Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part IV–Secondary Offerings and the Impact of Public Trading)

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Deborah Fields, Holly Belanger and Eric Lee, in Part IV, pick up after the PTP has gone public and examine the issues that arise during the operative life of the partnership.

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Introduction

This article is the fourth installment of a multiple-part primer regarding the unique and complex set of U.S. federal income tax issues associated with the formation and operation of a natural resources publicly traded partnership (PTP). The primer focuses on natural resources PTPs, such as exploration and production ("E & P" or "upstream"), pipeline ("mid-stream") and refining or marketing ("downstream") companies. Nonetheless, many of the issues discussed in this primer are common to all PTPs (including PTPs the activities of which are financial in nature), as well as to partnerships in general.

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Parts I, II and III of this primer (hereinafter referred to as "Part I," "Part II" and "Part III," respectively) were published in previous issues of this publication.[1] Among other things, Part I, Part II and Part III:

- provided background information regarding natural resources PTPs;
- explored why PTPs may want to be classified as partnerships for U.S. federal income tax purposes;
- discussed the requirements that must be satisfied in order for a natural resources PTP to be classified as such;
- introduced several basic concepts that are critical to understanding the U.S. federal income tax issues PTPs confront (such as the typical "players" involved in a PTP structure, the types of economic rights associated with units held by the sponsor or management, and the concepts of "fungibility," "minimum cash distributions," and "tax shield");
- highlighted certain structural issues a sponsor may want to consider in forming a PTP—such as

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whether to legally organize the PTP as a limited partnership or a limited liability company (LLC), the potential impact of the choice of legal entity on allocations of liabilities under Code Sec. 752, and whether to have the PTP hold property directly or through a lower-tier entity;

- explained how the formation transaction affects the capital accounts of the unitholders and the PTP's tax shield;[2]
- discussed the different U.S. federal income tax consequences that can stem from the formation transaction, depending upon how the sponsor decides to structure the transfer of property to the PTP;
- discussed the U.S. federal income tax consequences of admitting the public and key members of management as partners to the PTP;
- highlighted some possible complications involved with taking pre-existing entities public; and
- walked through some of the unique U.S. federal income tax issues arising from the operation of a natural resources PTP, such as the rules governing allocations of partnership profits and losses and the special allocation rules applicable to oil and gas properties.

This fourth installment of the primer picks up after the PTP has gone public and focuses on issues that can arise during the operative life of the partnership. This installment first examines the issues surrounding raising additional capital through secondary offerings and the potential impact of raising capital on partnership allocations. The installment then outlines the numerous issues that are implicated by the trading of PTP units on the public market, including certain conventions typically adopted by PTPs in an attempt to make the rules of Subchapter K work in a public context.[3]

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II. Raising Capital Through Future Unit Offerings

After the PTP has rolled along for a while, at some point it invariably will want to consider raising additional capital. The desire to raise new capital may be motivated by a desire to grow the partnership's business or to acquire new property to increase the tax shield available to the public unitholders. Alternatively, a PTP may wish to raise additional capital to pay down a portion of its debt under favorable market conditions. Regardless of the reason that the PTP wishes to raise additional capital, the choice of method of raising that capital largely will be market driven. The basic decision facing the PTP is whether the infusion of capital should be accomplished through issuing additional equity or through borrowing. The discussion below focuses on the issuance of additional units.

As was indicated in Part I, the PTP can raise new capital through a secondary public offering (SPO) or a PIPE transaction.[4] While the business and regulatory issues surrounding them may differ significantly, from a tax perspective, the issues associated with issuing additional units to the public in an SPO or to a private investor in a PIPE transaction largely are the same. As with the IPO, an SPO or PIPE transaction generally can be structured as a nonrecognition transaction governed by Code Sec. 721.[5] The issuance of additional units by an existing PTP, however, creates additional complexity compared to the issuance of units in connection with the PTP's formation.

A. Revaluation of the Partnership's Code Sec. 704(b) Balance Sheet

From an economic standpoint, the issuance of new units through an SPO or PIPE transaction represents a change in the underlying economic arrangement of the partners. The new investors in the partnership make their investment based on the current fair market value of the partnership's assets, rather than the value that the partnership has been reflecting on its Code Sec. 704(b) balance sheet.[6]

While the rules of Code Sec. 704(b) provide that the assets of the partnership generally are not revalued for Code Sec. 704(b) purposes, there are a handful of transactions that can allow for the revaluation of the partnership's Code Sec. 704(b) balance sheet.[7] Each of these events represents a modification of the business deal among the partners. One such change to the business deal that allows for a revaluation is the issuance of new partnership units in exchange for the contribution of money or other property.[8] It should be noted that the revaluation of the partnership's Code Sec. 704(b) balance sheet is permissive upon the issuance of new partnership units and not mandatory.[9] Nonetheless, the partnership agreement of a natural resources PTP generally calls for the PTP to revalue its assets whenever it is permissible, for reasons that are discussed below.[10]

Example 1. To illustrate a revaluation of partnership property, let's turn back to Example 5 from Part III. At the formation of a PTP, the sponsor

contributed a pipeline with a fair market value of $100x and a tax basis of $40x. The public investors contributed a total of $100x of cash. The partners share in the partnership's net income or loss on a 50/50 basis and the partnership has decided to utilize the remedial method for Code Sec. 704(c). For simplicity, we assumed that the pipeline was recovered over the straight-line method and had 10 years remaining upon its contribution to the partnership. In addition, we assumed that a newly purchased pipeline would have a 15-year life, also recovered on the straight-line method.

Because the partnership is using the remedial method, Code Sec. 704(b) depreciation on the pipeline will be $8x for the partnership's first year, with tax depreciation of $4x.[11] Therefore, after the first year of the partnership's operations, the pipeline has a Code Sec. 704(b) basis of $92x and a tax basis of $36x. For simplicity, assume that the partnership otherwise broke even on its operations for the year, such that it still has $100 of cash on hand at the end of the year.

At the beginning of the partnership's second year, the sponsor decides to raise additional capital through an SPO. At the time that the SPO investors make their contributions to the partnership, the pipeline has risen in value to $150x. Because the economic arrangement has changed, the partnership revalues its assets on its Code Sec. 704(b) balance sheet immediately prior to the SPO investors joining the partnership. At the time of the SPO, the pipeline has appreciated by $58x (the $150x value of the pipeline *less* the $92x adjusted Code Sec. 704(b) basis of the pipeline at the time of the revaluation). The PTP will adjust the Code Sec. 704(b) book basis of the pipeline to $150x.

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In addition to revaluing the partnership's property to its current fair market value on the partnership's Code Sec. 704(b) balance sheet, the unrealized gains and losses in the partnership's properties must be allocated to the partners' Code Sec. 704(b) capital accounts.[12] The partners share in the unrealized gains or losses in the same manner that the gains or losses would have been allocated to the partners had the partnership sold all of its assets in a taxable transaction immediately before the admission of the new partner.[13] Essentially, the allocation reflects the manner in which the partners anticipate sharing in the appreciation or depreciation in the value of the partnership's assets. The hypothetical transaction upon which the revaluation is based is often interpreted as being equivalent to a hypothetical liquidation of the partnership, requiring that the unrealized gains or losses be allocated to the partners in the same manner as they would be on a liquidation of the partnership. This approach has been adopted in the typical PTP partnership agreement. As a result, a revaluation of partnership property generally takes into account the entitlements of any incentive interest holders to the net termination gains or losses of the partnership.[14]

Example 2. As a result of the SPO and corresponding revaluation, the PTP has increased the Code Sec. 704(b) book basis of the pipeline by $58x. This appreciation would have been shared equally by the sponsor and the initial public investors had the pipeline been sold for its fair market value at the time of the revaluation. Accordingly, the PTP allocates the Code Sec. 704(b) increase to the basis of its pipeline equally to the sponsor and the initial public investors in the aggregate, raising their Code Sec. 704(b) capital accounts to $125x each.[15] The SPO investors receive a 1/3 interest in the partnership in exchange for a contribution of $125x in the aggregate.

Finally, to the extent that property subject to depreciation, depletion or amortization ("DD & A") is revalued for purposes of Code Sec. 704(b), the amount of the revaluation can give rise to an increase or a decrease in the Code Sec. 704(b) DD & A available to allocate to the partners.[16] For purposes of determining how the amount of the new Code Sec. 704(b) basis is recovered, many choose to view the revalued amount as a new asset placed-in-service by the partnership at the time of the revaluation. Under this view, the amount of the revaluation is recovered over a new useful life (or is treated as additional basis subject to depletion), depending on the nature of the property. The revaluation of a PTP's assets for Code Sec. 704(b) purposes, however, does not affect the tax basis of the PTP's assets or the manner in which such tax basis is recovered.[17]

B. The Impact of Revaluations on Code Sec. 704(c)

A revaluation of partnership property for Code Sec. 704(b) purposes is not a recognition event for U.S.

federal income tax purposes. Thus, the revaluation creates a difference between the Code Sec. 704(b) book basis and the tax basis of the partnership's property—a built-in gain or loss. This raises the question of how the tax items associated with such built-in gain or loss should be allocated.

The Code Sec. 704(b) regulations provide that a partnership's tax allocations under Code Sec. 704(c) must take into account the unrealized gains or losses in partnership property that result from a revaluation of partnership property.[18] Similar to Forward Code Sec. 704(c) Allocations,[19] this difference must be taken into account by the partnership under a reasonable method that is consistent with the purpose of Code Sec. 704(c).[20] Allocations of partnership tax items to take into account the unrealized gains or losses resulting from the revaluation of partnership property ("Reverse Code Sec. 704(c) Gains and Losses") are commonly referred to as "Reverse Code Sec. 704(c) Allocations." The use of this title should come as no surprise given the parallels between the formation of a partnership and the admission of a new partner. In the latter scenario, the existing partners have entered into a new business arrangement with the new partner. Many choose to view the transaction as being analogous to a scenario in which the existing partnership contributes its assets into a new partnership with the new partner. The existing partnership's property is reflected on the Code Sec. 704(b) books of the new partnership at its current fair market value, with the existing partnership responsible for the built-in gain or loss in the contributed assets under Code Sec. 704(c).[21]

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As with the rules governing the treatment of built-in gain or loss on the contribution of property to a partnership, the application of Code Sec. 704(c) to the unrealized gain or loss resulting from a revaluation of partnership property is intended to prevent the gain or loss from shifting away from the existing partners to the newly admitted partner (*i.e.,* the "noncontributing partner" with respect to the built-in gains and losses in the partnership's existing property). This principle applies to gain or loss realized on the sale of the revalued property, as well as additional Code Sec. 704(b) DD & A generated by the revaluation.

