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Person To Contact:
, ID No.
Telephone Number:

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Legend

Trust =

LP =

GP =

X =

State =

Property =

Country =

a =

b =

c =

Date 1 =

Date 2 =

Dear :

This responds to a letter dated February 2, 2012, and additional correspondence, submitted on behalf of Trust, requesting rulings described below regarding the proper income tax classification of Trust and related matters.

FACTS

Trust is a trust established under the laws of State on Date 1. Trust uses the calendar year and the accrual method of accounting for federal income tax reporting purposes.

LP is a limited partnership established under the laws of State. LP uses the calendar year and the accrual method of accounting for federal income tax reporting purposes. Through a subsidiary partnership, the LP indirectly owned an interest in Property. Approximately a individuals, nearly all of whom reside in Country, are the limited partners of LP.

GP, a limited partnership under the laws of State, is the general partner of LP. GP uses the calendar year and the accrual method of accounting for federal income tax reporting purposes.

X, a limited partnership under the laws of State, is an affiliate of GP and the trustee of Trust. X uses the calendar year and the accrual method of accounting for federal income tax reporting purposes.

On Date 2, LP entered into a Purchase Agreement with an unrelated third party buyer. Pursuant to the Purchase Agreement, LP sold all of its assets, consisting of its interest in the subsidiary partnership that owned Property. Although LP sold all of its assets under the Purchase Agreement and terminated all of its business activity as a consequence, it was aware of two significant contingent liabilities that could be asserted against it. Additionally, unknown contingent liabilities may also exist (all such liabilities, both known and unknown, are hereinafter referred to as “Contingent Liabilities”).

LP desired to distribute the sales proceeds it received in connection with the Purchase Agreement and dissolve. However, GP believed that it would be impractical to collect each partner’s pro rata share in the event that a payment was required as a result of one of more of the Contingent Liabilities, and under the law of State, the general partner of a dissolved partnership is liable for any unpaid liabilities of LP, including the Contingent Liabilities.

To resolve this problem, LP caused Trust to be organized. The Liquidating Trust Agreement for Trust appoints an affiliate of GP, as the trustee. The Trustee is authorized to resolve the Contingent Liabilities by payment, defense, or compromise, to invest the assets of Trust in short-term investments (subject to several limitations), and to perform administrative tasks. The Trustee is explicitly prohibited from engaging in any business, from making investments other than short-term cash equivalents, from retaining cash in excess of an amount reasonably necessary to provide for the Contingent Liabilities, and from holding assets such as publicly-traded stock or partnership interests. The Trust Agreement provides that the Trustee may distribute a beneficiary's share of the trust assets if the Trustee determines that the distribution would not impede Trust's purpose of providing for the orderly payment of the Contingent Liabilities and the distribution of the remaining assets to the partners. The term of Trust expires three years from Date 1. Trust represents that the three-year term was selected to match the statute of limitations for the Contingent Liability. However, the Trustee may extend the term of Trust if a claim is asserted within the three-year period and more time is required to resolve it. However, under no circumstances may the term extend beyond five years from Date 1. At the termination of Trust, its remaining assets will be distributed to the beneficiaries.

When LP was liquidated, the amount of money placed in Trust was calculated based on an estimate of the maximum amount that was reasonably likely to be payable with respect to the Contingent Liabilities. The remaining cash of LP was distributed to the partners, and LP took the necessary actions under state law to terminate its legal existence.

To ensure that limited partners of LP would not be unduly inconvenienced by an inability to receive all of their proceeds in cash at the time of liquidation, X offered a "buy-out" option to the limited partners of LP. If a limited partner elected to sell its beneficial interest in Trust, X purchased that former limited partner's beneficial interest for b% of the gross asset value of the interest. Limited partners holding approximately c% of the interests LP accepted the buy-out option.

