

The Unique Alternative to the Big Four



Partnership Divisions

By Bruce J. Belman, CPA, JD

Facts

Campbell and Jane Cleveland have always had a green thumb for making money. For the past thirty years they have provided two important services to the residents of their small town. In 1975, they started a garbage collection business. A few years later they began manufacturing widgets. They run both businesses out of a limited partnership that Campbell formed many years ago. The partnership also owns an apartment building and a portfolio of marketable securities.

Facts (continued)

Campbell and Jane have three adult children. Mike and Cara get along well and help their parents manage the widget manufacturing business full-time. The widget business has grown substantially and the growth is largely due to Mike and Cara's involvement. Not surprisingly, Campbell and Jane think the world of Mike and Cara and want them to benefit from their commitment to the business.

Facts (continued)

Steve is the black sheep of the family. Generally irresponsible and a poor businessman, Steve has turned the garbage business into trash. The other family members have a short fuse when discussing Steve's business acumen. Campbell is particularly disgusted that Steve has allowed the value of the garbage business to decline as far as it has.

Facts (continued)

Steve on the other hand, thinks he has managed the garbage business well. He also wants to bring his friend Matt into the business as a new partner. Matt's never worked a day in his life, but has a lot of money to invest in the business. Steve's family, however, thinks less of Matt than Steve. As a result, they are willing to walk away from the garbage business and let Steve and Matt have it.

Facts (continued)

Campbell, Jane, Mike, Cara, and Steve each currently own 20% of the limited partnership. Further, the children received their partnership interests as gifts from their parents five and a half years ago.

Facts (continued)

Campbell and Jane have asked you if there is a way for them to let Steve take the garbage business, preserve the widget business for Mike and Cara, and leave the partnership's real estate and portfolio of marketable securities for the benefit of the entire family. What is your advice?

Recommendation

- Divide the partnership's assets among the partners.
- How?

Primer on Divisions

- Can occur in the assets-over or assets-up form.
- The default is assets-over.
- A division occurs if a partnership becomes two or more partnerships. Sec. 708(b)(2)(B).
- The resulting partnerships will be considered a continuation of the old partnership unless the members of any of the resulting partnerships owned an interest of 50% or less in the old partnerships.

Primer on Divisions

- The resulting partnership that is treated as the divided partnership must file the tax return for the year of division using the EIN of the old partnership and attach a statement showing the names, addresses, and EINs of all resulting partnerships that are regarded as continuing.
- Generally, if the old partnership stays in existence, it will be the divided partnership.
- If the old partnership liquidates, the continuing partnership with the greatest asset FMV will be the divided partnership.
- Other continuing partnerships will be treated as new partnerships. So will any other new partnerships.