In general, the same Code Sec. 704(c) methods (*i.e*. the traditional method, the traditional method with curative allocations and the remedial method) are available for taking into account Reverse Code Sec. 704(c) as are available for Forward Code Sec. 704(c).[22] While a partnership has the option of choosing a different Code Sec. 704(c) method for each property, including choosing a different Code Sec. 704(c) method for different revaluation layers of a property, as discussed in Part III, PTPs generally utilize the remedial method. This can be both a benefit and a burden for sponsors of PTPs. The primary benefit to the sponsor is that, as with Forward Code Sec. 704(c), Reverse Code Sec. 704(c) can be used to give a newly admitted partner the tax consequences of the partnership having full basis in its assets. Specifically, when the partnership does not have sufficient tax basis in its assets to satisfy the Code Sec. 704(b) entitlement to DD & A of SPO partners, the remedial method with its notional tax items helps maintain the tax shield of the SPO partners. However, the price of generating remedial deductions to satisfy the economic entitlement to DD & A of an SPO group is that it generates additional remedial income to the earlier investors.

Example 3. Continuing with Example 2 above, the SPO investors expect to receive the economic benefit of depreciation on a pipeline worth $150x. From a Code Sec. 704(c) perspective, the SPO investors in this example are participating in two separate deals with respect to the pipeline. They are joining the original deal between the sponsor and the initial public investors (*i.e.*, with respect to the $92x remaining value of the $100x value of the pipeline at the time of the contribution). The sponsor, still responsible for the remaining built-in gain in that "property," now has to make both sets of public investors whole for the depreciation on the initial value of the property. However, the SPO investors also share in the depreciation on the $58x appreciation in value of the pipeline. The sponsor and the initial public investors are considered the "contributors" of this new "property" to the partnership and are responsible equally for the tax effects associated with the additional unrealized gain in the pipeline. Therefore, both the sponsor and the initial public investors are responsible for making the SPO investors whole for the depreciation on their newly contributed "property." Because the initial public investors will bear some of the burden of giving tax DD & A to the SPO investors on the $58x appreciation in value, they end up with less total tax DD & A allocated to them than the SPO investors.

This example highlights a common misconception regarding the fungibility of PTP units. While fungibil-

ity requires equal economic returns, it does not mean that the tax allocations to the partners must be the same. Reverse Code Sec. 704(c) generally prevents partners who received units in different public offerings from having equal tax allocations.[23]

As can be seen from this simple example, tracking Reverse Code Sec. 704(c) can be very difficult and only gets more complex when several revaluations have resulted in multiple layers of unrealized gain and/or loss on a single property.[24] This is true of any large partnership with numerous assets and partners. However, as explained below, PTPs have unique issues to consider with regard to Reverse Code Sec. 704(c).

C. Complications Associated with Incentive Interests

As mentioned above, the typical partnership agreement calls for unrealized gains or losses resulting from revaluations of property to be allocated among the partners' Code Sec. 704(b) capital accounts according to how those gains and losses would have been allocated on a liquidation of the partnership. This can create the possibility of a distortion of the economic deal of the partners when a PTP has incentive interests outstanding, such as IDRs[25] or MIUs.[26] By their typical terms, IDRs and MIUs participate in an increasing share of the upside of the PTP's business. This generally results in the holders of the IDRs or MIUs receiving an increasingly large percentage allocation of the "net termination gains" of the partnership on a liquidation of the partnership, as various distribution hurdles are met with regard to the public shareholders. Therefore, because the typical PTP agreement allocates gain or loss from the sale of all of the PTP's property on the liquidation of the PTP, taking into account the entitlement to distributions of money under the IDRs or MIUs, a revaluation of the PTP's property under Code Sec. 704(b) may result in the allocation of a larger portion of any unrealized gain in the PTP's properties to the capital accounts of the holders of the IDRs or MIUs.

The disproportionate allocation of unrealized gain to the holders of the IDRs or MIUs can create an issue when the partnership allocates the additional DD & A generated by the revaluation among the partners. While a revaluation of the partners' capital accounts takes into account the liquidation entitlements of the IDRs or MIUs, the Code Sec. 704(b) allocations of the partnership relating to partnership operating items generally continue to be made according to the percentage interests of the partners (which often are not based solely on the liquidation entitlements of the partners). This difference could result in a distortion of the economics of the partnership. While the public unitholders are allocated a relatively smaller portion of the revaluation of the capital accounts, they continue to be allocated a larger share of the current Code Sec. 704(b) items, including DD & A, from the partnership. If a large amount of additional Code Sec. 704(b) DD & A is generated by the revaluation, the public partners may see their capital accounts rapidly reduced to zero and have their ability to take future deductions limited. For example, because the liquidation entitlements of IDR or MIU holders are taken into account in a revaluation, the public partners may be allocated only 30 percent of the unrealized appreciation in the PTP's assets. However, the public partners may be allocated 50 percent of the Code Sec. 704(b) book DD & A that is generated from the asset.

1. Original Corrective Provision

To prevent a potential distortion in the economics, and to ensure that the public partners are able to be allocated the full share of any Code Sec. 704(b) deductions to which they are entitled under the partnership agreement, most PTP partnership agreements historically provided for "corrective" allocations. These corrective allocations attempted to neutralize the allocation to the IDR or MIU holder's capital account of additional Code Sec. 704(b) value resulting from a revaluation of partnership property to reflect the manner in which the DD & A on the PTP's property would actually be shared. Rather than the capital accounts reflecting the partners' liquidation entitlements, the corrective allocations attempted to make the capital accounts more closely reflect the economic sharing of partnership Code Sec. 704(b) items during the life of the partnership.

The corrective allocation provision generally applied after the application of the other Code Sec. 704(b) allocations contained in the partnership agreement and would reallocate Code Sec. 704(b) items to the extent necessary to alleviate any distortion caused by the revaluation and subsequent DD & A allocations. A typical corrective allocation provision caused either (1) the reallocation of gross Code Sec. 704(b) income or gain away from the IDR or MIU holder and to the public partners, or (2) a reallocation of deductions and losses away from the public partners and to the IDR or MIU holder to the extent that the public partners' remaining capital account

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balances were less than their allocable share of the Code Sec. 704(b) DD & A that would result from the revaluation of partnership property. The corrective allocations were meant either to increase the public partners' capital accounts or to prevent a decrease in the public partners' capital accounts, to make sure that there was sufficient capital account balance to support the allocation of DD & A contemplated by the partnership agreement during the life of the PTP. Therefore, corrective allocation provisions were intended to allow both technical compliance with the rules under Code Sec. 704(b) and adherence to the economic arrangement of the partners.

2. Typical Current Approach to Corrective Allocations

Many PTPs have recently adopted as part of their partnership agreements a corrective provision that is based on a Code Sec. 704(c) method commonly adopted by nonpublic oil and gas partnerships—the "keep-your-own" method. Under the keep-your-own method, as traditionally employed, all of the economics associated with contributed property are allocated back to the contributor until the property is sold. Under this approach, Code Sec. 704(c) would apply to any gain or loss recognized on the eventual sale of the contributed property, but would not affect any allocations of DD & A on the contributed property, because no allocation of Code Sec. 704(b) DD & A is made to a noncontributing partner. The IRS has addressed whether the method was a reasonable Code Sec. 704(c) method in private letter rulings, but has declined specifically to provide the method as a reasonable method in the Code Sec. 704(c) regulations.[27]

Example 4. Producer A and Producer B come together to form a partnership. Producer A contributes Lease A and Producer B contributes Lease B, both of which are producing oil and gas properties, to the partnership. Lease A has a fair market value of $100x, with a tax basis of $40x. Lease B has a fair market value of $100x, with a tax basis of $10x. The partners choose to utilize the keep-your-own method for purposes of Code Sec. 704(c).

Under the keep-your-own method, Producer A is allocated the entire $100x of Code Sec. 704(b) basis and $40x of tax basis in Lease A and Producer B is allocated the entire $100x of Code Sec. 704(b) basis and $10x of tax basis in Lease B. It follows that Producer A will receive all available depletion on Lease A and Producer B will receive all available depletion on Lease B. Because the contributors are entitled to 100 percent of the depletion on their contributed properties, there would be no allocation to a noncontributing partner that would require the application of Code Sec. 704(c).

The new corrective allocation provision adopted by many PTPs is a variation on the typical keep-your-own method. One of the primary differences is that the modified keep-your-own method is applied only to unrealized gains (and related Code Sec. 704(b) book-basis items derived from the revaluation) associated with revaluations of partnership property. The allocations with respect to the initial Code Sec. 704(b) layer of the property, including the tax basis of the property, continue to be allocated to all partners based on their percentage interests and subject to the remedial method of Code Sec. 704(c).

The other primary difference relates to how the new corrective allocation provision allocates Code Sec. 704(b) items associated with any unrealized gain stemming from a revaluation of partnership property. With regard to the sponsor and the holders of any IDRs or MIUs in the partnership, the corrective provision functions like the historic keep-your-own method. This allocation scheme essentially treats the portions of any revaluation allocated to the sponsor or general partner and the holders of any IDRs or MIUs as separate Code Sec. 704(b) properties, as if each had separately contributed the properties to the partnership. The allocations of any Code Sec. 704(b) items derived from the revaluation gain in partnership property (including both DD & A and any gain or loss on the sale of the property) are allocated to the sponsor and the holders of any IDRs or MIUs in the same proportion as the underlying revaluation was allocated. The intended effect is for the sponsor and the holders of any IDRs or MIUs to be treated as if they have been allocated all of the Code Sec. 704(b) items associated with the unrealized gain that each is deemed to have contributed to the partnership, such that no portion of their contributed "property" is being shared with a noncontributing partner (*e.g.*, the public). Because no noncontributing partner is entitled to any of the Code Sec. 704(b) DD & A associated with contributed "property," there would be no corresponding Code Sec. 704(c) allocations, including remedial deductions to the noncontributing partner. Thus, while PTPs generally utilize the remedial method for purposes of Code Sec. 704(c),

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the sponsor and the holders of any IDRs or MIUs generally would not be allocated any remedial income from any reverse Code Sec. 704(c) attributable to unrealized gains in the property arising from revaluations.[28]

In contrast, the corrective provision treats all public unitholders, regardless of the public offerings in which particular units were issued, as a single partner for purposes of this version of the keep-your-own method. Toward this end, the partnership agreement allocates Code Sec. 704(b) items associated with any unrealized gain in the partnership's assets to the public group in proportion to how the unrealized gain had been allocated to any member of the group in the revaluation. Therefore, just as the general partner and the holders of any IDRs or MIUs kept all of the Code Sec. 704(b) items associated with their contributed unrealized gain "property," so too do the public unitholders. However, by treating all public partners as a group for purposes of Code Sec. 704(b) allocations, the corrective allocation diverges from the historic application of the keep-your-own method. This is because this group of partners that is sharing in the Code Sec. 704(b) DD & A allocations may contain both partners who would be considered the contributors of the group's "property" (*i.e.*, who had been allocated a portion of the unrealized gain in the revaluation) and noncontributors (*i.e.*, the newlyadmitted public group that caused the revaluation). Thus, unlike the sponsor and the holders of any IDRs or MIUs, the contributors of this group's "property" share the Code Sec. 704(b) items arising from the property with a noncontributor. Because the group's "property" has a zero tax basis, and because the partnership generally utilizes the remedial method for purposes of Code Sec. 704(c), the "contributor" public unitholders will remediate the "noncontributor" public unitholders. For example, the investors who received their units in the IPO may be required to recognize remedial income to pay for remedial deductions allocated to the unitholders from a later SPO.