The Trustee has determined that a distribution of GP's and X's pro rata shares of Trust assets would be consistent with Trust's mission. Contingent on the outcome of this ruling, if the Trustee makes a distribution to GP and X of their pro rata shares of Trust assets, then GP, X, and Trust represent that they would enter into a contribution agreement to ensure that liabilities are shared among the parties in the same manner as if GP and X did not receive an advance distribution of their beneficial share of Trust's assets.

RULINGS REQUESTED

The taxpayer requests the following rulings:

1. Trust is a “liquidating trust” within the meaning of Treas. Reg. § 301.7701-4(d);

2. Trust is properly taxed as a grantor trust;

3. The final distributions by LP of its assets to the partners and Trust, followed by the dissolution of LP under state law, resulted in a termination of the partnership under § 708(b)(1)(A) and the liquidation of the partners’ interests in the partnership; and

4. The proposed distribution by Trust to the GP and X of their respective pro rata shares of Trust’s assets will not cause Trust to be treated other than as a grantor liquidating trust or cause LP not to have terminated.

LAW AND DISCUSSION

Entity Classification as a Liquidating Trust

Section 301.7701-4(d) of the Procedure and Administration Regulations provides that certain organizations which are commonly known as liquidating trusts are treated as trusts for purposes of the Internal Revenue Code. An organization will be considered a liquidating trust if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose. A liquidating trust is treated as a trust for purposes of the Code because it is formed with the objective of liquidating particular assets and not as an organization having as its purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships. However, if the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to be lost or abandoned, the status of the organization will no longer be that of a liquidating trust.

Rev. Proc. 82-58, 1982-2 C.B. 847, lists conditions under which “[a] ruling will generally be issued that an organization is classified as a liquidating trust.” The requirements outlined in Rev. Proc. 82-58 were amplified by Rev. Proc. 91-15, 1991-1 C.B. 484, which provided a checklist to accompany ruling requests on liquidating trust classification. Rev. Proc. 94-45, 1994-2 C.B. 684 also modified Rev. Proc. 82-58 by providing special ruling requirements for liquidating trusts created in bankruptcy cases. Since Trust was not formed in the context of a bankruptcy, the special requirements of Rev. Proc. 94-45 do not apply.

The ruling conditions of Rev. Proc. 82-58, as amplified by Rev. Proc. 91-15, are (1) the trust is organized for the primary purpose of liquidating the assets transferred to it with no objective to engage in a business, and its governing instrument so provides; (2) the instrument contains a fixed or determinable termination date that is generally not more than three years in the future and that is reasonable based on all the facts and circumstances; (3) if the trust is created in connection with a corporate liquidation, (a) the trustee is selected by the shareholders or by a court, and (b) if the trust is to hold assets for unlocated shareholders, due notice has been given to such shareholders in accordance with local law; (4) the trustee's investment powers are limited to demand and time deposits in banks and temporary investments such as short-term certificates of deposit or Treasury bills; (5) the trust does not (a) receive transfers of listed stock or securities, any readily-marketable assets, or any operating assets of a going business, and (b) receive cash in excess of a reasonable amount to meet claims and contingent liabilities; (6) the trust does not receive 80% or more of the stock of an issuer or any general or limited partnership interests; (7) the trust is required to distribute income and proceeds from the sale of assets at least annually (however, the trust may retain a reasonable amount of income or proceeds to meet claims or contingent liabilities); (8) the ruling request must represent that the trustee will make continuing efforts to dispose of the trust assets, make timely distributions, and not unduly prolong the duration of the trust.

