Overview of Partnership Tax

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Topics

1. Classifying a Partnership
2. Contributions to Partnership
3. Partnership Operations
4. Allocations
5. Payments from Partnership to Partner
6. Sale & Transfer of a Partnership Interest
7. Distributions & Retirement of a Partner

1. Classifying a Partnership

Typical Entities Taxed as Partnerships

- General partnership
- Limited partnership
- Limited liability partnership
- Limited liability limited partnership
- Limited liability company (LLC)
- Certain business trusts

Classification of Arrangement as Partnership

Section 761(a)

"Partnership" includes syndicate, group, pool, joint venture or other unincorporated organization through which business, financial operation or venture is carried on . . .

Ability to "elect out" of subchapter K if organization is

1. for investment only and not active business,
2. for joint production, extraction or use of property but not selling, or
3. securities underwriting syndicate.

Classification of Arrangement as Partnership

Step 1: Determine whether there is an "entity." Reg. § 301.7701-1.

- Distinguish: contractual relations, loan with equity interest, lease with equity rent, tenancy in common, etc.
- Local law not determinative
  - Can have tax partnership without local law entity
  - Some local law entities (e.g., state agency) may not be tax entity.

✓ If arrangement is an entity, proceed to step 2.

Classification of Arrangement as Partnership

Step 2: Distinguish "trust." Reg. § 301.7701-4.

- "Ordinary trust" is an entity formed by will or other inter vivos declaration where trustee takes title to property to conserve it for beneficiaries.
- "Business trust" is generally not a trust if the business is transferred to the trust by the beneficiaries. If donors are not beneficiaries, must decide whether transfer is to protect or conserve property.
- If donors are beneficiaries, it's still a trust if the purpose is to conserve assets.
- "Investment trusts" have (1) single class of ownership and (2) no power of trustee to vary (manage) the investments.

✓ If entity is not a trust, it is a "business entity." Proceed to step 3.

Classification of Arrangement as Partnership

Step 3: Classify the business entity. Reg. §§ 301.7701-2, 301.7701-3.

- A business entity may be
  1. a corporation or
  2. a partnership or "disregarded entity" if there is a single owner (i.e., treated as a division of the owner).
- Some entities are automatically ("per se") corporations:
  - Titled corporation, incorporated, body corporation, body politic, joint stock company or association, insurance company, state chartered bank. Reg. § 301.7701-2.
  - Listed foreign entities. Reg. § 301.7701-2(b)(8).

✓ If entity is not a "per se" corporation, it is a "eligible entity." Proceed to step 4.

Classification of Arrangement as Partnership

<u>Step 4</u>: Classify the eligible entity. Reg. § 301.7701-3.

Eligible entity can elect ("check the box") to be taxed as corporation or partnership (or "disregarded").

- Default classification if no election,
  - For domestic entity – partnership (or disregarded);
  - For foreign entity:
    - corporation of all members have limited liability
    - partnership if some member has unlimited liability
- Tax-exempt entities: if determined or claimed to be exempt, then deemed corporation election
- Observation: single owner eligible entities can be a corporation or disregarded

Publicly traded partnership ("master limited partnership" MLP)

Section 7704

Definition: interests traded on established securities market or readily tradable on a secondary market.

Taxed as corporation unless,

- 90% of income is "qualifying" – investment income, rents, income and gain from exploration, processing or transporting natural resources.
- If 90% requirement is met, then taxed as partnership.

2. Contributions to Partnerships

Contribution of Property to Partnership – Non-Recognition Rule

Section 721: Nonrecognition of gain or loss on contribution of property by partner to partnership

- Applies to both partner and partnership.
- Doesn't cover contribution of services.
- Exception: gain (but not loss) recognized on contribution to "investment company." Section 721(b). Rules and definitions contained in § 351(e) and regulations under § 351. Gain recognized if
  1. Partnership is "investment company," meaning at least 80% of assets are investment-type holdings (but not including real estate), and
  2. Transfer results in diversification of transferor's interest.
- Compare corporate rule and requirements under § 351.

Contribution of Property to Partnership – Basis and Holding Period

Section 722. Basis of contributed property is "transferred" to partner's basis in partnership interest ("outside basis").

- Increase for gain recognized (if any).
- Consider effect of shifting liabilities.
- Corollary is tacking of holding period for capital and § 1231 assets. Section 1223.

Section 723. Inside basis of contributed property to partnership is "carryover" from contributing partner.

- Increase for recognized gain.
- Tacked holding period. Section 1223.

Liabilities – Section 752

Section 752(a): increase in partner's share of liabilities treated as contribution of money.

Section 752(b): decrease in partner's share of liabilities treated as distribution of money.

Partner's Share of Liabilities

- "Recourse liability": some partner or related person risk of loss. Reg. § 1.752 – 1.
- "Nonrecourse liability": no partner or related person bears risk of loss. Reg. § 1.752 – 1.

