

Office of Chief Counsel
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Memorandum

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date: October 09, 2014

to: Associate Area Counsel, (CC:LB&I:)
(Large Business & International)

from: Chief, Branch 1
(Passthroughs & Special Industries)

subject: Whether a publicly traded partnership's restructuring of Incentive Distribution Rights into common units was a taxable exchange.

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Partnership =

Date 1 =

Date 2 =

Parent =

a =

b =

c =

d =

e =

ISSUE

Did a taxable exchange result when the general partner of a publicly traded partnership restructured its interest in the partnership, including exchanging its Incentive Distribution Rights for newly issued publicly-traded common units?

CONCLUSION

No, under the facts described below, the restructuring of the general partner's interest in the partnership was not a taxable transaction.

FACTS

Taxpayer, a corporation, is the general partner of Partnership, a publicly traded partnership within the meaning of § 7704(b) that is treated as a partnership for federal tax purposes through the operation of § 7704(c). Partnership was formed on Date 1, and its original partnership agreement granted Taxpayer an a percent general partner interest in profits, losses, and capital, and in addition granted Taxpayer certain "Incentive Distribution Rights" (IDRs). The IDRs are a form of non-publicly-traded limited partnership profits interest that did not carry any interest in partnership capital on Date 1, but entitled Taxpayer to share in future partnership profits and quarterly distributions. The original partnership agreement provided that, as Partnership's total quarterly distributions reached certain thresholds, distributions and income allocations to Taxpayer under the IDRs increased, up to a maximum of b percent. Additionally, the IDRs entitled Taxpayer to a share of Partnership's proceeds on liquidation if Partnership's assets appreciated after Date 1.

On Date 2, Taxpayer and Partnership consummated an exchange agreement and amended the partnership agreement to replace Taxpayer's IDRs with common units and less valuable IDRs. Specifically, Taxpayer's interest was restructured as follows: Taxpayer continued to hold its a percent general partner interest; Taxpayer's old IDRs were cancelled; Partnership granted Taxpayer c newly-issued publicly-traded common units; Taxpayer also received new, less valuable, IDRs containing higher thresholds and a lower maximum (d percent rather than b percent). The terms of the newly-issued IDRs and the number of newly-issued publicly-traded common units were calculated to produce the same distribution to Taxpayer as the old IDRs had produced the prior quarter.

Although Taxpayer's IDRs did not carry any capital interest on Date 1, by Date 2 Partnership had significant appreciation in its assets, and if Partnership were to have

liquidated immediately before the Date 2 restructuring, a substantial amount of the proceeds would have been allocated to Taxpayer under the old IDRs. However, before Date 2, Partnership had not experienced a revaluation event in some time, and as a result its significant unrealized appreciation in its assets had not been “booked-up” and reflected in the capital accounts of its partners. Thus, Taxpayer’s capital account at the beginning of Date 2 did not reflect Taxpayer’s full economic entitlements upon liquidation. Thus, Taxpayer’s capital account with respect to its newly-issued publicly-traded common units would have been below the capital account of the other publicly-traded common units, which would have meant that Partnership’s publicly-traded common units were no longer fungible. However, also on Date 2, Taxpayer’s corporate owner Parent contributed approximately \$e to Partnership in exchange for newly-issued publicly-traded common units of Partnership. As a result of this contribution, Partnership revalued its assets, crediting its partners’ capital accounts to reflect how its built-in gain would be allocated if Partnership sold the assets. Partnership had sufficient unbooked built-in gain to equalize Taxpayer’s capital account with respect to the c newly-issued publicly-traded common units without needing to shift capital from other partners or allocate extra taxable income to Taxpayer.

LAW AND ANALYSIS

Section 704 provides in general that a partner's distributive share of income, gain, loss, deduction, or credit shall be determined by the partnership agreement, unless the partnership agreement does not address the allocation or the allocation lacks substantial economic effect.

Section 761(c) provides that for purposes of subchapter K, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement. In Lipke v. Commissioner,¹ the Tax Court interpreted §§ 704 and 761 in holding that changes to the partners’ sharing ratios are permissible as long as the change is made within the time prescribed by § 761 and the change is not attributable to a variation under § 706 (such as when a partner sells part of its partnership interest, is partially redeemed, or makes an additional capital contribution). Absent a variation under § 706, the Tax Court ruled that the partnership’s changes “constituted nothing more than a readjustment of partnership items among existing partners which, by itself, is permissible.”² The principles of Lipke were adopted in the 2009 proposed § 706 regulations.³

Rev. Rul. 84-52, 1984-1 C.B. 157, addresses the conversion of a four-person state-law general partnership into a limited partnership in the same state, with two

¹ 81 TC 689 (1983).

² Id. at 698.

³ Prop. reg. § 1.706-4(b)(1), 74 FR 17119, April 14, 2009.

partners becoming limited partners and two partners becoming both limited and general partners. Each partner's total percent interest in the partnership's profits, losses, and capital remains the same. Rev. Rul. 84-52 concludes that the conversion of general partnership interests into limited partnership interests will not cause the partners to recognize gain or loss under §§ 741 or 1001. Rev. Rul. 95-37, 1995-1 C.B. 130, holds in part that the federal income tax consequences described in Rev. Rul. 84-52 apply to the conversion of an interest in a domestic partnership into an interest in a domestic LLC. Rev. Rul. 95-55, 1995-2 C.B. 313, holds in part that that the consequences of Rev. Rul. 84-52 apply to a conversion of a general partnership into an LLP.

Section 1.704-1(b)(2)(iv)(f) provides rules for partnership revaluations of property, and states in part that a partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property on the partnership's books. Capital accounts so adjusted will not be considered to be determined and maintained unless: (1) the adjustments are based on the fair market value of partnership property on the date of adjustment; (2) the adjustments reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date; (3) the partnership agreement requires that the partners' capital accounts be adjusted for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property; (4) the partnership agreement requires that the partners' distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under section 704(c); and (5) the adjustments are made principally for a substantial non-tax business purpose-- (i) in connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, (ii) in connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, (iii) in connection with the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner, (iv) in connection with the issuance by the partnership of a noncompensatory option (other than an option for a de minimis partnership interest), or (v) under generally accepted industry accounting practices, provided substantially all of the partnership's property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market.

The restructuring of Taxpayer's interest in Partnership was a readjustment of partnership items among existing partners, not a taxable exchange. Additionally, no taxable capital shift occurred; although the restructuring of Taxpayer's rights under the partnership agreement was not a revaluation event under § 1.704-1(b)(2)(iv)(f)(5) and did not itself affect Taxpayer's capital account, Parent's Date 2 contribution was a revaluation event under § 1.704-1(b)(2)(iv)(f)(5)(i) and Partnership had sufficient unbooked built-in gain in its assets to increase Taxpayer's capital account with respect to the newly issued common units without needing to shift capital from other partners.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine the ability of the Internal Revenue Service to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Benjamin Weaver at (202) 317-6769 or Wendy Kribell at (202) 317 5033 if you have any further questions.

Sincerely,

David R. Haglund
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(Passthroughs & Special Industries)