Trust satisfies all of the requirements outlined in Rev. Proc. 82-58 for issuance of a ruling that an entity is a liquidating trust, as amplified by Rev. Proc. 91-15. Section 8(B)(i) of the Trust Agreement expressly prohibits Trust from engaging in the conduct of a trade or business. Section 4(A) of the Trust Agreement provides that Trust will generally terminate on the third anniversary of its formation. Section 4(B) provides that the Trustee may extend this term for up to two years if the extension is necessary to allow Trust to defend against a claim or to allow a statute of limitations to run. Under no circumstances may Trust continue for longer than five years. Therefore, the duration of Trust is reasonable under the circumstances. Rev. Proc. 82-58 includes additional requirements for liquidating trusts created incident to corporate liquidations. Since Trust was created to facilitate the liquidation of a partnership, these requirements do not apply. Section 7(B) of the Trust Agreement, which describes the powers of the Trustee, provides that the Trustee may invest in "demand or time deposits in banks or savings institutions or temporary investments such as short-term certificates of deposit or Treasury obligations." The section also includes a proviso that any investments must be consistent with Trust's status as a liquidating trust.

The only asset transferred to Trust was cash. During its existence, Trust has only held cash and short-term cash equivalent investments. Furthermore, the Trust Agreement expressly forbids the Trustee from making investments in assets such as stock, securities, or assets of an operating business. Therefore, Trust has not owned and cannot own any of the proscribed assets described in Section 4.05 of Rev. Proc. 82-58. Second, Section 6(A) of the Trust Agreement requires the Trustee to distribute any amounts that are no longer needed to accomplish the purposes of Trust. If either of the known Contingent Liabilities are resolved during the term of the Trust, this provision would require the Trustee to distribute any cash that is no longer needed. Finally, Section 6(C) of the Trust Agreement outlines a procedure through which the Trustee can make early distributions to particular beneficiaries if satisfactory arrangements can be made to provide for the Contingent Liabilities outside of the liquidating trust form. Trust was initially funded with a transfer solely of cash. No further transfers to Trust have occurred or are expected to occur. Section 6(A) of the Trust Agreement requires the Trustee to distribute any net income to the Beneficiaries at least annually. However, the Trust Agreement provides that the Trustee will receive any income produced by Trust's assets as compensation for serving as Trustee. Therefore, there will be no net income to distribute to the Beneficiaries. Section 11(A) of the Trust Agreement requires that Trust make payments of income to the Trustee at least annually. Trust represents that the Trustee will make continuing efforts to resolve the Contingent Liabilities, thereby allowing the distribution of Trust's assets. The Trust also represents that the Trustee will make timely distributions and not unduly prolong the duration of the Trust.

Therefore, based on these representations, we rule that Trust is a "liquidating trust" within the meaning of § 301.7701-4(d). Furthermore, we conclude that if the Trustee makes a distribution to GP and X of their pro rata shares of Trust assets, such a distribution will not cause Trust's classification as a liquidating trust under § 301.7701-4(d) to terminate.

Income Tax Treatment of Liquidating Trust and its Beneficiaries

Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 1.671-2(e)(1) of the Income Tax Regulations provides that, for purposes of part I of subchapter J, chapter 1 of the Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property (including cash) to a trust. Section 1.671-2(e)(2)(i) provides that a gratuitous transfer is any transfer other than a transfer for fair market value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.

Section 1.671-2(e)(2)(ii) provides that a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust

Section 1.671-2(e)(3) provides that a "grantor" (for purposes of Subpart E) includes "any person" who acquires an interest in a trust from a grantor of the trust if the interest acquired is (among other types of qualifying interests) an interest in an “liquidating trust” described in § 301.7701-4(d). Section 7701(a)(1) of the Code defines “person” to include an individual, trust, estate, partnership, or corporation.

Sections 673 through 679 specify the circumstances under which the grantor or another person will be regarded as the owner of a portion of a trust.

Section 673(a) of the Code provides that the grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

Section 677(a) of the Code provides that the grantor of a trust shall be treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be (1) distributed to the grantor or the grantor’s spouse, (2) held or accumulated for future distribution to the grantor or the grantor’s spouse, or (3) applied to the payment of premiums on certain policies of insurance on the life of the grantor or the grantor’s spouse.