Example 5. If we look at our Reverse Code Sec. 704(c) example above, one can see how the corrective provision changes the sharing of the partners. In the fact pattern above, the three groups of partners (the sponsor, the initial group of public investors and the SPO investors) shared equally in the depreciation on the $58x appreciation in value of the pipeline. The corrective provision would essentially treat the $58x property as something closer to two separate $29x properties.

Under the corrective provision, the sponsor is the only partner entitled to share in any of the items that are derived from the amount of the unrealized gain that was allocated to the sponsor in the Code Sec. 704(b) revaluation of the partnership's property. From a Code Sec. 704(c) perspective, this means that there is no noncontributing partner who needs to be made whole with regard to the depreciation on the sponsor's share of the appreciation. This approach is similar to the traditional oil and gas "keep-your-own" Code Sec. 704(c) method.

On the other side, the initial public investors share the economic benefits associated with the unrealized gain that was allocated to them in the revaluation with the SPO investors. In other words, the initial public investors and the SPO investors share equally in the depreciation stemming from the initial public investors' $29x appreciation in the pipeline, with the initial public investors responsible for making the SPO group whole for their tax depreciation.

This simple example shows that the corrective allocation provision can add another layer of complexity to the already difficult task of tracking the effects of Code Sec. 704(c) across multiple revaluations of partnership property. The corrective allocation provision divides the amount of the revaluation into multiple properties, the economic entitlements to which are different for different partners.

D. Summary

As seen from the foregoing, many of the difficult federal income tax issues that were implicated in bringing a PTP public in an IPO resurface whenever a PTP wishes to raise additional capital from the issuance of new units. The difficulties of tracking the effect of built-in gains or losses under Code Sec. 704(c) are compounded by subsequent revaluations of the property, with each change in value resulting in a new layer of built-in gain or loss to be tracked. When the entitlements of any incentive interests are factored in, the intricate Code Sec. 704(c) allocations that result present a challenge for the most experienced Subchapter K practitioner. Therefore, the need

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to have a basic understanding of the workings of Code Sec. 704(b) and Code Sec. 704(c), and how these Code sections affect the allocations to the different public groups, is vital for a PTP.

III. Trading of Units on the Market

The public market is the means by which the vast majority of partners obtain their units in the partnership. Consequently, it is important for a sponsor of a PTP to understand the significant U.S. federal income issues arising from trading of units.

The consequences for an investor who acquires his or her partnership interest *via* purchase from an existing partner in the open market can be significantly different than if the partner had acquired the partnership interest in an issuance by the partnership itself. These differences can be both economic (*i.e.*, they can affect the amount of money the partner would be entitled to on a liquidation of the partnership) and tax-related (*i.e.*, the tax attributes of the interests being acquired may be different). In addition to understanding the nature of these differences, it is important to understand the tools employed by PTPs to help minimize these differences for buyers of units on the public markets.

While not an exhaustive list of the issues that may arise as the result of the trading of units, the following are of particular importance to the sponsor of a PTP:

- The need for the PTPs units to be fungible and the steps taken to ensure that they remain fungible
- The special basis adjustments that buyers of PTP units receive and their role in fungibility
- The impact of the trading of units on the income allocations of the PTP
- The possibility that public trading can result in a technical termination of the PTP
- Issues relating to the information provided to public unitholders who sell their units

Each of these issues will be discussed below.

A. The Need for Fungibility

As described in Part II of this primer, when a partner acquires units in an issuance by the partnership, he receives a Code Sec. 704(b) capital account equal to the amount of the money and the fair market value of any property he contributed to the partnership. As discussed above, the rules under Code Sec. 704(c) are designed to shield the new partner from any built-in gain or loss in the partnership's assets at the time of the units' issuance. Essentially, the issuance of new units by the partnership is viewed as a new economic deal between the existing partners and the new partner.

By contrast, the basic rules for the purchase of a partnership interest from an existing partner are not designed to treat the transaction as a change in the underlying business deal of the partnership. Rather, the purchaser is viewed as a substitute for the selling partner in the same economic arrangement. This means that the attributes of the selling partner carry over to the buying partner. Specifically, the remaining Code Sec. 704(b) capital account balance of the selling partner becomes the initial Code Sec. 704(b) capital account balance of the buying partner.[29] Thus, the buying partner's entitlement to money in a liquidation of the partnership is based on the Code Sec. 704(b) capital account of the selling partner and not the amount of money paid for the interest. Further, the buyer generally becomes responsible for any built-in gains or losses that would have been allocated to the selling partner under Code Sec. 704(c), including any allocations of remedial income or loss.[30] Therefore, rather than being able to strike his own deal with the other partners, the buyer of a partnership interest steps into the shoes of the selling partner in some very important ways.

Because of the step-in-the-shoes treatment of a buyer of a partnership interest, it is important for a buyer to understand the tax attributes of the partnership interest that is being acquired. In determining the price she will pay for the partnership interest, a buyer typically takes into account the interest's entitlements to cash on a liquidation of a partnership, and the amount of any unrealized gains or losses that the buyer will be allocated from the partnership. It is impractical, however, for buyers of publicly traded PTP units to take that information into account when buying PTP units in the public market for at least two reasons. First, it simply is not possible for a buyer on the public market to obtain that information about the specific seller or sellers of his or her units. Second, taking information specific to the seller into account would necessarily involve having different prices for different PTP common units, which is inconsistent with a public market. To allow for public trading of its units, the PTP must make this seller-specific information irrelevant to a prospective buyer of units on the public market.

PTPs make the attributes of the selling partner irrelevant to the buyer by making their units fungible, such

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that a buyer on the public market does not care from which potential selling partner the units are acquired. With regard to the liquidation entitlement of the buyer, in Part I we explained that the PTP maintains fungibility by going to great lengths to ensure that each of its publicly traded units has the same Code Sec. 704(b) capital account.[31] In terms of the built-in gain or loss that will be allocable to a buying partner as a result of the Code Sec. 704(c) step-in-the-shoes rule, the Internal Revenue Code provides a mechanism *via* the Code Sec. 754 election (and resulting special basis adjustments) that generally shields the buyer from such gain or loss inherent in the acquired partnership interest.

B. The Special Basis Adjustment

Generally, the basis of partnership property is not adjusted as the result of a transfer of a partnership interest.[32] However, Code Sec. 754 allows a partnership to elect to adjust the basis of its property with respect to the purchasing partner on the sale of a partnership interest.[33] This adjustment is made under Code Sec. 743(b).[34]

Because the basis adjustment generally is designed to shield the buyer of a partnership interest from built-in gain or loss that came with the acquired partnership interest, it follows that other partners in the partnership should not benefit from the additional basis generated by the adjustment. To accomplish this, the Code Sec. 743(b) rules provide that the basis adjustment is specific to the buying partner, and is not an adjustment to the common basis of the partnership's property.[35] Thus, the partnership must track not only the common basis in its assets, but also a separate basis adjustment amount that it holds apart for the benefit of an individual transferee partner.

Once made, the Code Sec. 754 election is binding on the partnership until the partnership terminates and can only be revoked with the permission of the IRS. For this reason, whether to make the Code Sec. 754 election can be a contentious negotiating point in setting up a partnership. However, in the case of a natural resources PTP, the need to make the Code Sec. 754 election generally is non-negotiable, and the natural resources PTP partnership agreement typically directs its general partner or managing member to make the election.[36]

1. Calculating the Basis Adjustment

It is common for practitioners to attempt to estimate the amount of a Code Sec. 743(b) adjustment by considering the amount of tax gain or loss the seller of the partnership interest recognized. However, this shortcut is not the methodology provided in the Code Sec. 743(b) regulations and does not always produce the correct results. Under the Code Sec. 743(b) regulations, the amount of the special basis adjustment is determined by comparing the buying partner's basis in the acquired partnership interest ("outside basis") with the partner's share of the partnership's basis in its assets ("inside basis").[37] The partner's outside basis in the acquired interest generally is, in the case of a purchased partnership interest, the cost of such interest (that is, the amount of money paid plus the fair market value of any other property transferred for the partnership interest), plus the partner's allocated share of the liabilities of the partnership.[38] Determining the buying partner's share of the inside basis of the partnership in its assets is more complicated. The partner's share of the inside basis of the partnership in its assets is the partner's share of the partnership liabilities plus the partner's interest in the partnership's previously taxed capital.[39] A partner's interest in the partnership's previously taxed capital is determined as follows:

> *Start:* The amount of money the partner would receive if the partnership sold all of its assets for their fair market value and then liquidated (the hypothetical sale);[40]
>
> *Add:* The amount of any tax losses that would be allocated to the partner in the hypothetical sale of all of the assets, taking into account any allocations of built-in gains or losses under Code Sec. 704(c);[41] and
>
> *Subtract:* The amount of any tax gain that would be allocated to the partner in the hypothetical sale of all of the assets, taking into account any allocations of built-in gains or losses under Code Sec. 704(c).[42]