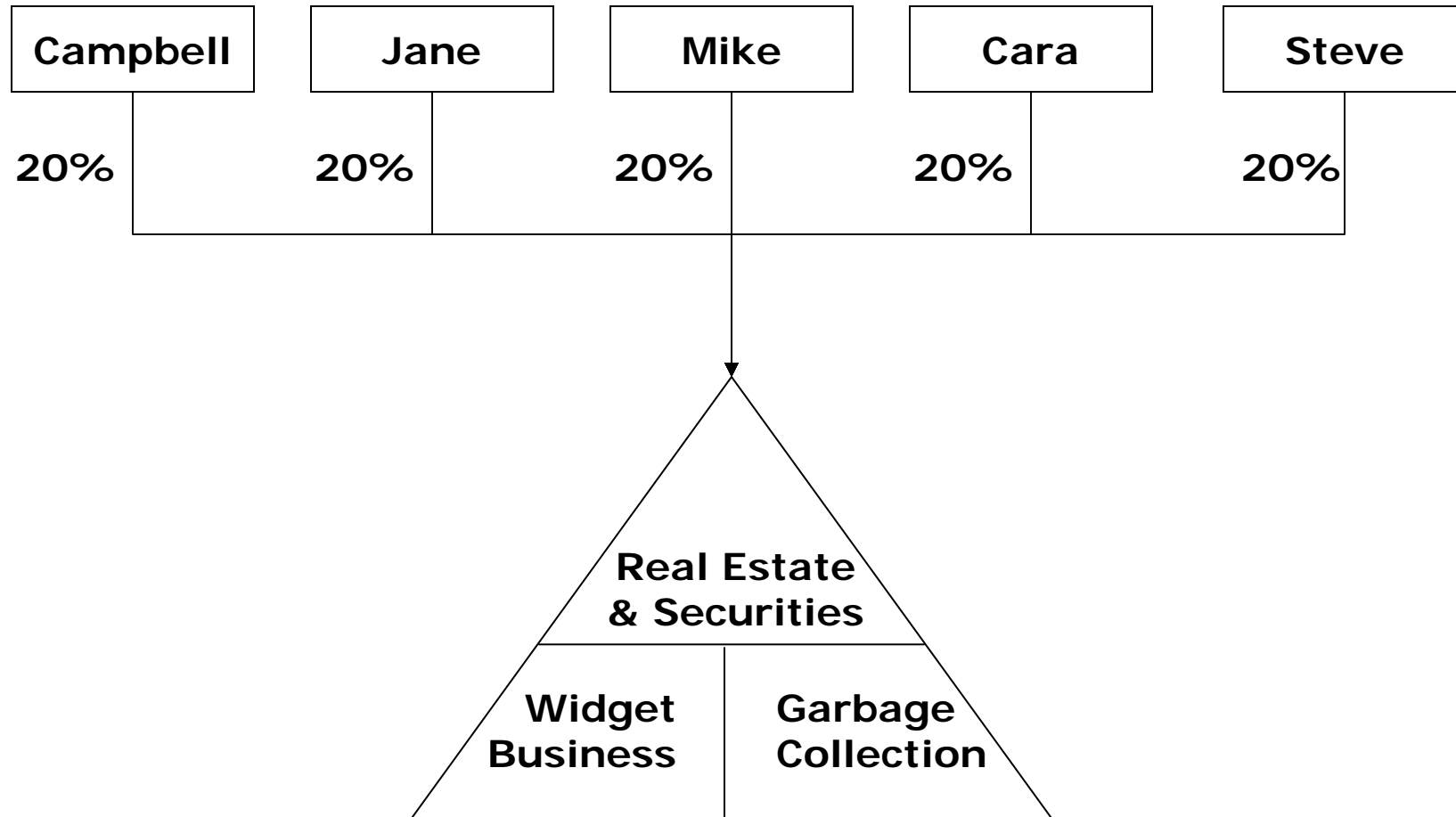
Primer on Divisions

- **Asset-Over:** This occurs when a partnership transfers certain assets and liabilities over to a resulting partnership in exchange for interests in the resulting partnership and then immediately transfers those interests to designated partners.