Sections 672(f)(1) and 1.672(f)-1 provide that, as a general rule, the grantor trust rules (§§ 671 through 679) apply only to the extent such application results in an amount (if any) being taken into account (directly or through one or more entities) in computing the income of a citizen or resident of the United States or a domestic corporation. Sections 672(f)(2)(A)(ii) and 1.672(f)-3(b)(1) provide that the general rule does not apply to any portion of a trust if the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor. Under § 1.672(f)-3(b)(2), amounts distributable to unrelated persons in discharge of legal obligations of the grantor or the spouse of the grantor are treated as amounts distributable to the grantor or the spouse of the grantor. Section 1.672(f)-3(b)(1) further provides that, for purposes of paragraph (b), payments of amounts that are not gratuitous transfers (within the meaning of § 1.671-2(e)(2)) are not amounts distributable.

We conclude that for purposes of §§ 672(f)(2)(A)(ii) and 1.672(f)-3(b)(1), the only amounts distributable from Trust are amounts distributable to the grantor or the spouse of the grantor. We also conclude that payments by Trust to GP that are proximately related to one or more Contingent Liabilities paid by GP are not amounts distributable because they are not gratuitous transfers within the meaning of § 1.671-2(e)(2). Thus, the general rule of § 1.672(f)-1 does not apply to Trust.

Therefore, we rule that Trust will be classified as a grantor trust of all partners of LP, by reason of §§ 673 and 677(a), each portion of which will be deemed owned by the partners in proportion to their pro-rata share of assets held in trust on their behalf.

Furthermore, we conclude that § 672(f) will not, by reason of the exceptions contained in §§ 672(f)(2)(A)(ii) and 1.672(f)-3(b)(1), prevent Trust from being classified as a grantor trust with respect to LP's nonresident partners deemed to be Trust's grantors under § 1.671-2(e)(1).

Additionally, pursuant to § 1.671-2(e)(3), any beneficial interests acquired by X will cause X to be treated as an owner of Trust for purposes of Subpart E of Part 1 of Subchapter J of the Code. X shall report its pro-rata share of all items of income, credit, gain, loss, or deduction consistent with being an owner of approximately c% of the Trust under §§ 671-679. Furthermore, when one or more of LP's former partners fully dispose of their beneficial interests in Trust to X, such former partners will cease being owners of Trust for Federal income tax purposes on the date of disposition.

Income Tax Treatment of Partnership Liquidation

Section 708(b)(1)(A) provides that a partnership terminates when no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Section 1.708-1(b)(1) provides, in relevant part, an example where "partners DEF agree on April 30, 1957, to dissolve their partnership, but carry on the business through a winding up period ending September 30, 1957, when all remaining assets, consisting only of cash, are distributed to the partners, the partnership does not terminate because of cessation of business until September 30, 1957."

Section 1.708-1(b)(3)(i) provides that for purposes of § 708(b)(1)(A), the partnership's termination date is the date on which the winding up of the partnership affairs is completed.

While the dissolution of a partnership is governed by state law, the termination of a partnership for Federal tax purposes is controlled by Federal law. A termination of a partnership for Federal tax purposes may be different from its termination, dissolution, or winding-up under state law, and a partnership may continue to exist for Federal tax purposes even though state law provides that the partnership has terminated, dissolved, or wound-up. *See* Fuchs v. Comm'r, 80 T.C. 506, 509–510 (1983); Neubecker v. Comm'r, 65 T.C. 577, 581–582 (1975). Whether a partnership has terminated for Federal tax purposes is a factual determination.

The regulations interpreting § 708(b)(1)(A) establish a liberal approach to a finding of a business nexus sufficient to maintain a partnership. In accordance with those regulations, a partnership continues to exist even when its operations are substantially changed or reduced in a period of winding up, and even when its sole asset during that period is cash. Harbor Cove Marina Partners Partnership v. Comm'r, 123 T.C. 64, 81 (2004).