Partner's Share of Recourse Liability Reg. § 1.752 – 2

- Partner's share of recourse liability is portion for which partner has risk of loss.
- Partner has risk if loss if obligated to make payment in constructive liquidation and not entitled to reimbursement.
- For this purpose only, constructive liquidation assumes:
  1. All assets sold for zero,
  2. Gain or loss allocated, and
  3. Liabilities paid in full.

Partner's Share of Nonrecourse Liability Reg. § 1.752 – 3

Partner's share determined in 3-tier waterfall:

1. Partner's share of "minimum gain,"
2. Partner's share of § 704(c) gain as if property were sold for the debt, and
3. According to profits interest (or, alternatively, reasonably expected share of deductions attributable to the nonrecourse debt).

Contribution of Cash Basis Payables

- Liabilities that are deductible when paid are <u>not</u> covered by § 752. Rev. Rul. 88-77.
- However, these are treated under § 704(c) as allocable to contributing partner when paid.

Contribution of Services for Partnership Interest

- Distinguishing a capital and profits interest:
  - "Profits interest" does not convey an immediate interest in partnership capital – i.e., on hypothetical immediate liquidation at FMV, profits interest holder gets nothing.
  - Profits interest holder starts with zero capital account. Shares only in profits earned and appreciation accruing after grant of interest.
- Historically a confusing question whether taxable income recognized from receipt of partnership interest by service partner. Cf. Diamond and Campbell cases.

Contribution of Services for Partnership Interest – Prior to Proposed Regulations

Rev. Proc. 93-27: Receipt of "profits interest" not taxable unless

1. It embodies a substantially certain income stream,
2. It is sold within 2 years, or
3. It is a limited partnership interest in a publicly traded partnership.

Rev. Proc. 2001-43: Grant of profits interest that is forfeitable does not require § 83(b) election to avoid income on vesting.

Contribution of Services for Partnership Interest – Proposed Regulations

- Proposed regulations would reverse rule but allow safe harbor election to value partnership interest granted in connection with services to be valued at liquidation value.

- Receipt of capital interest for services results in income to recipient equal to the associated capital account transferred. Partnership has deduction (or capitalized expense) corresponding to services income.

Problem 1. A and B each contribute $30,000 cash to the ABC partnership and C contributes land held for more than one year, worth $60,000 and subject to a recourse debt of $30,000. A, B and C are all general partners with a one-third interest in the profits and losses of ABC.

a. What are the tax consequences to A, B, C and ABC if the land has a basis to C of $40,000 and the partnership assumes the debt?

Applying Sections 721, 722, 723, 752, and 753, no recognition on the contribution to neither any partner nor the partnership. In terms of basis, each partner has a carryover basis of his/her basis in the property in his/her partnership interest. Regarding the liability, each partner is treated as having assumed one third of the debt ($10,000). Therefore, A and B's basis becomes $40,000 and C's basis goes down to $20,000.

Balance Sheet of the partnership

Assets			**Liabilities and Partners' Capital**			
	A.B.	**Bk. Val.**			**A.B.**	**Bk. Val.**
Cash	$60,000	$60,000	Liabilities:			$30,000
Land	$40,000	$60,000	Capital:			
				A	$40,000	$30,000
				B	$40,000	$30,000
				C	$20,000	$30,000
Total	$100,000	$120,000			$100,000	$120,000

b. Same as (a), above, except that the land has a basis to C of $10,000.

Applying Sections 721, 722, 723, 752, and 753, no recognition on the contribution to A and B nor the partnership. In terms of basis, partner A and B has a carryover basis of his/her basis in the property in his/her partnership interest. Regarding the liability, each partner is treated as having assumed one third of the debt ($10,000). Therefore, A and B's basis becomes $40,000. **C must recognize a LTCG of $10,000 (most likely LTCG, depending on how C held it). C's basis in his/her partnership interest is $0. To avoid this recognition of gain, C could contribute an asset or cash with at least $10,000 of basis or assume at least $10,000 more of the liability.**

Balance Sheet of the partnership

Assets			**Liabilities and Partners' Capital**			
	A.B.	**Bk. Val.**			**A.B.**	**Bk. Val.**
Cash	$60,000	$60,000	Liabilities:			$30,000
Land	$20,000*	$60,000	Capital:			
				A	$40,000	$30,000
				B	$40,000	$30,000
				C	$0	$30,000
Total	$70,000	$120,000			$80,000	$120,000

* Note: C has a basis in the land before the transfer for partnership of $10,000. Due to the partnership assuming the debt and C recognizing $10,000 of LTCG on transfer, the land basis will increase by $10,000.

3. Partnership Operations

Partnership Operation Overview

Sections 701, 702, 703: Partners report on their share of partnership income, gain, loss, deduction, credit.

Section 704: How to determine each partner's share of partnership items.

Section 705: Determining partner's outside (adjusted) basis.

Section 706: Taxable year of partnership.