The difference between the partner's outside basis and the partner's share of the partnership's inside basis is the partner's Code Sec. 743(b) adjustment.[43] After calculating the total Code Sec. 743(b) adjustment for a partner, the partnership must allocate that total amount of adjustment among the partnership's properties. Code Sec. 755 contains the applicable rules for the allocation of the basis adjustment to the partnership's properties. If a Code Sec. 743(b) adjustment is triggered by a purchase of a partnership

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interest, the Code Sec. 743(b) adjustment is spread such that generally it covers both the built-in gains and the built-in losses in the partnership's properties.[44] This can result in an increase in the basis of some properties and a decrease in the basis of other properties. To ensure that the adjustment protects the buying partner from any gain taxable at ordinary income rates that is inherent in the partnership, the Code Sec. 755 rules require that the adjustment be made to ordinary income assets (including assets subject to DD & A recapture) before capital gain assets.[45]

2. The Effect of the Basis Adjustment

Because the Code Sec. 743(b) special basis adjustment is intended to shield the buying partner from built-in gain or loss attributable to the selling partner, the adjustment to basis is used as an offset to the items of income, gain, loss, or deduction that are allocated to the buying partner arising from the partnership property subject to the adjustment. This means that the partnership first determines and allocates to the partner his or her share of the items arising from the adjusted property determined in accordance with Code Sec. 704(b) and Code Sec. 704(c) (described above), and then adjusts the buying partner's share of such items to reflect the effects of the Code Sec. 743(b) adjustment.[46]

The rules governing the use and recovery of a Code Sec. 743(b) adjustment are intended to treat the buying partner as if he or she purchased a proportionate share of each of the assets of the partnership, rather than a partnership interest. Therefore, the rules attempt to give the buying partner the tax effect that would have been obtained if the partnership's assets had a tax basis equal to their fair market value at the time of the purchase. In the case of the gain or loss on a sale of a partnership property subject to a Code Sec. 743(b) adjustment, the Code Sec. 743(b) adjustment is applied as an offset to any tax gain or loss allocated to the partner by the partnership.[47]

The role of the Code Sec. 743(b) adjustment in determining the buying partner's DD & A is more complicated, and more relevant to the operations of a natural resources PTP. A Code Sec. 743(b) adjustment made to property subject to DD & A is itself subject to DD & A as well.[48] A positive adjustment to partnership property generates additional tax DD & A deductions for the buying partner. This additional DD & A helps neutralize the impact of Code Sec. 704(c) on the buying partner's DD & A, either by compensating the partner for the DD & A shifted to other partners or by offsetting remedial income allocated to the buying partner. The determination of the amount and timing of this additional DD & A is based on the Code Sec. 704(c) method utilized by the partnership. For partnerships using either the traditional or traditional with curative methods, a positive Code Sec. 743(b) adjustment will be treated as property newly placed in service and recovered over a new useful life.[49] This will be consistent with treating the buying partner as having purchased a share of each of the assets. However, for partnerships that use the remedial method for Code Sec. 704(c), the portion of the Code Sec. 743(b) adjustment that offsets the excess book basis of the property (*i.e.*, the amount of Code Sec. 704(c) gain that the buying partner would be allocated) is recovered over the remaining life of the excess book basis.[50] This bifurcation generally results in the Code Sec. 743(b) adjustment being available to exactly offset any remedial income that would be allocated to the buying partner with respect to the purchased interest.

In contrast, a negative adjustment to the basis of partnership property offsets the DD & A (that is, reduces the DD & A) allocated to the buying partner from the partnership.[51] It should be noted that, if the amount of DD & A offset that is produced by the negative Code Sec. 743(b) exceeds the DD & A that is actually allocated to the buying partner from the partnership, the buying partner will recognize income equal to the excess.[52] Unlike in the case of a positive adjustment, the recovery of the negative adjustment does not depend on the Code Sec. 704(c) method of the partnership. Rather, in all events, a negative Code Sec. 743(b) adjustment to property subject to DD & A is recovered over the remaining useful life of the partnership's tax basis in such property.[53]

3. Code Sec. 743(b) and Oil and Gas Properties

As with many partnership concepts, Code Sec. 743(b) becomes more difficult to apply where a partnership owns oil and gas property subject to depletion. As discussed in detail in Part III, much of this difficulty stems from the fact that the partners, rather than the partnership, are viewed as holding the depletable basis in oil and gas property.[54] It follows, then, that the buying partner, and not the partnership, would adjust the basis of partnership oil and gas property under Code Sec. 743(b).[55] The buying partner would then determine his tax depletion by taking the amount of the basis adjustment into account.[56]

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However, the tax fiction of the partner individually holding the partnership's basis in the oil and gas property becomes somewhat strained by the Code Sec. 743(b) rules. While the partner may be the one who makes the special basis adjustment to partnership oil and gas property, the partnership is still required to determine the amount of the adjustment to the oil and gas property and report the amount of the adjustment allocated to the oil and gas property to the partner.[57] Therefore, much of the burden associated with the Code Sec. 743(b) basis adjustment still rests on the partnership, even in the case of oil and gas property.

4. Summary

For a partnership that has a Code Sec. 754 election in place, the rules allowing for a special basis adjustment under Code Sec. 743(b) upon the purchase of a partnership interest ensure that a buying partner need not be concerned with any Code Sec. 704(c) built-in gain or loss to which he or she has stepped into the shoes. The calculation of the Code Sec. 743(b) adjustment should take into account any gain or loss inherent in the purchased interest, including any gain or loss (notional or otherwise) under Code Sec. 704(c). For PTPs, the making of the Code Sec. 754 election, coupled with the use of the remedial method under Code Sec. 704(c), gives a potential buyer on the public market the peace of mind that it does not matter from which potential selling partner the buyer's units come. No matter the Code Sec. 704(c) position the seller is in, the buyer's Code Sec. 743(b) adjustment neutralizes it such that the PTP's units remain fungible from a net tax perspective.

The burden of making and tracking the Code Sec. 743(b) basis adjustment of buying partners generally falls on the partnership.[58] This burden can be significant when there are a large number of sales of interests in the partnership, as is the case with a PTP. The thousands of individual Code Sec. 743(b) adjustments that a PTP potentially would be required to make and track in a given month easily could consume the tax department of any PTP.

Adding to the strain on the PTP is the challenge of gathering accurate information about the trading of its units. A large percentage of PTP units are held by brokers in street name as nominees for the beneficial owners of the units. As a result, the PTP must depend on the brokers to provide it with information about the ownership of its units. However, nominees, such as brokers, are not required to report the information about the beneficial ownership of units to the PTP until the last day of the first month following the close of the PTP's tax year.[59] For most PTPs, this means that they will not receive data about the ownership of a large portion of their units until January 31. While some brokers voluntarily report partial information about the trading of PTP units periodically throughout the year, this information is often incomplete and is occasionally inaccurate.

Due to the large number of Code Sec. 743(b) basis adjustments that must be made each year, and the fact that the information necessary to make the adjustments only becomes available shortly before the PTP must provide its unitholders with their Schedule K-1s, PTPs have generally adopted a convention that provides a practical solution to these issues. Specifically, because calculating an individual Code Sec. 743(b) basis adjustment for each trade of units may be impractical, PTPs typically calculate a single Code Sec. 743(b) basis adjustment for all transfers within a particular month based on a single unit price.[60]

C. The Impact of Public Trading on Income Allocations

In addition to calculating and tracking the Code Sec. 743(b) basis adjustments of buying partners, a PTP must also determine how to allocate its items of income, gain, loss, deduction and credit ("partnership items") to take into account transfers of its units. Code Sec. 706(d) provides that, if, during any tax year of the partnership, there is a change in any partner's interest in the partnership, each partner's distributive share of partnership items for such tax year shall be determined by taking into account the varying interests of the partners in the partnership during such tax year. Code Sec. 706(d) requires that a partnership take into account any change in the interests of the partners, whether the result of a partner joining or leaving the partnership or simply increasing or decreasing its partnership interest.[61]

Because there can be thousands of trades of PTP units during a given month, taking into account the varying interests of the partners is exceedingly difficult. PTPs generally have tried to minimize the additional complexity that the volume of trades creates by adopting a convention pursuant to which a buyer of units on the public market during the month typically is not allocated partnership items until the first day of the month following the month of purchase.

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Example 6. Partner A sells a unit in a PTP in the public market on September 10. Partner B purchases the unit on the public market the same day. Under the convention generally used by PTPs for recognizing the transfer of units, Partner B does not receive an allocation of PTP income during September. Partner B is recognized as a partner effective October 1, and begins to receive allocations of income on that date. Partner A receives the allocations for the entire month of September with respect to the transferred unit.

Example 7. Assume the same facts as Example 6, except that the sale and purchase of the unit in the PTP takes place on December 31. Under these facts, for allocation purposes Partner B is not recognized as a partner in the PTP until January 1 of the following calendar year.

Code Sec. 706(d) leaves unanswered the question of when the varying interests of the partners should be taken into account. While neither the statute nor the regulations addresses the issue, the legislative history to Code Sec. 706(d) provides support for recognizing partners either on a monthly or semi-monthly basis.[62] To provide greater clarity with respect to this issue, the IRS and the Treasury issued proposed regulations in 2009 that provide a special Code Sec. 706(d) rule for PTPs.[63] The proposed regulations provide a safe harbor for PTPs that adopt the monthly convention that historically has been employed.[64] While, as of the time of this writing, these proposed regulations have not been finalized, they appear to represent a helpful clarification of the application of Code Sec. 706(d) rules to PTPs.[65]

D. Technical Terminations

One might find it inconceivable that a publicly traded entity could be considered to have terminated for U.S. federal income tax purposes solely because of the fact that its equity is traded on a public market. Clearly, this is not a concern that publicly traded corporations have. However, partnerships are a very different animal altogether. Historically, one of the key features that differentiated partnerships from other business entities, such as corporations, for U.S. federal income tax purposes was that they lacked continuity of life.[66] This meant that turnover in the general partners of a partnership, such as from the death, retirement, resignation or expulsion of a general partner, would cause the partnership to terminate.[67] This reflected the general approach taken under state law at the time, which typically provided that a partnership would terminate upon a withdrawal of a general partner, with the remaining general partners having the opportunity to continue their business in a reconstituted partnership.[68] While the modern view of partnerships under state law has moved away from that approach, a vestige of this remains in Subchapter K as an anachronism of which PTPs must be aware.

The general rule is that a partnership will only be considered as terminating 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.[69] However, a partnership is considered as terminating 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.[70] This is colloquially referred to as a “technical” termination.