The Ninth Circuit, in affirming the Tax Court, held that no termination occurs until all the assets of a partnership are distributed to the partners and all partnership activity ends. Baker Commodities, Inc. v. Comm'r, 415 F.2d 519 (9th Cir. 1969), *aff'g* 48 T.C. 374 (1967) (cert. denied). The Second Circuit, in affirming the Tax Court, held that the sale of a partnership's principal asset was not, by itself, a terminating event under § 708(a)(1)(A). Estate of Aaron Levine, 72 T.C. 780 (1979), *aff'd*, 634 F.2d 12 (2d Cir. 1980). However, the Sixth Circuit found in favor of a partnership termination prior to distribution of funds retained by the partnership to satisfy possible security-deposit obligations. Goulder v. United States, 64 F.3d 663 (6th Cir. 1995). However, the parties in Goulder did stipulate that the partnership did not operate or carry on "any business, financial operation or venture" after the year when the termination was deemed to occur.

In the current case, all activities of LP have ceased; LP distributed all its assets (cash and beneficial interests in Trust) to its partners in accordance with the terms of the partnership agreement; and State has terminated LP's status as a limited partnership. As a consequence of the aforementioned actions, GP has assumed full responsibility for the Contingent Liabilities under state law. The resolution of the Contingent Liabilities is the only ongoing activity that economically connects the former partners of LP. If one of more of the Contingent Liabilities were to ripen to the point where GP personally satisfies the liability, GP would be able to, presumptively, assert a state law claim against LP's former limited partners for contribution to reclaim a portion of their liquidation proceeds. However, the agreement between LP's partners, which led to the creation of Trust, provides that the GP can look only to the assets of Trust to satisfy its state law claim against the limited partners for contribution. Trust's intent, existence and operation is solely one of an aggregate of the partners in order to provide a procedurally efficient manner to liquidate LP and retain access to short-term liquid assets held in trust to satisfy one or more Contingent Liabilities.

Generally, a state law claim by GP against the limited partners (or against Trust) for contribution to reclaim a portion of excess liquidation proceeds is a matter adjudicated between the partners. In the present case, any state law claim initiated by GP (or even the ability to initiate such a claim) flows from the state law right of contribution between a general partner and its limited partners after the cessation of a partnership's business.

Therefore, we conclude that the final distributions by LP of its assets to the partners and Trust, followed by the dissolution of LP under State law, resulted in a termination of the partnership under § 708(b)(1)(A) and the liquidation of the partners' interests in the partnership. Each partner of LP will be deemed to have received his pro rata share of Trust corpus and to have contributed it to Trust. Furthermore, we conclude that if the Trustee makes a distribution to GP and X of their pro rata shares of Trust assets and consequently enters into a contribution agreement to ensure that liabilities are shared among GP, X, and Trust's remaining beneficial owners, then such a transaction is between the Trustee, GP, and X with respect to the continuing operation of Trust, and therefore would not cause LP to continue as a partnership.

Except as specifically ruled above, we express no opinion concerning the federal tax consequences of the transactions described above under any other provisions of the Code. Specifically, we express no opinion to LP, GP, X, Trust, and Trust's beneficial owners, as applicable, concerning the proper federal tax treatment of (1) the amount of gain or loss recognized by any partner of LP pursuant to § 731; (2) the payments from Trust to GP that are proximately related to payment of one or more Contingent Liabilities; (3) the purchase of beneficial interests in Trust for either X or the selling beneficial owners; (4) the Trustee's distribution to GP and X of their pro rata shares of Trust assets; and (5) subsequent contributions to Trust by GP or X pursuant to a contribution agreement discussed above to GP, Trust, and Trust's beneficial owners (including X).

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. Pursuant to a power of attorney on file, a copy of this letter is being sent to X's authorized representative.

Sincerely,

Bradford Poston
Senior Counsel, Branch 2
(Passthroughs & Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes

cc: