Objectives

- Review partnership termination rules before and after the TCJA of 2017.
- Explain income allocation rules when a partner leaves the partnership and when a partner interest varies during the tax year.
Partnership Terminations prior to 1/1/2018

A partnership would terminate if:

- No part of the partnership’s activities was carried on by any of its partners (e.g. the partnership ceases its activities and liquidates (IRC §708(b)(1)(A)), or
- There was a sale or exchange of 50% or more of the interests in the partnership’s capital and profits within a 12-month period (IRC §708(b)(1)(B)). This was referred to as a “technical termination.”
“Technical” Terminations Repealed

- A partnership will 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.
Example 1 – Pre TCJA

- **1/1/2005** – A and B purchased real property and contributed it to rental real estate partnership AB.

- **1/5/2017** – Partners sold greater than 50% of their capital and profits interests in AB, causing a technical termination under IRC § 708(b)(1)(B). AB filed a final return for the short period ending on the partnership termination date 1/5/2017.

- **1/6/2017** – New partnership AB retained the same name and taxpayer ID. New partnership AB filed a short period return beginning on 1/6/2017.
  - New elections had to be made.
  - Basis of assets carried over, but depreciation period reset.
Example 1 – Pre TCJA (cont’d)

- Departing partners and new partners received short year K-1s.
- Remaining partners got two sets of short period K-1s, one of which showed “final” K-1 for the first short period.

- Tax advantages of Technical Terminations
  - Ability to make new elections (e.g. accounting methods).
  - Ability to change depreciation methods.

- Tax disadvantages
  - Depreciable property deemed transferred from the old partnership to the new partnership is considered newly acquired, and depreciation is restarted on the remaining basis.
Example 2 – Post TCJA

- **1/1/2005** – A and B purchased real property and contributed it to rental real estate partnership AB.

- **1/5/2018** - Partners sold greater than 50% of their capital and profits interests in AB.
  - There is no technical termination under IRC §708(b)(1)(B) since that section has been repealed.
  - There is no short period return filed since there is no technical termination.
  - There is no ability to reset elections, and no change to depreciation.
  - Departing partners and new partners get short period K-1s. Remaining partners get full year K-1s.
Polling question 1

A technical termination allows a partnership to make new elections.

- True
- False
Technical Terminations after TCJA

- A partnership may not voluntarily create or elect a technical termination after 12/31/2017.
- A fiscal year partnership whose tax year began after 1/1/2017 may be subject to the technical termination rules for its fiscal period that began in 2017.
Year of Inclusion When a Partner Sells Entire Partnership Interest

Sale of Entire Interest

- The partnership’s tax year ends for that partner. IRC 706(c)(2)(A).
- This does not mean that the partnership must file a short-year return.
- Instead, this means that, if the partner and the partnership have different tax years, the partner may have to include income in an earlier year than would have been required had the partner retained an interest in the partnership for the full taxable year.
Income Allocation When a Partner Sells Part of Partnership Interest

- **Partial Sale of Partnership Interest**
  - The partnership’s tax year does not end for that partner.
  - The partnership must allocate income or loss in a way that recognizes the partner’s varying interests during the tax year. This can be done in one of two ways (Treas. Reg. §1.706-4(a)(3)(iii)):
    - The interim closing method (default method), or
    - The proration method - the proration method can only be used if agreed to by the partners in writing.
Changes in Partner’s Interest in The Partnership

Regulations under IRC §706 provide allocation rules for the following situations:

- When a partner’s interest in the partnership changes during the year due to a disposition of the entire interest as described in Treas. Reg. §1.706-1(c)(2) such as partner’s death or sale or exchange or liquidation of a partner’s entire interest, or
- When a partner disposes of less than an entire interest, including the admission of a new partner as described in Treas. Reg. §1.706-1(c)(3).
XYZ was formed in 2014. It has 3 partners (X, Y & Z). X and Y each own a 16.667% interest, and Z owns a 66.666% interest.

XYZ adopted a tax year ending June 30.

The partners are individuals filing on the calendar year.

On 12/31/2018, Z sold her entire interest in XYZ to S. The partnership has a written provision to use the proration method for varying interests.

For its fiscal years ending 6/30/2018 and 6/30/2019, XYZ earned $300,000 of income.
Sale Of Partnership Interest – Income Allocation

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- XYZ adopted a tax year ending June 30.
- The partners are individuals filing on the calendar year.
- On 12/31/2018, Z sold her entire interest in XYZ to S. The partnership has a written provision to use the proration method for varying interests.
- In each of its fiscal years ending 6/30/2018 and 6/30/2019, XYZ earned $300,000 of net income.

Did XYZ terminate as a result of Z’s sale of her interest to S?
Sale Of Partnership Interest – Income Allocation

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No. The transaction occurred after 12/31/2017
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Z’s 2/3 share through 12/31/2018 (entire interest sold – XYZ’s tax year closes for Z) (½ of $300,000 X 66.666%)  

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Polling question 2

A partnership can elect to have a technical termination for tax years beginning after 12/31/2017.

- True
- False
Summary

- Technical terminations are repealed for tax years beginning after 12/31/2017.
- If a partner’s interest terminates:
  - The partnership’s tax year ends for that partner.
  - The partnership allocates income or loss for the year between the transferor and transferee partner based on the sale date.
If a partner’s interest changes, the partnership must allocate income or loss in a way that recognizes the partner’s varying interests during the tax year. This can be done in one of two ways (Treas. Reg. §1.706-4(a)(3)(iii)).

- The interim closing method (default method), or
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