Flow-through of Partnership Items

Form 1065 and K-1:

- Partnership files information return, but pays no tax. Reports to partners their share of partnership items.
- Partnership must report separately those items that could receive different treatment on partner return depending on partner circumstances (e.g., charitable contributions, long and short term capital gain).
- Can combine ordinary business income and deductions that could also combine on partners returns.

Taxable Year of Partnership – Section 706

Section 706(a): partnership income flows through to partners on last day of partnership year. Potential for postponing income recognition by judicious selection of partnership year.

Taxable Year of Partnership – Section 706

Section 706(b): addresses perceived abuse potential with rules for selecting partnership year. The following tier of rules applies:

1. If a group of partners having more than 50% of profits and capital all have the same tax year, then partnership must elect that year.
2. If all partners having at least 5% of profits or capital have the same year, then partnership must elect that year.
3. Partnership must elect the year that provides the least deferral.

Supervening: partnership may adopt "natural business year," defined as year for which at least 25% of gross receipts occur in last 2 months (and this holds true for preceding 3 years.) Rev. Rul. 87-57, Rev. Proc. 87-32.

Outside Basis – Section 705

A partner's outside basis is:

- increased by partners share of income (including tax-exempt income),
- increased by basis of contributions (§ 722),
- decreased by partner's share of losses (including non-deductible expenses),
- decreased (but not below zero) by basis of distributed property.

Note the effect of

- Section 752 deemed contribution or distribution of cash
- Parallel rules to capital account maintenance.

Limitations on Use of Flow-through Losses

Limitations apply to losses incurred by partnership and properly allocated to partner under § 704(b) regulations (discussed at length in following weeks' classes).

1. Use of losses is limited to partner's outside basis. Losses that are limited carry over to next year. Section 704(d).
2. "At risk" limitations of § 465 apply at partner level.
   - Note: at risk rules are more stringent than § 704(d) chiefly regarding nonrecourse debt (except "qualified nonrecourse financing").
3. "Passive activity loss" limitations of § 469 apply at partner level.

4. Allocations

Partnership Allocations – Section 704

What items and amounts of income and loss are properly reportable by a partner given

1. the allocations set forth in the partnership agreement or
2. the absence of allocations in the partnership agreement?

Or stated another way:

What allocations are allowed to be in the partnership agreement assuming we wish the allocations to be respected when reported by partners on their returns?

- Allocations not in compliance with § 704(b) regulations risk being adjusted by IRS to be in accordance with "partners' interest in the partnership." Reg. § 1.704-1.

Partnership Allocations – Section 704

Addressed as three sub-topics:

1. Substantial economic effect;
2. Deductions attributable to nonrecourse debt;
3. Items attributable to book-tax disparities under § 704(c).

Substantial economic effect

Section 704(b) lays out a safe harbor regarding the allocation in the partnership agreement.

- If the allocation meets substantial economic effect, it will be respected.
- If the allocation does not meet substantial economic effect, the allocation will be determined by considering the "partners' interest in the partnership."

Substantial economic effect

Reg. § 1.704-1(b)(2) regulations <u>substantial economic effect</u> divide into two topics:

1. "economic effect" and
2. "substantiality"

<u>Economic Effect</u> intends that a partner who receives for tax purposes allocations of income or loss should be the partner who receives the economic effect of the item. – 1(b)(2)(ii)(a).

Economic effect: Basic Test

Three primary requirements - 1(b)(2)(ii)(b)

1. Capital accounts maintained according to - 1(b)(2)(iv) regulations;
2. Liquidating distributions according to positive capital account balances;
3. Deficit capital account restoration required.

Reg. § 1.704-1(b)(2)(iv)

Capital account maintainance rules - 1(b)(2)(iv)

Capital account is increased by

1. Money contributed
2. Fair market value of property contributed,
3. Allocations of partnership income and gain (book method, not tax).

Capital account is decreased by

1. Money distributed to partner,
2. FMV of property distributed to partner,
3. Allocations of partnership loss and deduction (book method).

Note: Capital account is not adjusted for § 752 deemed contribution/distribution of cash. Therefore, in simple situations, outside basis differs from capital account by amount of debt.

Economic effect: Alternate Test

Alternate test

- If basic test 1 and 2 are met and
- Partnership agreement contains "qualified income offset" (QIO)

then allocation will be respected to the extent it doesn't cause capital account to be more negative than partner's obligation to restore. Reg. § 1.704 – 1(b)(2)(ii)(d).

- Capital account must be adjusted down for reasonably anticipated distributions.

Qualified Income Offset (QIO)

- A QIO provision comes into effect when a partner unexpectedly receives a distribution causing a capital account deficit greater than partner's restoration obligation.

- A proper QIO provision in the partnership agreement must provide this partner with allocated items of income or gain to eliminate excess deficit as quickly as possible.

Substantiality

<u>Reg. § 1.704– 1(b)(2)(iii)</u>

Substantiality requirement is an anti-abuse provision to prevent assigning items to take advantage of tax characteristics of item in hands of particular partner.