The regulations provide that, upon a technical termination, the following is deemed to occur: (1) the partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, (2) immediately thereafter, the terminated partnership distributes interests in the new partnership to its partners in liquidation of the terminated partnership.[71] The consequences of a technical termination can be confusing and are not always intuitive to someone who is not intimately familiar with the partnership income tax rules. This is largely because a technical termination is treated as an actual termination of the partnership for some purposes, but disregarded for others. Of particular concern to a PTP, suffering a technical termination generally has the following U.S. federal income tax consequences:

- **Close of tax year.** A technical termination results in the closing of the PTP’s tax year as of the date of the termination.[72] This triggers a return filing requirement, with accompanying Schedule K-1s issued to the unitholders, for the short period ending on the date of the termination.
- **EIN.** The PTP continues to use the same employer identification number following the technical termination.[73]
- **Tax elections and methods.** The PTP is required to make new tax elections and methods of accounting following the termination. Of particular concern would be the PTP’s Code Sec. 754 election.
- **Restart of depreciation.** Depreciable property is treated as newly acquired by the partnership following the termination.[74] This means that the remaining tax basis in the property is recovered

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over a new life, in most cases slowing down depreciation. This can have a significant negative impact on a PTP's tax shield.

- **No restart of Code Sec. 197 amortization.** While depreciation is subject to restart following a technical termination, the "new" partnership steps into the shoes of the terminated partnership for purposes of Code Sec. 197 amortization.[75]
- **No effect on depletion.** Because the allowance for depletion is calculated based on the production from the property, rather than using a placed-in-service concept, a technical termination has no impact on the depletion of partnership property other than the need to separately take into account the two short tax years.
- **Impact on lower-tier partnerships.** A technical termination of an upper-tier partnership is treated as a sale or exchange of the upper-tier partnership's interest in a lower-tier partnership.[76] Therefore, if an upper-tier partnership holding 50 percent or more of a lower-tier partnership suffers a technical termination, it will result in a technical termination of the lower-tier partnership as well.
- **Carryover of partners' capital accounts, Code Sec. 704(c) characteristics, and Code Sec. 743(b) basis adjustments.** Despite the regulations deeming that, following a technical termination, the terminating partnership contributes all of its assets to a new partnership and then liquidates, a technical termination essentially is disregarded for some of the key U.S. federal income tax rules for partnerships. For example:
  - The Code Sec. 704(b) capital accounts of the partners carry over to the "new" partnership.[77]
  - The deemed contribution of property to the "new" partnership does not give rise to new Code Sec. 704(c) property.[78] Moreover, the technical termination does not trigger gain under the "mixing bowl" rules of Code Sec. 704(c)(1)(B) or Code Sec. 737.[79]
  - Code Sec. 743(b) basis adjustments of the partners in the terminating partnership carry over to the "new" partnership.[80]

While a technical termination can cause difficulties for any partnership, it poses a unique challenge for a PTP. A PTP that has more than 50 percent of its total units held by the public market must be vigilant in tracking the turnover in its units. Because the technical termination rules look to sales or exchanges within a 12-month period, rather than during a given tax year, partnerships with significant partner turnover must track changes in ownership on an ongoing basis. Keeping a running 12-month tally of the percentage of the partnership that has been sold or exchanged is a daunting task both because of the volume of data that must be analyzed and the timing of when reliable information is available.[81] Because multiple sales of the same unit within a 12-month period are only counted once in determining whether the partnership has technically terminated,[82] analyzing the PTP's trading data can be a time consuming process.

Moreover, the PTP may not be able to get reliable data about the trading of its units until after the close of its normal tax year. As mentioned above, brokers are not required to provide the PTP with information about the units they hold in street name on behalf of customers until the last day of the first month following the close of the PTP's tax year, which usually is January 31 for most PTPs.[83] The information available throughout the tax year is often too incomplete to get an accurate view of the turnover in the PTP's units. Thus, in order to determine whether the PTP has had a technical termination that triggered a short-year filing obligation, the PTP must try to analyze a massive volume of imperfect information. As a result, unless the PTP has knowledge of a large unit transaction, such as a large institutional investor selling its units, it may be impossible for the PTP to determine that it has suffered a technical termination in time to meet its short year filing requirement.[84]

The IRS is aware of the difficulties that PTPs face in complying with the technical termination requirements.[85] In 2008, the IRS announced that it would issue guidance under its Industry Issue Resolution program.[86] After considering comments submitted by the interested parties, on February 9, 2010, the IRS announced a program under which PTPs could receive relief from the harshest burdens of the technical termination rules.[87] After giving consideration to the facts surrounding the technical termination, the IRS will determine whether it is appropriate to enter into a closing agreement with the PTP.[88] The proposed terms of the closing agreement allow the PTP and the IRS to agree on when the Form 1065s for the two short periods will be due, giving the parties some flexibility in dealing with the timing of the return for the short tax year that ends with the technical termination. Perhaps more importantly, the proposed closing agreement allows the PTP to issue a single Schedule K-1 to each of its partners, which covers the partner's interests from both short tax years and

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which will be due as part of the filing for the short tax year ending with the PTP's normal tax year end.[89] Hopefully this new relief program will prove to be a useful tool for easing the burden of the technical termination rules on PTPs while ensuring that the government's interests are protected as well.

E. Issues Relating to Selling Partners

There is a relatively simple process for determining the tax effect of the sale of a share of stock in a corporation. When an investor sells a share of stock in a corporation, the investor compares the sales price with the investor's basis in the stock to determine her gain or loss. If the investor owns shares in the corporation bought at different times, the investor is allowed to specifically identify which shares were sold for purposes of determining the tax basis and holding period of the disposed stock. If the investor does not specifically identify the stock that is sold, there are rules that govern the determination so that the investor can properly determine its gain and holding period.[90] In general, if an investor does not specify which shares are sold, the investor is considered to sell its share on a first-in, first-out (FIFO) basis.[91] The character of the investor's gain or loss is generally capital.[92]

Unfortunately, the seller of an interest in a partnership faces a much more complicated set of rules. This, in turn, places a burden on the PTP in terms of the information it is expected to provide, or may choose to provide, to the public investors upon sales of their units. The discussion below focuses on the information that PTPs commonly choose to provide to selling unitholders on a sales schedule, as well as information that the PTP is required to provide with regard to the character of gain or loss on the sale of units in the PTP.

1. Basis Used in Determining Gain or Loss on Sale

While a partnership generally is not responsible for tracking the tax basis its partners have in their partnership interests, PTPs historically have chosen to provide each selling partner with information that would be useful to such partner in determining its basis at the time the partner sells units. Specifically, it is common for PTPs to provide, as a convenience to a partner who has sold units in the partnership, the aggregate adjustments to the partner's basis that have arisen during the partner's ownership of the sold units. This would include the impact of the allocations of net income or loss to the partner, as well as any distributions of money made to the partner. However, as explained below, the general rules applicable to a partner's basis in their partnership interest do not mesh well with public ownership.

A partner has a single, unitary basis in its partnership interest.[93] If a partner acquires partnership units at different times at different prices, its basis is blended over the entire interest. This is particularly relevant when a partner sells a portion of its partnership interest. Because the partner has a unitary basis, the partner must allocate its single unitary basis between the portion sold and the portion retained. Generally, the portion of a selling partner's basis that is attributable to the sold partnership interest is determined as follows:

$$\text{Basis of the sold portion} = \text{Total basis} \times \frac{\text{FMV of sold portion}}{\text{FMV of entire interest}}$$ [94]

Thus, in the case of the sale of units in a PTP, the general unitary basis rule dictates that a proportionate share of the selling partner's total basis in all of its units is applied to the units sold. The partnership basis rules do not allow a selling partner to specifically identify which units were sold for purposes of determining the basis to be used in calculating the gain or loss on the sale. This approach can be somewhat of a surprise to public investors who are used to the rules applicable to stock ownership, which generally allow for specific identification of the shares sold, or a FIFO rule, to determine the applicable basis of shares sold if no specific identification made.[95] The unitary basis rule can be illustrated as follows:

Example 8. Partner A acquired 100 units in a PTP on January 1 for $20x per unit. Later that year, on June 1, Partner A acquired 100 more units in the PTP for $25x per unit. On November 1 of the same year, Partner A sold 50 units for $30x per unit. For the sake of simplicity, assume that there were no adjustments to the partner's basis during the year (for example, there were no distributions made during the year).

Partner A realized $1,500x on the sale of the 50 units. Partner A had a total basis in his partnership interest of $4,500x at the time of the sale. The portion of that basis that Partner A would apply to the proceeds of the sale would be determined

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by reference to the ratio of the fair market value of the units sold ($1,500x) to the fair market value of Partner A's total interest ($6,000x) or 25 percent. Therefore, Partner A would apply $1,125x of basis (25 percent of his $4,500x total basis) against the $1,500x sales price, realizing a total gain of $375x on the sale.

As mentioned above, the partnership basis rules often are foreign to investors accustomed to the rules applicable to stock ownership. In addition, the concept of a unitary basis can be difficult to apply in the context of a PTP. With a large percentage of its units held by nominees on behalf of the actual beneficial owners, the PTP may not have sufficient information to determine which partner's units were sold. Therefore, it is common for PTPs to make a simplifying assumption in providing information on the sales schedules to partners who have sold units in the PTP. Rather than following the unitary basis concept, PTPs often follow the rules for publicly traded stock and employ a FIFO approach to determining the basis information to provide the selling partner. Presumably a partner who has not tracked his own basis can request that the PTP provide the basis information under the unitary basis approach.

2. Holding Period

In addition to including information useful to a selling partner in determining the tax basis in the units sold, a PTP often chooses to provide information on the sales schedule relating to the partner's holding period in the sold units. However, the rules for determining the partner's holding period in its partnership interest typically are easier to apply in the PTP context than the rules for determining the partner's tax basis.

While a partner has a unitary basis in its partnership interest, if a partner acquires portions of an interest in a partnership at different times, it is possible for the partner to have a bifurcated holding period.[96] In other words, a partner's interest in the partnership can be partially a long-term capital asset and partially a short-term capital asset. Under the general rule, if a selling partner has a bifurcated holding period in its partnership interest, the portion of any gain or loss on the sale that will be short-term versus long-term will be based on the relative fair market values of the portions of the partner's interest.[97] Therefore, if a partner with a bifurcated holding period sells a portion of his partnership interest, generally the partner will recognize both short-term and long-term capital gain.[98]

However, while no special PTP rule was provided with regard to a partner's basis, the holding period regulations do provide a special rule for partners in PTPs. A unitholder in a PTP is allowed to use the actual holding period of the units that he sold, provided that he does so consistently.[99] Therefore, a partner that holds units with both long-term and short-term holding periods can specifically identify which of his units has been sold, with the holding period consequences following from that designation. PTPs generally assume that partners choose to sell their units on a FIFO basis for purposes of preparing the sales schedule provided to selling partners.

3. Character of Gain or Loss on the Sale of Units

The general rule is that the sale of a partnership interest is the sale of a capital asset, just like the sale of a share of stock in a corporation.[100] However, due to the nature of a partnership as a passthrough entity, by selling its interest in the partnership, a partner effectively has sold its share of both the capital and ordinary assets of the partnership. Simply treating the sale of a partnership interest as the sale of a capital asset would allow a partner essentially to sell its share of the partnership's ordinary assets and recognize capital gains.

To avoid this possible character conversion, Code Sec. 751(a) provides an exception to the general rule and requires that a selling partner look through the partnership and recognize ordinary income to the extent the partner has sold its interest in certain of the partnership's ordinary assets.[101] Under Code Sec. 751(a), to the extent that money or property received by a partner in exchange for all or part of the partnership interest is attributable to the partner's share of the value of partnership unrealized receivables or inventory items (*i.e.*, the partnership's "hot assets"), the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset (*i.e.*, will give rise to ordinary income or loss).[102] For this purpose, an upper-tier partnership is considered to own its proportionate share of the property held by any lower-tier partnership that the upper-tier is invested in.[103]

a. Determination of the Amount of Code Sec. 751(a) Ordinary Income or Loss. In order for a selling partner to know the correct mixture of capital and ordinary gain or loss to recognize on the sale of a partnership interest, it is incumbent on the partnership

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to provide the partner with the necessary information. Particularly in the case of a large investment partnership, such as a PTP, the individual investors will not have access to the information necessary to determine the amount of ordinary income or loss that Code Sec. 751(a) will require them to recognize on a sale of units.

As described by the Code Sec. 751(a) regulations, the income or loss realized by a partner upon the sale or exchange of its interest in Code Sec. 751 property is the amount of income or loss from Code Sec. 751 property that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account the effect of nonrecourse liabilities) immediately prior to the partner's transfer of the interest in the partnership.[104] The amount of ordinary income allocable to the selling partner will be determined by taking into account any remedial Code Sec. 704(c) allocations that would be made to the partner.[105]

Similar to the determination of a purchasing partner's Code Sec. 743(b) adjustment, the determination of a selling partner's Code Sec. 751(a) ordinary income amount requires the partnership to analyze the tax allocations to a partner under a hypothetical liquidation of the partnership. This requires the partnership to have two categories of information available in order to make the determination, both of which can be difficult to maintain in a partnership the size of a PTP, both in terms of numbers of partners and numbers of assets.

First, in order for the partnership to determine the ordinary income allocation to a selling partner on a hypothetical liquidation, it must determine the fair market value of its assets. Where it is not practical to conduct a full valuation of the assets of a partnership, it is common for partnerships to look to the price the buyer was willing to pay for an interest in the partnership as an indication of the value of the partnership's assets. Notwithstanding the sometimes unpredictability of the public markets over the last couple of years, this may be a good indicator of value in the case of a PTP, where generally it is assumed that the public markets price units based on full knowledge of the true value of the partnership. Therefore, PTPs generally look to the trading price of their units to determine the fair market value of their assets for purposes of the Code Sec. 751(a) hypothetical liquidation. However, given the level of turnover in a PTP's units (typically thousands of trades every month) it is simply not practical for a PTP to value its assets based on each individual sales price for each unit sale. Rather, PTPs generally base their asset valuations on a single price for purposes of all sales of units during a given month (or a handful of values in months in which there is significant volatility in the unit price).[106]

Second, having determined the proper fair market value of the partnership's assets, the PTP must determine how the tax gains and losses would be shared on a hypothetical liquidation of the partnership. This is yet another instance where it will be key for the PTP to understand how the built-in gains and losses in the partnership's assets would be shared under Code Sec. 704(c). This also illustrates that, the more complicated a PTP's business arrangement becomes, the more difficult it becomes to provide information to selling partners with regard to the amount of ordinary income the partner will recognize under Code Sec. 751(a) on the sale.

b. Items Subject to Code Sec. 751(a). Under Code Sec. 751(a), a selling partner is required to recognize ordinary income or loss to the extent that the partner has sold its share of the partnership's unrealized receivables and inventory items. The terms "unrealized receivables" and "inventory items" are terms of art that have broad definitions that encompass many of the possible sources of ordinary income in a partnership. Specifically, Code Sec. 751 provides that the terms include the following items:

Items of Inventory[107]

- Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the tax year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business as described in Code Sec. 1221(1).[108]
- Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in Code Sec. 1231.[109]
- Any other property retained by the partnership which, if held by the partner selling his partnership interest would be considered property described in the prior two categories of property.[110]

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Unrealized Receivables[111]

- Any rights (contractual or otherwise) to payment for goods delivered or to be delivered (to the extent that such payment would be treated as received for property other than a capital asset), or services rendered or to be rendered, to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership.[112]
- Potential depreciation recapture under Code Sec. 1245.[113] This also includes the recapture of amortization of Code Sec. 197 intangibles, such as goodwill.[114]
- Potential depreciation recapture under Code Sec. 1250.[115]
- Potential recapture of depletion, intangible drilling costs, mine exploration costs and mine development costs under Code Sec. 1254.[116]
- Potential gain from the disposition of certain mining property under Code Sec. 617(d).[117]
- Potential gain from the disposition of a Domestic International Sales Corporation under Code Sec. 992(a).[118]
- Potential gain from the disposition of stock in a foreign corporation under Code Sec. 1248.[119]
- Potential gain from the disposition of farm property under Code Sec. 1252.[120]
- Potential gain from the disposition of franchises, trademarks and trade names under Code Sec. 1253.[121]
- Potential ordinary income from market discount bonds (as defined in Code Sec. 1278) and short-term obligations (as defined in Code Sec. 1283).

While the definitions of unrealized receivables and inventory items are very broad, the unitholders in a PTP primarily are concerned with the recapture of DD & A. The downside to a PTP having a robust tax shield is that property that gives rise to DD & A typically also gives rise to the possibility of a large amount of recapture. As seen below, this can mean that selling PTP units can result in the recognition of a significant amount of ordinary income to the selling partner.

c. Ordinary Income vs. Capital Gain on the Sale of a Partnership Interest. The Code Sec. 751(a) regulations generally provide that the difference between the amount of capital gain or loss that the partner would realize if there were no Code Sec. 751(a) and the amount of ordinary income or loss determined under Code Sec. 751(a) is the transferor's capital gain or loss on the sale of its partnership interest.[122] In other words, the selling partner's capital gain or loss is determined as his or her total gain on the sale of the interest, less the amount recast as ordinary under Code Sec. 751(a).[123] This can be illustrated by the following formula:

Capital Gain/Loss = Total Gain (*i.e.,* Amount Realized – Tax Basis) – Ordinary Income/Loss

The application of Code Sec. 751(a) to a sale of a partnership interest can be confusing to some public unitholders. A common misconception is that a selling partner must only recognize ordinary income to the extent that he or she would have realized total gain from the sale of the partnership interest. This approach would be similar to the rule for depreciation and depletion recapture, but is not the result contemplated by the Code Sec. 751(a) regulations. Rather, if a partner's share of ordinary income exceeds the total gain recognized on the sale of the partnership, the Code Sec. 751(a) regulations instruct the partner to recognize the full amount of ordinary income attributable to the sold interest, with an offsetting capital loss to net to the correct total gain or loss on the sale of the units.[124] The impact of Code Sec. 751(a) on a partner's total gain or loss is illustrated in the following examples:

Example 9. Partner sells a unit in a PTP for $25x. When compared to his $15x tax basis in the unit, Partner has a total gain of $10x on the sale. Partner's share of ordinary income from the PTP's inventory and unrealized receivables is $6x. Therefore, Partner recognizes $6x of ordinary income and $4x of capital gain on the sale of the unit.

Example 10. Assume the same facts, but that Partner sells the unit for $20x. Under these facts, Partner has a total gain of $5x on the sale. However, Partner's share of ordinary income is $6x. Therefore, Partner recognizes $6x of ordinary income and a $1x capital loss, to net to the $5x of total gain on the sale of the unit.

Example 11. Assume the same facts, but that Partner sells the unit for $14x. Partner will recognize a loss of $1x on the sale of the unit. As with Example 10, Partner still recognizes the $6x share

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of ordinary income. Therefore, to net to the $1x loss on the sale of the unit, Partner recognizes an offsetting $7x of capital loss.

Because, in the case of a PTP, the ordinary income generated under Code Sec. 751(a) largely will be from the recapture of DD & A deductions, it is common for a selling partner's Code Sec. 751(a) ordinary income to be no higher than the partner's total gain on the sale of his or her units. This is because recapture of DD & A under Code Secs. 1245(a) and 1254(a) is capped at the total gain recognized on the sale of the asset that gave rise to the cost recovery deductions. However, where the interests in the partnership are trading at a discount, such that the unit price does not reflect the fair market value of the partnership's assets, it is possible that a selling partner could find himself in the situations described in Example 10 or 11. Given the market conditions of the last several years, many PTPs may find themselves in this situation. Therefore, a PTP that has had a recent downturn in its unit price may expect to receive inquiries from selling unitholders confused by this somewhat counterintuitive result.

IV. Conclusion

This installment of the primer explored many of the difficult issues that arise when a partnership's units are traded on the public markets. This includes the complexities of raising additional capital through issuing additional units and the impact of new unit issuances on the Code Sec. 704(c) allocations of the partnership. Moreover, this installment walked through the numerous issues that a PTP should consider as the result of its units being traded on the public market, including the possibility that the trading of units could result in a termination of the PTP for federal income tax purposes.

The next installment of this primer, which will be the last in the series, will focus on the significant state and local tax issues faced by PTPs. As with the federal partnership income tax rules, many state and local partnership tax rules are difficult to apply to a PTP. The next installment will discuss the filing of composite returns, and other special filing rules employed by certain states, the imposition of nonresident withholding rules on PTPs by some states, and other issues.