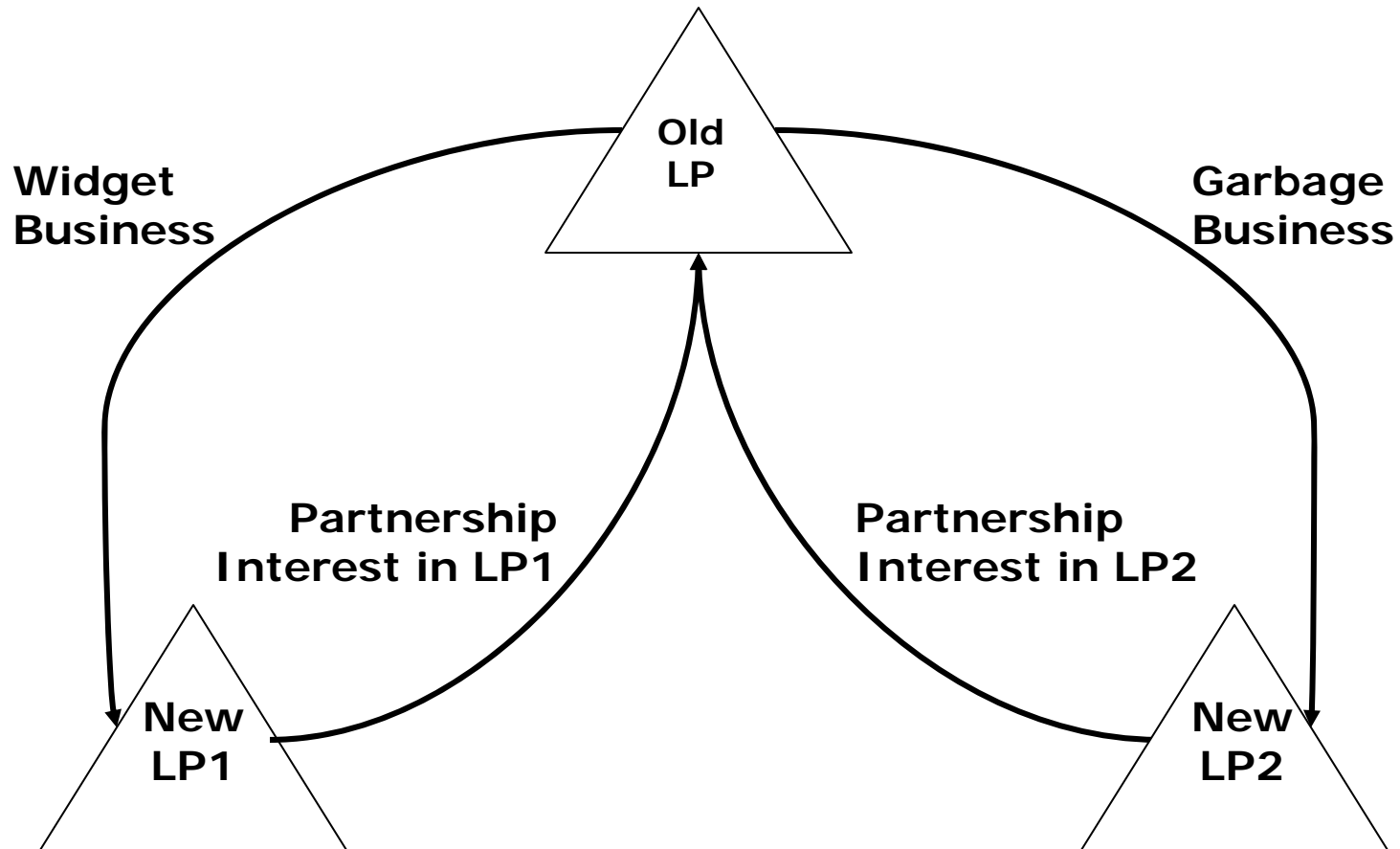
Primer on Divisions

- **Asset-Up:** This occurs when a partnership transfers certain assets and liabilities over to a partner in exchange for the partner's partnership interest with the recipient partner immediately transferring those assets into a new partnership.

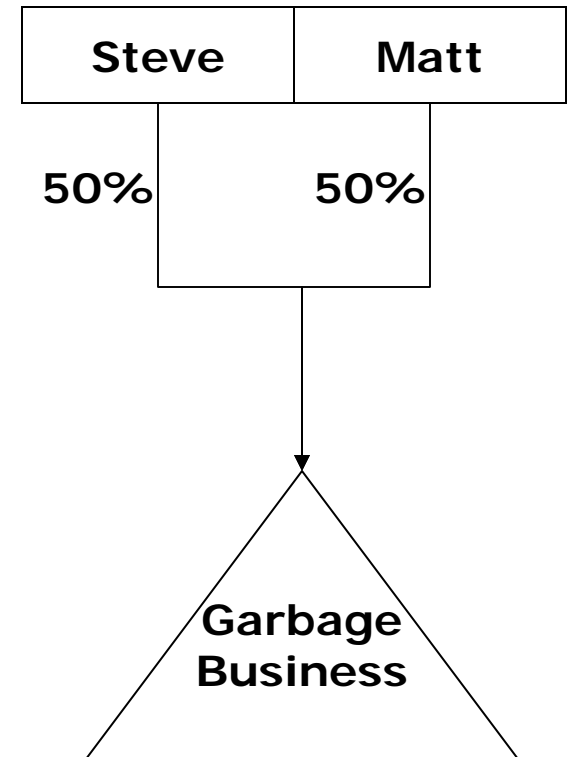
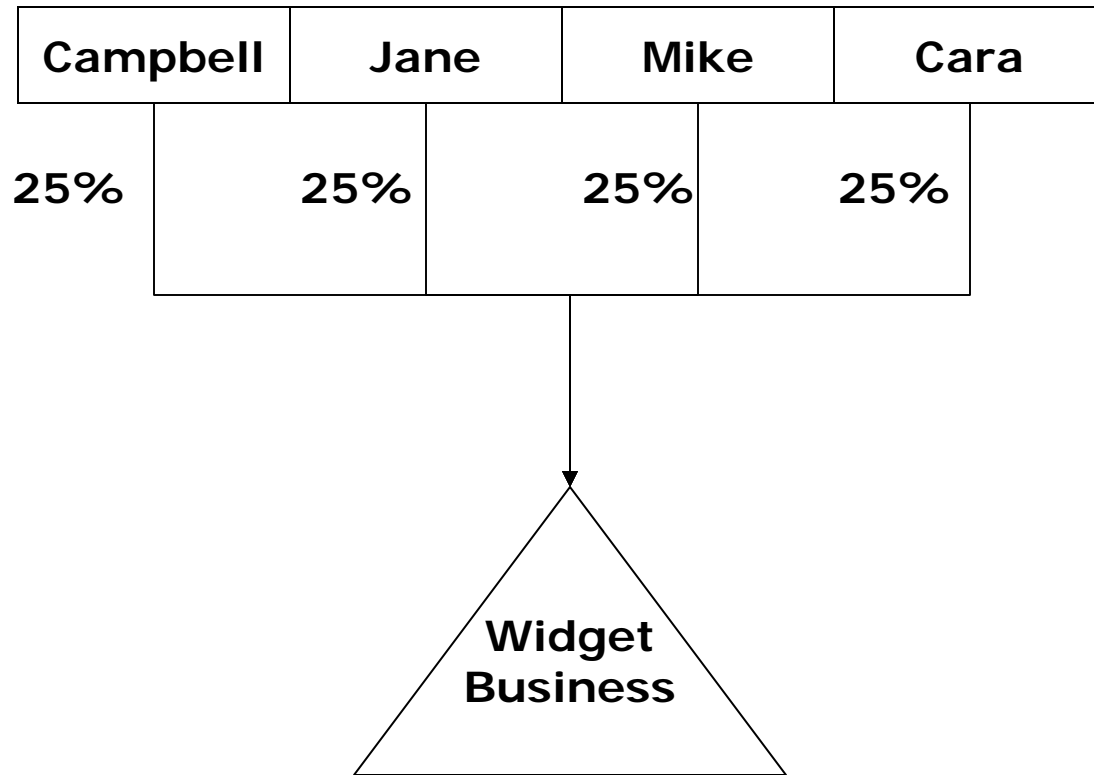
Before The Division



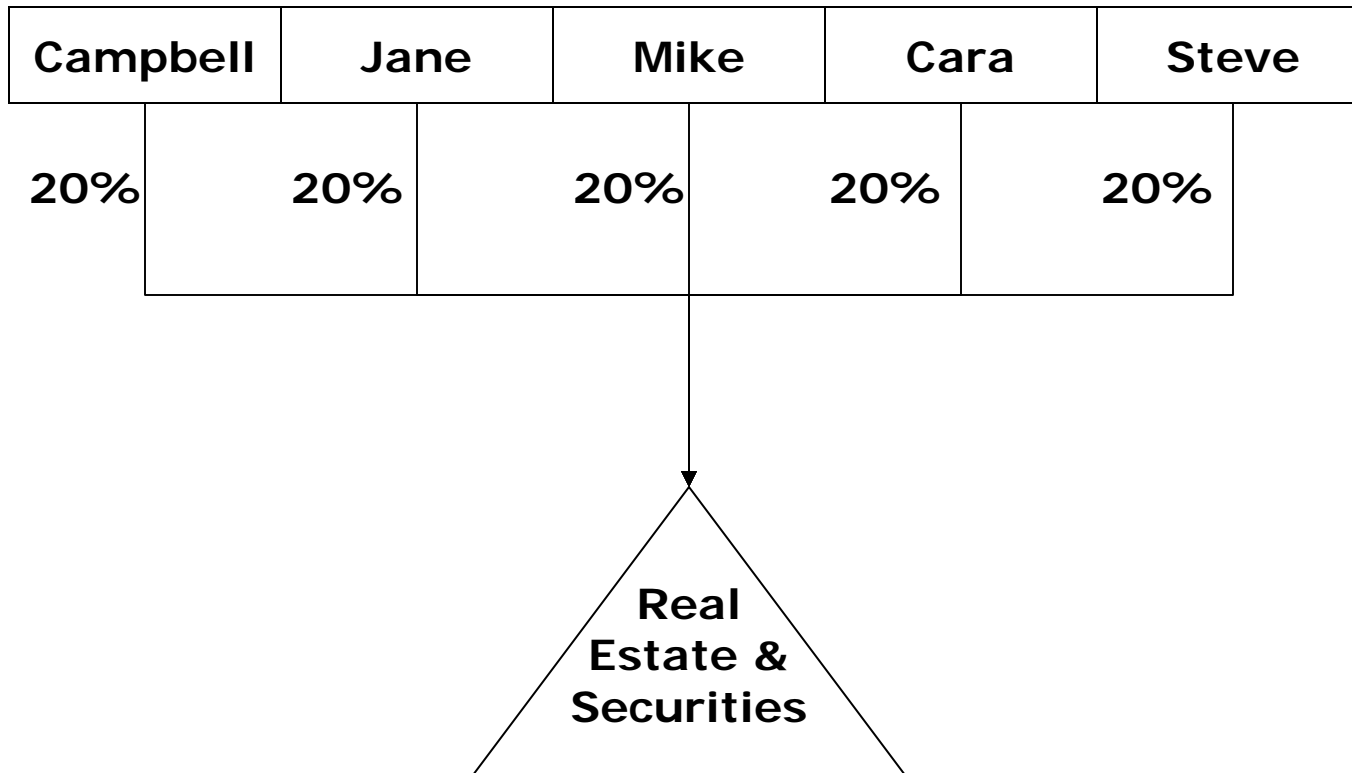
The Division



After The Division



After the Division



So what's happening here?

- Formation of new entities.
- Partial liquidation of interests in a divided partnership.
- The divided partnership and the one with the widget business are continuing partnerships.
- The garbage business is treated as a new partnership.

Observations

- Inside and outside basis - The form of division matters.
- Depreciation, accounting methods and elections – Generally “step into the shoes.”
- Shifting liabilities may create gain.
- The disguised sale rules and anti-mixing bowl rules have to be considered.
- 704(c) taint of an asset carries over to a subsequent partnership.
- Application of Section 751(b).
- Potential application of 731(c).
- What would happen if the marketable securities were distributed with the widget business?

Planning Opportunities and Issues

- Treatment as a division is not optional. If the transaction qualifies as a division under the regulations, the new partnership will be treated as a continuation of the old partnership. For example, the resulting partnership will be saddled with the accounting methods and elections of the old partnership (754, LIFO, etc.) even if continuation of those methods was not desired by the partners.
- Could a division be used to facilitate a 1031 exchange where it would otherwise have “swap and drop” or “drop and swap” issues?