- An allocation has "substantial effect" if there is reasonable possibility that it will substantially affect dollar amounts to be received by partner.
- Allocation <u>is not</u> substantial if
  1. The allocation may increase the present value of after-tax economics to some partner; <u>and</u>
  2. There is strong likelihood that PV of after-tax economics to no partner is diminished.

  Note: Take into account tax position of partners outside partnership.

Substantiality

Example of allocations lacking substantially:

1. "Shifting" allocations
   - Allocation of one type of item offset in same year by an offsetting allocation.
2. "Transitory" allocations
   - Allocation likely to be largely offset over time, and partners have reduced tax liability.
   - Not transitory if offset won't occur within 5 years.
   - Okay to presume that the true value of property corresponds to book value (so gain chargeback on sale of property is not transitory).

Allocations Failing Basic and Alternate Tests

If basic test rules 1 and 2 are satisfied and substantially exists, determine "partner's interest in partnership" by comparing

1. proceeds from hypothetical book value liquidation at year-end with
2. proceeds at prior year end.

Allocations related to Nonrecourse Liabilities

Principles of Nonrecourse (NR) Debt

Under *Tufts, Crane,* and Reg. § 1.1001-2

1. Acquisition debt is included in basis of property.
2. Basis attributable to NR debt may be depreciated.
3. Sales proceeds include amount of NR transferred or relieved (e.g. in foreclosure).

Example in Partnership Context

- General Partner contributes $10; Limited Partner contributes $90.
- Partnership borrows $900 nonrecourse, to acquire real property for $1000, depreciable $50/yr.
- Allocate depreciation 10% to GP, 90% to LP.
- After two years:

Realty	1000	Debt			900
depr.	(100)	Capital			
			G	10	
			Depr.	(10)	
	900				0
			L	90	
			Depr.	(90)	
					0

Question: How to allocate third year depreciation that will cause negative capital account(s)?

Safe Harbor for Nonrecourse Deduction

<u>Reg. § 1.704-2(e)</u>

1. Meets either basic or alternate test for substantial economic effect.
2. NR deductions allocated in a manner "reasonably consistent" with other allocations having substantial economic effect or attributable to property securing NR debt.
3. Partnership agreement has “minimum gain chargeback.”
4. All other allocations respected under Reg. § 1.704-1(b).

Minimum Gain Chargeback (MGC)

Reg. § 1.704-2(f)

- A MGC provision comes into effect when there is a net decrease in Partnership Minimum Gain for the year.

- A proper MGC provision in the partnership agreement must provide each partner must be allocated items of income and gain for that year at least equal to Partner's Share of Net Decrease in Minimum Gain.

Partnership Minimum Gain

"Partnership Minimum Gain"

Gain realized if partnership disposed of all properties subject to NR liabilities for consideration (equals discharge of debt).

Calculation

- Minimum Gain = NR debt – book value (or basis) of property
- Minimum gain increases for additional debt or decrease in property basis (depreciation).
- Use book method not basis if book-tax disparity.
- Add only gain properties.

Partner's Share of Net Decrease in Partnership Minimum Gain

Formula under Reg. § 1.704-2(g)

The net decrease in Partnership Minimum Gain times fraction

$$\frac{\text{Partner's share of Minimum Gain at prior year-end}}{\text{Partnership Minimum Gain at prior year-end}}$$

Partner's Share of Minimum Gain

Partner's Share of Minimum Gain is the sum of

- Nonrecourse Deductions allocated to partner,
- Plus, distributions to partner of NR borrowing proceeds (allocable to an increase in Partnership Minimum Gain),
- Minus, partner's share of net decreases in Partnership Minimum Gain,
- Minus, partner's share of decreases in Partnership Minimum Gain from revaluations (equals increase in partner's capital account from revaluations to extent Minimum Gain is reduced).

Nonrecourse Deductions

Nonrecourse Deductions are deductions resulting in an increase of Partnership Minimum Gain

- depreciation of property resulting in book value less than NR debt secured by the property.
- NR borrowing retained in Partnership (deemed by regulations to be spent proportionally on other expenses).

Formula

Nonrecourse deductions equal the increase in Partnership Minimum Gain minus distributions of NR borrowing proceeds (allocable to increase in Partnership Minimum Gain).

Additional Items

- "Partner Nonrecourse Liability (or Partner NR Debt)": a liability that is nonrecourse under Reg. § 1.1001-2 (i.e., includible in basis and sales proceeds) where a partner has risk of loss (e.g., partner is creditor or guarantor).
- "Partner Nonrecourse Debt Minimum Gain": minimum gain attributable to Partner NR Debt.
- "Partner Nonrecourse Deductions": Nonrecourse deductions attributable to Partner NR Debt.
- Required tax treatment:
  - Partner Nonrecourse Deductions must be allocated to partners bearing risk of loss.
  - Decrease in Partner NR Debt Minimum Gain must be allocated to corresponding partner ("chargeback").

Allocations related to Book-Tax Disparities (and other allocation issues)

Section 704(c): Book-Tax Disparities

- Contributed property may have tax basis ≠ FMV
- Same disparity can occur upon book-up to FMV of existing property in partnership, for example, upon admission of new partner – "Reverse § 704(c)"
- Formula for "Built-in gain" and "built-in loss”
  - Book value – basis.
- Built-in gain, loss can change over time, generally as book value and basis depreciate.

Section 704(c): Book-Tax Disparities

<u>The problem with using the substantial economic effect rules</u>

"Substantial economic effect" is based on book value, not tax basis. Therefore, allocations of built-in gain or loss cannot have substantial economic effect.

Section 704(c) regulations provide tax treatment of these items. Reg. § 1.704-3. There are three allowed methods:

1. Traditional (respects ceiling rule).
2. Remedial (ignores ceiling rule).
3. Curative (traditional combined with other actual items).

Section 724 – Character of Gain and Loss from Certain Contributed Property

- Prevents conversion of ordinary income in hands of partner into capital gain for partnership.
- Prevents conversion of capital loss in hands of partner into ordinary loss for partnership

Section 706(d) Allocations Where Interests Vary Within Year

Example: A and B are equal partners in AB Partnership, which is a calendar year, cash method partnership. C joins the partnership on December 1st and becomes an equal 1/3 partner.

- Analysis: proposed regulations specify (1) "closing of books" or (2) proration.
  - Closing of Books: Determine actual profit/loss for two short periods (i) Jan-Nov. and (ii) December. Allocate Jan-Nov to A and B, allocate December to A + B + C.
  - Proration: C gets 1/3 of 1/12 of year's results.
    - Note: Proration method can distort, for example where cash-basis expense paid at year end, giving C large deduction that really accrued throughout year. Section 706(d)(2) and (3).

Section 704(e) Family Partnership

Example: Mother has successful software business. She transfers the business to partnership with children as owners. Partnership allocates income to children in low tax bracket.

Section 704(e) requires:

1. Child's share of income must be proportional to child's capital (requiring in usual case that Father has made gift of capital interest).
2. Child's share of income must be net of reasonable compensation to Mother.

Problem 2. S and P are general partners in a general partnership (SP). Upon formation S contributed $50,000 cash in exchange for a partnership interest. P contributed depreciable machinery (FMV $50,000; AB $20,000). The machinery had a ten-year cost recovery period, of which 5 years were remaining on the contribution date. The partnership elected to depreciate under the straight-line method. The partnership agreement allocates profits and losses equally between S and P. Each year the partnership has $12,000 of gross income and the only deduction is depreciation on the machinery.

1. How will depreciation be allocated to S and P for book and tax purposes applying the "traditional method" with the ceiling rule?

Under Treas. Reg. § 1.704-3(b), here is a summary of the steps to follow when allocating the depreciation under the traditional method (note this does not affect the allocation of any other items):

1. Calculate tax and book depreciation.
2. Allocate the book depreciation among the partners.
3. First consider the non-contributing partners with respect to the asset that creates the § 704(c) disparity (NCP) and match NCP's tax depreciation with book depreciation allocated in step 2.
4. Allocate any remaining tax depreciation to the contributing partner.

If the adjusted basis of the property contributed by P is $20,000, annual tax depreciation is $4,000, which is less than S's allocation of book depreciation. The ceiling rule of the traditional method, Treas. Reg. § 1.704-3(b), prevents allocation of tax items in excess of the partnership's tax item. Thus, although S acquires a one-half interest in the property for $25,000, under the ceiling rule, S will be allowed depreciation deductions of only $4,000 (instead of $5,000).

Here is the capital account analysis for Year 1:

Partners	S		P	
	Tax	Book	Tax	Book
Initial Capital Bal.	50,000	50,000	20,000	50,000
Gross Income	6,000	6,000	6,000	6,000
Depreciation	-4,000	-5,000	0	-5,000
End of Yr 1 Cap. Bal.	52,000	51,000	26,000	51,000

At the end of five years, S will have a built-in loss attributable to the shortfall of depreciation allocable to him. S would recognize the loss (and hence the shortfall in depreciation that economically should have been available to him) on termination of his partnership interest. Thus, the deduction is deferred, not totally lost.

Here is the capital account analysis for Years 1 through 5:

Partners	S		P	
	Tax	Book	Tax	Book
Initial Capital Bal.	50,000	50,000	20,000	50,000
Gross Income YR1	6,000	6,000	6,000	6,000
Depreciation YR1	-4,000	-5,000	0	-5,000
End of Yr 1 Cap. Bal.	52,000	51,000	26,000	51,000
Gross Income YR2	6,000	6,000	6,000	6,000
Depreciation YR2	-4,000	-5,000	0	-5,000
End of Yr 2 Cap. Bal.	54,000	52,000	32,000	52,000
Gross Income YR3	6,000	6,000	6,000	6,000
Depreciation YR3	-4,000	-5,000	0	-5,000
End of Yr 3 Cap. Bal.	56,000	53,000	38,000	53,000
Gross Income YR4	6,000	6,000	6,000	6,000
Depreciation YR4	-4,000	-5,000	0	-5,000
End of Yr 4 Cap. Bal.	58,000	54,000	44,000	54,000
Gross Income YR5	6,000	6,000	6,000	6,000
Depreciation YR5	-4,000	-5,000	0	-5,000
End of Yr 5 Cap. Bal.	60,000	55,000	50,000	55,000

S would recover a $5,000 loss on liquidation of the partnership and distribution of cash-the difference between his capital account and his outside basis. Correspondingly, P would recognize a $5,000 gain on receipt of a cash distribution in liquidation of her partnership interest.

5. How will depreciation and partnership gross income be allocated to S and P for book and tax purposes applying “curative allocations?”

Under Treas. Reg. § 1.704-3(c), here is a summary of the steps to follow when allocating under the traditional method with curative:

1. Calculate tax and book depreciation.
2. Allocate the book depreciation among the partners.
3. First consider the non-contributing partners with respect to the asset that creates the § 704(c) disparity (NCP) and match NCP’s tax depreciation with book depreciation allocated in step 2.
4. Allocate any remaining tax depreciation to the contributing partner.
5. Calculate the subtotal in capital account balances.
6. Allocate the book income of the corresponding income/gain among the partners.

7. First consider the NCPs and allocate tax income of the corresponding income/gain in order to make the NCP's end of year tax capital balance equal the end of year book capital balance.
8. Allocate the remaining tax income of the corresponding income/gain to the contributing partner.

Curative allocations under Treas. Reg. § 1.704-3(c) permit the partnership to overcome the problem created by the ceiling rule. The partnership may use reasonable curative allocations of other partnership items to cure disparities created by the ceiling rule. The items allocated as curative allocations must have the same character as the item that creates the disparity. In the case of depreciation, the partnership may allocate taxable gain to the contributing partner (which reduces the taxable income of the other partners) or additional deduction items to the noncontributing partner. Use of the curative method is dependent upon the presence of partnership tax items of appropriate character to cure the disparity. The partnership may allocate $1,000 of operating income to P (and away from S) to cure the disparity between the allocation of book and tax depreciation to S as limited by the ceiling rule.

Here is the capital account analysis for Year 1:

Partners	S		P	
	Tax	Book	Tax	Book
Initial Capital Bal.	50,000	50,000	20,000	50,000
Depreciation	-4,000	-5,000	0	-5,000
Subtotal	46,000	45,000	20,000	45,000
Gross Income	5,000	6,000	7000	6,000
End of Yr 1 Cap. Bal.	51,000	51,000	27,000	51,000

In this fashion, the allocations shift $1,000 of tax income from S to P without changing the allocations of book income. This allocation of tax consequence does not have substantial economic effect, but Treas. Reg. § 1.704-2(b)(2)(iv)(d)(3) subordinates the § 704(b) regulations to § 704(c) and requires revaluation of capital accounts under Treas. Reg. § 1.704-2(b)(2)(iv)(g). At the end of five years, disparities between the partners' tax and capital accounts will have been eliminated.

Here is the capital account analysis for Years 1 through 5:

Partners	S		P	
	Tax	Book	Tax	Book
Initial Capital Bal.	50,000	50,000	20,000	50,000
Depreciation YR1	-4,000	-5,000	0	-5,000
Gross Income YR1	5,000	6,000	7000	6,000
End of Yr 1 Cap. Bal.	51,000	51,000	27,000	51,000
Depreciation YR2	-4,000	-5,000	0	-5,000
Gross Income YR2	5,000	6,000	7000	6,000
End of Yr 2 Cap. Bal.	52,000	52,000	34,000	52,000
Depreciation YR3	-4,000	-5,000	0	-5,000
Gross Income YR3	5,000	6,000	7000	6,000
End of Yr 3 Cap. Bal.	53,000	53,000	41,000	53,000
Depreciation YR4	-4,000	-5,000	0	-5,000
Gross Income YR4	5,000	6,000	7000	6,000
End of Yr 4 Cap. Bal.	54,000	54,000	48,000	54,000
Depreciation YR5	-4,000	-5,000	0	-5,000
Gross Income YR5	5,000	6,000	7000	6,000
End of Yr 5 Cap. Bal.	55,000	55,000	55,000	55,000

9. How will depreciation and partnership gross income be allocated to S and P for book and tax purposes applying "remedial allocations?"