ENDNOTES

[*] The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

[1] Part I of the primer was published in the December 2009 issue of TAXES—THE TAX MAGAZINE. Deborah Fields, Holly Belanger, Eric Lee and Robert Swiech, *Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part I),* TAXES, Dec. 2009, at 21. Part II of the primer was published in the February 2010 issue of TAXES. Deborah Fields, Holly Belanger and Eric Lee, *Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part II—Property Acquisitions),* TAXES, Feb. 2010, at 71. Part III of the primer was published in the May 2010 issue of TAXES. Deborah Fields, Holly Belanger and Eric Lee, *Triangles in a World of Squares: A Primer on Significant U.S. Federal Income Tax Issues for Natural Resources Publicly Traded Partnerships (Part III—Bringing in the Public and Management and Partnership Allocations),* TAXES, May 2010, at 33.

[2] The tax shield of the PTP's investors is a recurring topic in this primer. As was explained in Part I, tax shield measures the amount of distributions that a partner receives relative to the amount of taxable income that the partner is allocated.

[3] As was indicated in Part I, this primer is limited in scope to a discussion of certain tax issues. It does not address other issues, such as legal, regulatory, or accounting issues. This primer is not intended to provide advice to investors as to the tax consequences of investing in a PTP. The tax consequences to each investor may vary depending upon such investor's particular facts and circumstances. A potential investor should seek advice from his or her own tax counsel regarding the tax consequences of investing in a particular PTP.

[4] As described more fully in Part I, a PIPE (*i.e.,* Private Investment in Public Entities) transaction is a common private placement transaction that enables the PTP to raise capital from large investors (*e.g.,* institutional investors). In exchange for being able to raise a significant amount of capital from a single investor, units issued in a PIPE transaction often are issued by the PTP at a discount.

[5] The general U.S. federal income tax consequences of IPOs are discussed in Part III. The Code Sec. 721 rules are discussed in Part II.

[6] As described more fully in Part III, assets are initially reflected on the PTP's balance sheet at their fair market values on the date of contribution or acquisition by the PTP. The balances on the Code Sec. 704(b) balance sheet are adjusted for Code Sec. 704(b) allowances for depreciation, depletion and amortization. Thus, over the life of the partnership, the values of assets reflected on the partnership's Code Sec. 704(b) balance sheet may not reflect the current fair market values of such assets.

[7] Reg. §1.704-1(b)(2)(iv)(f).

[8] Reg. §1.704-1(b)(2)(iv)(f)(5)(i). In addition, revaluations of the partnership's Code Sec. 704(b) balance sheet are allowable upon the liquidation of a partner's interest, the admission of a partner in exchange for services, or in the case of certain investment partnerships. Reg. §1.704-1(b)(2)(iv)(f)(5)(ii)–(iv).

[9] As a result, it is common for partnerships to leave the decision of whether to revalue to the discretion of the general partner or manager. Whether and when the partnership will revalue its assets and capital accounts also may be a point of negotiation between the parties.

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[10] A PTP may choose not to revalue its assets if the change in the business deal between the partners is *de minimis*, such as where a very small number of units are issued to key employees of the PTP. Another consideration in revaluing partnership property is whether the partnership has the ability to determine the fair market values of its individual properties. To the extent that this information is not readily available, valuations can be very expensive. However, as will be discussed elsewhere in this edition, assuming that the public market has access to near-perfect information about the value of the PTP enterprise, it is common for a PTP to use the price the market is willing to pay for its units as an indication of the value of its assets.

[11] As discussed in Part II, under the remedial method of Code Sec. 704(c), the Code Sec. 704(b) basis of a property is broken into two components. The portion of the Code Sec. 704(b) basis equal to its tax basis is recovered under a step-in-the-shoes method. Therefore $40x of Code Sec. 704(b) basis is recovered over the 10 years remaining on the recovery of the property's tax basis, yielding Code Sec. 704(b) depreciation of $4x in the first year. The remaining Code Sec. 704(b) basis is recovered as a newly placed in service asset. Therefore, the remaining $60x is recovered over a new 15-year life, yielding another $4x of Code Sec. 704(b) depreciation in the first year.

[12] Reg. §1.704-1(b)(2)(iv)(f)(2).

[13] *Id.*

[14] As discussed in Part I, the holders of incentive interests generally are entitled to an increasingly large share of the gains the partnership would recognize if it sold all its assets in liquidation, but may bear losses on liquidation prior to the public investors.

[15] This reflects an initial Code Sec. 704(b) capital account of $100x, reduced by $4x of Code Sec. 704(b) depreciation in the first year, and increased by the $29x share of appreciation in the pipeline.

[16] Reg. §1.704-1(b)(2)(iv)(g).

[17] If an asset's available tax DD & A is not sufficient to enable all noncontributing partners to receive an allocation of tax DD & A that equals the partners' corresponding allocations of Code Sec. 704(b) book DD & A from the asset (*i.e.,* a ceiling rule issue), there is no specific guidance addressing which group of noncontributing partners (*e.g.,* the IPO group or the SPO group) should have priority to allocations of the available tax DD & A. In most cases, however, a PTP will have adopted the remedial method under Reg. §1.704-3(d) for purposes of making its Code Sec. 704(c) allocations. Under the remedial method, to the extent there is insufficient tax DD & A to allocate to any noncontributing partner, the PTP creates a notional item of DD & A to make the noncontributing partner whole. Thus, even if a noncontributing partner group is not allocated the available tax basis from an asset, under the remedial method, the partner group is allocated a notional item of deduction to the extent of any shortfall. Thus, investors in a PTP are generally indifferent to the manner in which the available tax DD & A is prioritized among various groups of public investors. Nevertheless, note that, in Notice 2009-70, IRB 2009-34, 255, the IRS requested comments regarding the proper allocation of available tax basis to property with multiple Code Sec. 704(c) layers.

[18] Reg. §1.704-1(b)(2)(iv)(f)(4).

[19] Forward Code Sec. 704(c) Allocations generally refer to those allocations required by Code Sec. 704(c) to take into account a variation between the fair market value and adjusted tax basis of a property contributed to the partnership by a partner. *See* discussion in Part III.

[20] Reg. §1.704-3(a)(6); Reg. §1.704-1(b)(2)(iv)(f)(4).

[21] One important distinction between Forward Code Sec. 704(c) and Reverse Code Sec. 704(c) is that the "mixing bowl" rules of Code Sec. 704(c)(1)(B) and Code Sec. 737 generally are viewed as only applying to Forward Code Sec. 704(c).

[22] Reg. §1.704-3(a)(6)(i). The application of these three methods was discussed in detail in Part II.

[23] As described more fully below, a PTP will generally have in effect an election under Code Sec. 754 that makes a buyer of units in the PTP on the public market indifferent to the tax attributes of the various common units that resulted from different public offerings. Thus, although the common units may have different tax allocations, the units remain fungible from a market perspective.

[24] Currently, there is some uncertainty as to the proper application of Code Sec. 704(c) over multiple valuation layers and, particularly, when it is appropriate to net negative adjustments against prior positive adjustments. The IRS and the Treasury currently have the issue under consideration. Notice 2009-70, IRB 2009-34, 255. As of the time of the writing of this edition, the American Institute of Certified Public Accountants and the Tax Section of the New York State Bar Association had submitted comprehensive comments on this proposal. *See* 2010 TNT 87-15 (May 6, 2010); 2010 TNT 16-22 (Jan. 22, 2010). In addition, there is only limited guidance on the application of Code Sec. 704(c) in the case of tiered partnerships. *See, e.g.,* Reg. §1.704-3(a)(9). This is of particular interest to those PTPs that are or have publicly traded general partners. Notice 2009-70 indicates that one of the issues under consideration is the difficult set of issues that arise in applying Code Sec. 704(c) to tiered partnerships.

[25] Incentive distribution rights. The general economic rights of holders of IDRs are discussed in greater detail in Part I.

[26] Management incentive units or management incentive interests. The general economic rights of holders of MIUs are discussed in greater detail in Part I.

[27] *See, e.g.,* LTR 200530013 (Apr. 14, 2005); LTR 9540034 (July 5, 1995); T.D. 8500, 1994-1 CB 183 (Dec. 22, 1993). Under Code Sec. 6110(k)(3), private letter rulings may not be cited as precedent. Nevertheless, such rulings do provide insight as to the IRS's opinion on certain issues.

[28] The overriding concern at play in both versions of the corrective provision is that the liquidation entitlement of the IDRs or MIUs could skew the economic deal of the partners following revaluations of the partnership's property. However, under the typical PTP partnership agreement, the IDRs' or MIUs' entitlement to money on a liquidation of the partnership is dependent on there being appreciation in the value of the partnership's property. The potentially distortive impact of the IDRs and MIUs does not come into play where those units have no liquidation entitlement (*i.e.,* they have a zero balance in their Code Sec. 704(b) capital accounts). As such, the current corrective allocation includes a special provision addressing negative revaluations that follow prior positive revaluations of partnership property. To ensure that the potentially distortive impact of the IDRs or MIUs is reversed, negative revaluations of partnership property are generally allocated to first reverse out any prior positive revaluations of the property. This allows the partnership to reverse out the capital accounts of the IDR or MIU holders, without creating the further distortive effect of disproportionately allocating unrealized losses to them.

[29] Reg. §1.704-1(b)(2)(iv)(l).

[30] Reg. §1.704-3(a)(7). In addition, the basis in any partnership oil and gas property allocated to the selling partner carries over to the buying partner. Reg. §1.613A-3(e)(6)(iv). *But see* Code Sec. 704(c)(1)(C).

[31] As discussed in Part I, where units are issued in a PIPE transaction at a discount, an economic uniformity allocation is necessary to ensure that the per-unit capital account of the units is the same as those of the public before the PIPE unitholder can sell his or her units on the market.

[32] Code Sec. 743(a).

[33] It should also be noted that certain partnerships are required to make basis adjustments under Code Sec. 743(b) even though the partnership has not made the Code Sec. 754 election. If the partnership has a "substantial built-in loss" in the

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value of its assets (as defined in Code Sec. 743(d)) at the time of a transfer of an interest in such partnership, the adjustment of the partnership's basis is mandatory. Code Sec. 743(d). In addition, while not specifically addressed herein, a partnership that has made an election under Code Sec. 754 must make a special basis adjustment under Code Sec. 734(b) following certain distributions of money or other property by a partnership to one or more partners. Adjustments under Code Sec. 734(b) are mandatory if the distribution results in a "substantial basis reduction" within the meaning of Code Sec. 734(d).

[34] There are special rules that address the application of the Code Sec. 743(b) rules in the context of tiered partnerships. *See, e.g.*, Rev. Rul. 87-115, 1987-2 CB 163. While these rules are not addressed herein, they should be considered by any PTP that is or has a publicly traded general partner. Moreover, the tiered partnership rules will be key to any PTP that holds its assets in an operating partnership or which enters into joint venture partnerships with third parties.

[35] Reg. §1.743-1(j)(1).

[36] However, it should be noted that not all financial service PTPs have elected to make an election under Code Sec. 754.

[37] Reg. §1.743-1(b).

[38] Reg. §1.743-1(c); Code Sec. 742.

[39] Reg. §1.743-1(d)(1).

[40] Reg. §1.743-1(d)(1)(i).

[41] Reg. §1.743-1(d)(1)(ii).

[42] Reg. §1.743-1(d)(1)(iii).

[43] The formula used to determine the amount of a Code Sec. 743(b) adjustment ensures that the amount of a buying partner's Code Sec. 743(b) adjustment takes into account any premium or discount paid for the buying partner's units. For example, if a buyer pays a discounted price for partnership units, the Code Sec. 743(b) adjustment may not cover all of the built-in gain that the buyer has stepped into. While historically it has not been considered possible for a buyer of PTP units on the public market to pay a premium or discounted price, due to the assumption that the market price of units accurately reflects the buyer's share of the value of the partnership's assets, this has become relevant for some PTPs as a result of the market turmoil of the past several years.

[44] Reg. §1.755-1(b)(1). It should be noted that different rules are applicable to allocate a Code Sec. 743(b) adjustment that results from a substituted basis transaction, such as the contribution of a partnership interest to another partnership. Reg. §1.755-1(b)(5). These rules only allow positive or negative adjustments, depending on whether the total adjustment is positive or negative.

[45] Reg. §1.755-1(b)(2).

[46] Reg. §1.743-1(j)(2).

[47] Reg. §1.743-1(j)(3).

[48] Reg. §1.743-1(j)(4).

[49] Reg. §1.743-1(j)(4)(i)(B)(1).

[50] Reg. §1.743-1(j)(4)(i)(B)(2).

[51] Reg. §1.743-1(j)(4)(ii)(A).

[52] *Id.*

[53] Reg. §1.743-1(j)(4)(ii)(B).

[54] Code Sec. 613A(c)(7)(D).

[55] Reg. §1.743-1(j)(5).

[56] Reg. §1.613A-3(e)(6)(iv).

[57] Reg. §1.743-1(k)(1)(ii).

[58] Reg. §1.743-1(k)(1)(i).

[59] Reg. §1.6031(c)-1T(b).

[60] The price typically used is the lowest price for the PTP's units during the month. Generally, the choice of the lowest price is intended to be conservative and results in a smaller total Code Sec. 743(b) special basis adjustment, and, therefore, a smaller amount of Code Sec. 743(b) DD & A.

[61] It should be noted that special rules apply under Code Sec. 706(d)(3) that address how tiered partnerships take into account their distributive shares of income from lower-tier partnerships for purposes of Code Sec. 706(d). Specifically, an upper-tier partnership's distributive share of items from a lower-tier is prorated over the upper-tier partnership's entire tax year for purposes of applying Code Sec. 706(d). While not much guidance is available on how this provision is intended to be applied, the IRS and the Treasury have indicated in the preamble to proposed Code Sec. 706(d) regulations that they will be giving consideration to any clarifications that may be necessary in the application of Code Sec. 706(d) in a tiered-partnership structure. *See* 74 FR 17119 (Apr. 14, 2009).

[62] *See, e.g.*, S. Rep. No. 98-169, at 221, 98th Cong. 2d Sess. (1984); H.R. Rep. No. 98-861, at 858, 98th Cong. 2d Sess. (1984).

[63] 74 FR 17119 (Apr. 14, 2009).

[64] Proposed Reg. §1.706-4(b)(3).

[65] For a detailed explanation of the proposed regulations, and their impact on PTPs, *see* the comment letter from the National Association of Publicly Traded Partnerships to the IRS and Treasury Department, dated July 13, 2009, 2009 TNT 137-15 (July 21, 2009).

[66] *See, e.g.*, former Reg. §301.7701-2(a)(1). Colloquially known as the "Kintner Regulations," the former entity classification rules looked to a number of factors to determine whether an entity more closely resembled a partnership or a corporation. Continuity of life was one of the factors that weighed in favor of corporate classification. The Kintner Regulations were replaced by the current "check-the-box" entity classification regime in 1996. T.D. 8697, 1997-1 CB 215 (Dec. 18, 1996).

[67] Former Reg. §301.7701-2(b)(1).

[68] *See, e.g., Glensder Textile Co.*, Dec. 12,249, 46 BTA 176 (1942).

[69] Code Sec. 708(b)(1)(A).

[70] Code Sec. 708(b)(1)(B). The termination will be deemed to occur on the date on which the sales or exchanges of partnership capital and profits during a 12-month period exceed 50 percent. Reg. §1.708-1(b)(3)(ii).

[71] Reg. §1.708-1(b)(4).

[72] Reg. §1.708-1(b)(3).

[73] *See* Example in Reg. §1.708-1(b)(4).

[74] Code Sec. 168(i)(7). Note that, for the terminating partnership, the transfer is generally considered a disposition of the property and, under Code Sec. 168(d), the disposition is deemed to occur at the time prescribed by the applicable convention of the property, *i.e.*, under the half-year convention, the mid-month convention or the mid-quarter convention. The disposition date needs to be determined consistently with the length of the terminating partnership's tax year. *See* Rev. Proc. 89-15, 1989-1 CB 816. Also, property placed in service by the terminating partnership during the year of technical termination would generally not be allowed any depreciation in that tax year. Reg. §1.168(d)-1T(b)(3)(ii).

[75] Code Sec. 197(f)(2).

[76] Reg. §1.708-1(b)(2). However, if there is no technical termination of the upper-tier partnership, there is no deemed sale or exchange of the interest in the lower-tier partnership. It is not the case that any sale or exchange of an interest in the upper-tier partnership will be deemed to be a sale or exchange of a proportionate interest in the lower-tier partnership.

[77] Reg. §1.704-1(b)(2)(iv)(l).

[78] Reg. §1.704-3(a)(3)(i).

[79] Reg. §1.704-4(c)(3); Reg. §1.737-2(a). The "mixing bowl" rules are discussed in Part II.

[80] Reg. §1.708-1(b)(5).

[81] Moreover, while many partnerships face significant compliance costs from having multiple short years resulting from technical terminations, this burden falls especially hard on PTPs. With many thousands of partners requiring Schedule K-1 reporting, doubling a PTP's printing and mailing costs can quickly add up to a significant amount of money.

[82] Reg. §1.708-1(b)(2).

[83] Reg. §1.6031(c)-1T(b).

[84] A partnership that misses the short period filing requirement faces very stiff penalties for the failure to file its Form 1065 and issue Schedule K-1s to its partners. Specifically, Code Sec. 6698 imposes on the partnership a penalty of $195 per partner per month for late filing.

[85] In addition to the impact on the PTPs themselves, the IRS was mindful of the effect technical terminations had on the average PTP investor. There was concern that investors, more familiar with the Form 1099 reporting of public corporations,

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would not understand the significance of receiving two Schedule K-1s from a single calendar year, and would fail to pick up the income from both Schedule K-1s.

[86] IR-2008-110, Sept. 25, 2008.

[87] The memorandum issued by Keith M. Jones, the Large and Midsized Business Division Industry Director for Natural Resources and Construction, explaining the details of the relief, is available at *www.irs.gov/businesses/article/0,,id=219212,00.html.*

[88] Of particular interest to the IRS is the impact of the relief on unitholders who hold five percent or more of the PTP's units. Presumably, this evidences a desire to understand the possible income deferral that the relief would allow to these unitholders when compared to requiring the PTP to meet the normal short year filing requirements.

[89] The proposed closing agreement assumes that the PTP is a calendar-year taxpayer.

[90] Code Sec. 1223.

[91] Reg. §1.1012-1(c)(1).

[92] Code Sec. 1221.

[93] Rev. Rul. 84-53, 1984-1 CB 159.

[94] *Id.* It should be noted that Rev. Rul. 84-53 provides a different formula for situations in which a partner's outside basis is less than his or her allocable share of the partnership's debt.

[95] Reg. §1.1012-1(c)(1).

[96] Reg. §1.1223-3(a).

[97] Reg. §1.1223-3(b).

[98] Subject to Code Sec. 751(a), as discussed below.

[99] Reg. §1.1223-3(c)(2).

[100] Code Sec. 741.

[101] While we focus on income taxable at the ordinary rates, Code Sec. 751(a) principles also would apply to other possible sources of income taxed at the different capital rates. For example, this would include items such as collectibles or potential unrecaptured Code Sec. 1250 gains. Code Sec. 1(h)(5); Reg. §1.1(h)-1(a) and (b).

[102] Reg. §1.751-1(a)(1).

[103] Code Sec. 751(f).

[104] Reg. §1.751-1(a)(2).

[105] *Id.*

[106] The price typically used is either the highest or average price for the PTP's units during the month. Generally, the price chosen is intended to be conservative and avoid any possible tax benefit for individual selling partners.

[107] Code Sec. 751(d).

[108] Reg. §1.751-1(d)(2)(i).

[109] Reg. §1.751-1(d)(2)(ii).

[110] Reg. §1.751-1(d)(2)(iii).

[111] Code Sec. 751(c).

[112] Reg. §1.751-1(c)(1).

[113] Reg. §1.751-1(c)(4)(iii).

[114] Reg. §1.197-2(g)(8).

[115] Reg. §1.751-1(c)(4)(v).

[116] Reg. §1.751-1(c)(4)(ix).

[117] Reg. §1.751-1(c)(4)(i).

[118] Reg. §1.751-1(c)(4)(ii).

[119] Reg. §1.751-1(c)(4)(iv).

[120] Reg. §1.751-1(c)(4)(vii). Potential gain from the disposition of farm property under former Code Sec. 1251 also is treated as an unrealized receivable under Code Sec. 751(c). Reg. §1.751-1(c)(4)(vi).

[121] Reg. §1.751-1(c)(4)(viii).

[122] Reg. §1.751-1(a)(2).

[123] *Id.*

[124] *See, e.g.,* Reg. §1.751-1(g), Example 1.

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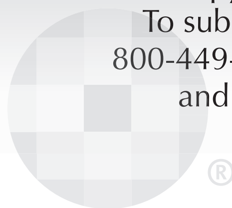

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