could be 0.01 percent) would be sufficient to satisfy the statutory requirement. Thus, under Example 2B and Example 3B, when applying the modified overlap rule, the inclusion of A as a partner apparently transforms ACD Partnership into a continuation of AB Partnership, irrespective of whether A owns 99.9 percent or 0.1 percent of ACD Partnership. Setting aside the goal of keeping partnerships in existence for the purpose of facilitating audit adjustments for prior tax years,[52] we cannot think of any policy reason that would justify treating one partnership as a continuation of the other partnership when the overlap of a historic partner is *de minimis*.

Also unclear is whether indirect investments by A could change the result relative to the direct investment by A, as in Examples 2B and 3B. For example, it seems inappropriate that taxpayers could structure around the historic partner requirement merely by holding interests through an upper-tier entity. This structure would, in all likelihood, be largely tax driven.[53] It is hard to reconcile treating an ACD Partnership, in which A directly owns a 0.1 percent interest, as a continuation of AB Partnership, with treating an ACD Partnership, in which A indirectly owns a 75 percent interest (but no direct interest), as not a continuation. Similarly, if A and B

---

50 If the Target was a disregarded entity (and AB Partnership's historic business was not holding Target stock but, for tax purposes, conducting Target's business), it would be harder to assert that CD Partnership (which solely holds corporate stock of CD Newco) is a continuation of AB Partnership.

51 Query whether the result should change if CD Newco and Target filed their tax returns on a consolidated basis.

52 According to estimates by the Joint Committee of Taxation, the repeal of the technical termination provision was expected to raise $1.6 billion over fiscal years 2018-2027. Joint Committee on Taxation, JCX-67-17, Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act" (Fiscal Years 2018 – 2027) (Dec. 18, 2017).

53 For example, A could own its interest in ACD Partnership through a wholly-owned LLC that is owned 99.9 percent by A and 0.1 percent by an S corporation wholly-owned by A.

contributed their respective interests in AB Partnership to A Subsidiary and B Subsidiary, respectively, absent rules that looked through transfers to related parties, this transaction, under the overlap rule, would also cause the transfer to be treated as a termination for tax purposes. These concerns are not present under the modified overlap or entity activity rules.

Another opportunity for tax planning in the context of Examples 2B and 3B under the modified overlap rule might be to admit A as a partner after the transaction. In the case of Example 2B, at the time of the purchase, the buyer of the interests (or the assets) would be CD Partnership, and Revenue Ruling 99-6 (Situation 2) would again apply to the transaction. Similarly, in the case of Example 3B, by waiting to admit A as a partner, the transaction would again take the form of an asset sale to an unrelated buyer.[54]

Finally, assuming a historic partner requirement under the overlap rule (also relevant to the modified overlap rule), a question arises as to the types of partnership interests that should be taken into consideration. Should a historic partner who holds a profits interests in one partnership, but a capital interest in the other, cause a partnership to continue? A profits interest is a partnership interest, and its holder is a partner. It is hard to see why the distinction between a profits interest and a capital interest would matter in respect of whether a person is a partner.[55] That said, in the context of section 708, ownership has generally been viewed in the context of an ownership of both capital and profits. Specifically, regulations under section 708 relating to the merger and division of partnerships focus on common ownership of more than 50 percent of the capital <u>and</u> profits of a partnership.[56] Similarly, the technical termination provision, in former section 708(b)(1)(B), was triggered only upon a sale or exchange of 50 percent or more of the total interest in partnership capital <u>and</u> profits.[57] Accordingly, these authorities could support the position that overlap is not satisfied by a historic partner that holds only a capital interest or only a profits interest.

The above discussion identified questions relating to what constitutes a historic partner for purposes of section 708(b)(1), but that is not the only variable giving rise to opportunities for electivity. For example, in Example 3 above, AB Partnership liquidated immediately after the sale. What if, instead, AB Partnership did not liquidate but retained and invested the sales proceeds? Clearly, both entities cannot continue. In such case, taxpayers would not expect that ACD Partnership, the buyer of AB Partnership's assets, continues (as the "continuing" AB Partnership), while AB Partnership terminates for tax purposes. Indeed, longstanding case law

[54] This opens the door to related questions, such as how much daylight is required between the transaction itself and the admission of A as a partner, and how a plan to admit A as a partner (and the extent to which it is formalized) could affect the conclusion.

[55] *See, e.g.*, section 707(b) (taking into account ownership of either profits or capital interests for purposes of relatedness determination); section 267(b)(10) (same); Prop. Treas. Reg. § 1.168-4(d)(6) (1984) (same, for purposes of anti-churning cost recovery rules); Treas. Reg. § 1.197-2(h)(12)(i) (same, for purposes of anti-churning rules).

[56] Treas. Reg. §§ 1.708-1(c)(1) (for partnership mergers, looking to common ownership of capital <u>and</u> profits interests), (d)(1) (for partnership divisions, looking to common ownership of capital <u>and</u> profits interests).

[57] Section 708(b)(1)(B) (2017) (under prior law technical termination provision, looking to common ownership of capital <u>and</u> profits interests).

and IRS authority establish that a partnership is treated as continuing as it winds up, even if the partnership has minimal assets and conducts minimal business.[58]

Another turn of facts relates to whether the tested partnership is newly formed or old and cold. In both of the above sets of examples, ACD Partnership was a newly formed partnership. What if, instead, ACD Partnership was an old and cold partnership? As noted above, under the modified overlap rule, ACD Partnership would apparently be treated as a continuation of AB Partnership (with AB Partnership, as well as the prior ACD Partnership, terminating). Under these facts, the rigid application of the modified overlap rule would, contrary to intuition, ignore the operating and tax history of ACD Partnership. Moreover, absent any materiality thresholds, ACD Partnership would need to apply the tax determinations of AB Partnership even if the pre-transaction value of ACD Partnership dwarfed that of AB Partnership. Indeed, every time a publicly traded master limited partnership acquired all of the assets of a "mom and pop" operating business, the master limited partnership could be bound by the mom and pop's tax determinations, a nonsensical result. It is hard to see how these tax results are justified by the bias towards partnership continuations.[59]

We acknowledge that the entity activity rule, because its conclusions do not turn on overlap among the partners, presents fewer opportunities for electivity than the modified overlap rule. That being said, it presents other drawbacks, as discussed above, in that it seems counter to the plain language of the statute and has unexpected results (particularly in Example 3A and 3B).

C. The Partnership Merger Rules

A reimagined version of the partnership merger rules could potentially address concerns raised by the examples above. Under section 708(b)(2)(A), if two or more partnerships merge or consolidate, "the resulting partnership shall, for purposes of [section 708], be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership."[60] Under Treasury regulations section 1.708-1(c)(1), if the members of none of the merging partnerships collectively own more than 50 percent of the capital and profits interests of the resulting partnership, then all of the merging partnerships terminate. The resulting partnership is treated as a new partnership. The regulation further provides that if the merging partnerships are commonly owned, and the members of one partnership own more than 50 percent of the capital and profits of the resulting partnership, then the resulting partnership is generally treated as a

[58] *See* supra note 27.

[59] The merger rules could be applied to sidestep these concerns where the tested partnership is old and cold. *See, e.g.*, Phillip Gall, *Nothing from Something: Partnership Continuations under Section 708(a)*, U. Chicago 2016 Fed. Tax Conf., Nov. 12, 2016, at 58-60 (examples 17 and 18). By contrast, if the tested partnership is newly formed, it should not be regarded as a partnership for the purposes of section 708(a) for the same reasons transitory merger subsidiaries generally are disregarded. *See* Rev. Rul. 90-95 (Situation 1), 1990-2 C.B. 67 (step-transaction doctrine applies in the context of corporate merger to disregard transitory merger subsidiary).

[60] *See also* Treas. Reg. § 1.708-1(c)(1).

continuation of that first partnership (with any other merging partnerships treated as terminating).[61]

Section 708 does not define what constitutes a merger or consolidation. In addition, the IRS has a history of widely applying section 708(b)(2)(A) to transactions that are not “mergers” or “consolidations” within the meaning of state law, and to transactions irrespective of their form.[62] Therefore, treating transactions where overlap is present like the transfer of partnership interests in Example 2B, or the asset transfer in Example 3B, as transactions subject to the merger rule would not be without precedent. However, in their current form, the merger rules do not apply to Example 1 because Example 1 involves only one partnership (*i.e.*, the merging and resultant partnerships are one and the same).[63]

The 50 percent threshold in the merger rules logically views a resulting partnership as a continuation only if one or more historic partners hold more than 50 percent of the partnership interests of the merging and resulting partnerships. Whether a partnership is old and cold (as opposed to newly formed) is not relevant. The merger rules also clearly establish that, if a resulting partnership is treated as a continuation of a merging partnership, then that merging partnership is treated as having terminated (even if it were in the process of dissolving and might otherwise be viewed as a continuing partnership under section 708(b)(1)). Finally, the merger rules also specify the types of partnership interests relevant to the overlap test: 50 percent of the capital <u>and</u> profits interests.

Indeed, it appears that, in cases involving two distinct legal entities as the target partnership and the tested partnership, the merger rules and the technical termination provision (prior to its repeal), reached the same answer as to *whether* the target partnership terminates. However, the manner of termination differed in some cases. For example, consider the following example:

> *Example 3D. Asset sale, buyer is a new partnership, old partnership liquidates.* A and B are 50/50 partners in AB Partnership. C and D form new CD Partnership. CD Partnership purchases 99 percent of AB Partnership’s assets for cash. AB Partnership liquidates, distributing cash to B and cash and assets to A. Immediately after, A transfers the assets to CD Partnership in exchange for an interest

61 If the resulting partnership could be viewed as a continuation of more than one of the merging partnerships, it is generally treated as a continuation of only the partnership that contributes assets with the greatest net fair market value to the resulting partnership. Treas. Reg. § 1.708-1(c)(1).

62 Rev. Rul. 90-17, 1990-1 C.B. 119 (partnership merger effected by each merging partnership contributing assets to resulting partnership for resulting partnership interests, which were then distributed proportionately to respective partners of merged partnerships); Rev. Rul. 77-458, 1977-2 C.B. 220 (same); Rev. Rul. 68-289, 1968-1 C.B. 314 (same); PLR 8619015 (Feb. 5, 1986) (same); PLR 8407029 (Nov. 14, 1983) (same). *But see* PLR 200049031 (Sept. 11. 2000) (two partnerships liquidate after transferring all assets to third partnership in exchange for interests in third partnership; form respected, technical termination provision applies, and third partnership treated as new partnership; merger rules not discussed).

63 If the IRS were to reconsider the role of the merger rules in the context of partnership transactions, it could be an opportunity to categorically state that the transaction described in Example 1 results in a continuation of AB Partnership.

> in the partnership. Is CD Partnership a continuation of AB Partnership?

Variations of Example 3C are commonly employed to acquire target operating companies, with management receiving rollover interests in the new partnership. In such cases, AB Partnership's asset transfer is viewed as a sale across to CD Partnership, while A's transfer of assets generally is treated as a tax-free contribution under section 721(a) of the Code. By contrast, if the merger rules applied, the transaction would generally be viewed as taking the assets-over form—*i.e.*, as if AB Partnership had contributed its assets to CD Partnership in exchange for CD Partnership interests, then distributed those interests to A and B in liquidation of AB Partnership. CD Partnership would then partially redeem A and completely redeem B.[64]

A full consideration of the merger rules is beyond the scope of this Report. Moreover, a reconsideration of the merger rules would represent a significant change to how partnership transactions are analyzed, and a full accounting of the issues triggered by such an undertaking is beyond the scope of this Report. However, it becomes apparent that, although the merger rules already appear to provide instructive and unambiguous guidance, in some cases, the merger rules—in their current form—would upend the expected tax treatment of transactions to taxpayers. For example, if the acquisition by newly formed CD Partnership of all of the AB Partnership interests from A and B was treated as a "merger" within the meaning of section 708(b)(2), then, under the current merger rules, the merger would result in the termination of AB Partnership, even if CD Partnership subsequently issued an interest to B immediately after acquiring all of the AB Partnership interests. Thus, the result under the merger rules would be at odds with a conclusion that AB Partnership continues in this transaction. If Treasury so requests, we would be pleased to consider these issues holistically, and discuss these issues more thoroughly, in a separate report.

V. Conclusion

The application and breadth of section 708(b)(1) after the TCJA is unclear. Each approach that could be used to clarify the intended outcome of certain transactions is imperfect. The modified overlap rule is difficult to apply consistently, and both the modified overlap rule and the entity activity rule are skewed towards finding continuations, which can lead to illogical results. IRS guidance could alleviate some of the issues and uncertainty with section 708(b)(1) and create a workable path forward. However, we believe that, as demonstrated by the examples discussed above, neither the status quo nor the proposed solutions will eliminate opportunities to implement technically distinguishable (but substantively similar) structures that allow taxpayers to choose, on a transaction-by-transaction basis, between continuation and termination treatment.

64 Treas. Reg. § 1.708-1(c)(3)(i). If the transaction documents were to take the form of an assets-up transaction (in which the merged partnership would distribute all of its assets to its partners in liquidation of their respective interests in the merged partnership and, immediately thereafter, the partners would contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership), that treatment would be respected for tax purposes. Treas. Reg. § 1.708-1(c)(3)(ii).