   While curative allocations use an item of partnership taxable income or expenditure to cure a book/tax disparity, the remedial allocation of Treas. Reg. § 1.704-3(d) creates notional items of partnership income or expense to eliminate disparities between book and tax accounts. Under Treas. Reg. § 1.704-3(d)(2), remedial allocations of depreciation require a two-step process. First, an amount of book value equal to the adjusted basis of contributed property is recovered over the remaining cost recovery period of the property. Second, the remaining book value is recovered over a new capital recovery period determined as if the partnership purchased the property on the date of contribution. Tax items are allocated to the partners in the same manner as under the traditional method. The tax item is allocated to a non-contributing partner to the extent of the partner's share of the book item. When the ceiling rule limits an allocation because the tax item is less than the book item, the non-contributing partner receives a notional tax allocation to the extent of the book adjustment. The contributing partner is thereupon allocated an offsetting tax item in the same amount.

Under Treas. Reg. § 1.704-3(d), here is a summary of the steps to follow when allocating the depreciation under the remedial method (note this does not affect the allocation of any other items):

1. Break the pre-contribution gain or loss asset up into two components: first, the original asset as if the contributing partner kept the asset and continued depreciating, and second, the "additional value" asset created by booking up the asset (the difference in BV and adjusted basis). The 2 assets will have different recovery periods.
2. Calculate tax and book depreciation using the different recovery periods for each asset.
3. Allocate the book depreciation among the partners.
4. First consider the non-contributing partners with respect to the asset that creates the § 704(c) disparity (NCP) and match NCP's tax depreciation with book depreciation allocated in step 2.
5. Allocate any remaining tax depreciation to the contributing partner.
6. Calculate the subtotal in capital account balances.
7. First consider the NCPs and allocate a fictitious item of tax loss in order to make the NCP's end of year tax capital balance equal the end of year book capital balance. Note the character of this loss is the same as the pre-contribution asset's character. It's possible that no item is needed in this step in certain years.
8. Allocate a fictitious item of tax income to the contributing partner in the same amount as to the NCP. This will make the fictitious items net out to 0. Note the character of this loss is the same as the pre-contribution asset's character. It's possible that no item is needed in this step in certain years.

In the SP partnership, the first portion of the depreciation deduction for book purposes is $4,000 ($20,000 recovered over five years), divided equally between the partners. The second portion of book depreciation is determined as if the property were newly purchased for the difference between adjusted basis and book value, $30,000. This second portion of book depreciation is recovered over a new recovery period for the property beginning on the date of the contribution. Thus, the second portion produces book depreciation of $3,000 per year for ten years. The total book depreciation for years one through five is $7,000. Thereafter, book depreciation is $3,000 per year. In each of the first five years, $3,500 of tax depreciation (equal to his share of book depreciation) is allocated to S. The remaining $500 of tax depreciation is allocated to P. During the sixth through tenth years, tax depreciation will be zero. Since S will still have an annual book depreciation allocation of $1,500, S is allocated a notational or fictional tax depreciation deduction in the same amount. To offset this remedial allocation, P is allocated notional income of $1,500.

The depreciation allocations in the partners' book and tax accounts are as follows:

Partners	S		P	
	Tax	Book	Tax	Book
Initial Capital Bal.	50,000	50,000	20,000	50,000
Gross Income YR1	6,000	6,000	6,000	6,000
Depreciation YR1	-3,500	-3,500	-500	-3,500
Subtotal	52,500	52,500	25,500	52,500
Remedial YR1	0	0	0	0
End of Yr 1 Cap. Bal.	52,500	52,500	25,500	52,500
Gross Income YR2	6,000	6,000	6,000	6,000
Depreciation YR2	-3,500	-3,500	-500	-3,500
Subtotal	55,000	55,000	31,000	55,000
Remedial YR2	0	0	0	0
End of Yr 2 Cap. Bal.	55,000	55,000	31,000	55,000
Gross Income YR3	6,000	6,000	6,000	6,000
Depreciation YR3	-3,500	-3,500	-500	-3,500
Subtotal	57,500	57,500	36,500	57,500
Remedial YR3	0	0	0	0
End of Yr 3 Cap. Bal.	57,500	57,500	36,500	57,500
Gross Income YR4	6,000	6,000	6,000	6,000
Depreciation YR4	-3,500	-3,500	-500	-3,500
Subtotal	60,000	60,000	42,000	60,000
Remedial YR4	0	0	0	0
End of Yr 4 Cap. Bal.	60,000	60,000	42,000	60,000
Gross Income YR5	6,000	6,000	6,000	6,000
Depreciation YR5	-3,500	-3,500	-500	-3,500
Subtotal	62,500	62,500	47,500	62,500
Remedial YR5	0	0	0	0
End of Yr 5 Cap. Bal.	62,500	62,500	47,500	62,500
Gross Income YR6	6,000	6,000	6,000	6,000
Depreciation YR6	0	-1,500	0	-1,500
Subtotal	68,500	67,000	53,500	67,000
Remedial YR6	-1,500	0	1,500	0
End of Yr 6 Cap. Bal.	67,000	67,000	55,000	67,000
Gross Income YR7	6,000	6,000	6,000	6,000
Depreciation YR7	0	-1,500	0	-1,500
Subtotal	73,000	71,500	61,000	71,500
Remedial YR7	-1,500	0	1,500	0
End of Yr 7 Cap. Bal.	71,500	71,500	62,500	71,500

Gross Income YR8	6,000	6,000	6,000	6,000
Depreciation YR8	0	-1,500	0	-1,500
Subtotal	77,500	76,000	68,500	76,000
Remedial YR8	-1,500	0	1,500	0
End of Yr 8 Cap. Bal.	76,000	76,000	70,000	76,000
Gross Income YR9	6,000	6,000	6,000	6,000
Depreciation YR9	0	-1,500	0	-1,500
Subtotal	82,000	80,500	76,000	80,500
Remedial YR9	-1,500	0	1,500	0
End of Yr 9 Cap. Bal.	80,500	80,500	77,500	80,500
Gross Income YR10	6,000	6,000	6,000	6,000
Depreciation YR10	0	-1,500	0	-1,500
Subtotal	86,500	85,000	83,500	85,000
Remedial YR10	-1,500	0	1,500	0
End of Yr 10 Cap. Bal.	85,000	85,000	85,000	85,000

5. Payments from Partnership to Partner

Payments from Partnership to Partner

Distinguish

1. ”Normal" distribution with respect to partnership interest: normal distributions are treated under § 731, not taxable generally (except to extent cash distribution exceeds outside basis), reduces outside basis and capital account. The taxation occurs in the year of allocation as determined under § 704.

2. Payments to partner for services: partner receives payment not in partner capacity. Partner and partnership treat transaction as if between unrelated parties. Section 707(a)(1).

Guaranteed Payment - Section 707(c)

Partner acting in partner capacity but receives payment for services or capital in amount independent of partnership income. Reg. § 1.707-1(c).

1. Treated like § 707(a)(1) [non-partner capacity] except partner reports receipt on partnership's method of accounting. For example, if partnership is a accrual, cash method, partner reports income in partnership's accrual year regardless of when payment is received.

2. Guaranteed payment is always ordinary income to recipient. Generally deductible to partnership (unless capitalization is required, e.g., legal services to acquire real property).

3. Recipient is not an employee. The payment is distribution of partnership income, therefore payment is self-employment earnings.

See Reg. § 1.707-1(c), Ex. 2; Rev. Rul. 69-180.

Example 1: Normal Distribution

A is a realtor and B is a lawyer. They form AB partnership as equal partners. Each contributes $500 to acquire rental property. A manages property; B is mostly inactive. A and B agree to share profits 2/3 to A, 1/3 to B.

- Partnership earns and distributes $75 from rental activity. A reports $50 ordinary income, B reports $25 ordinary income.
- Partnership earns and distributes $60 capital gain. A reports $40 capital gain, B reports $20 capital gain.

Example 2: Not in Partner Capacity - Section 707(a)(1)

Same as Example 1. Tenant sues Partnership and Partnership hires B to defend the Partnership. Partnership pays B $9.

- Partnership earns $75 of rental income and has $9 legal expense, net $66 ordinary income.
  - A reports 2/3 x $66 = $44 ordinary income.
  - B reports 1/3 x $66 = $22 ordinary income flow-through from partnership, <u>plus</u> $9 ordinary legal fee, total $31 ordinary income.

Example 2 - Continued

- What if instead the Partnership earns $75 of capital gain and has $9 legal expense paid to B?
  - A reports 2/3 x ($75 capital gain - $9 legal expense) = $50 capital gain and $6 ordinary loss.
  - B reports
    - From Partnership: 1/3 ($75 capital gain - $9 legal expense) = $25 capital gain and $3 ordinary loss, <u>plus</u>
    - $9 legal fee as ordinary ncome

      <u>net</u> $25 capital gain and $6 ordinary income.

Example 3: Guaranteed Payment - Section 707(c)

After several lawsuits, A and B amend their agreement. A will continue to manage property for partnership and B will provide legal service to partnership (in his capacity as partner, same as A). A and B will share everything equally.

Application to Example 2 is same; differences are:

1. Treated like § 707(a)(1) [non-partner capacity] except partner reports receipt on partnership's method of accounting. For example, if partnership is a accrual, cash method, partner reports income in partnership's accrual year regardless of when payment is received.
2. Guaranteed payment is always ordinary income to recipient. Generally deductible to partnership (unless capitalization is required, e.g., legal services to acquire real property).
3. Recipient is <u>not</u> an employee. The payment is distribution of partnership income, therefore payment is self-employment earnings.

Example 4: Disguised Payment for Services – Sec. 707(a)(2)(A)

AB equal partnership (from earlier examples) earns $100 rental income, capitalizing (as required) $10 fee to lawyer partner B for acquiring realty. Each partner also receives a $45 cash distribution at end of the year.

- A reports $50 flow-through ordinary rental income.
- B reports $50 flow-through rental income plus $10 lawyer fee, total $60 of ordinary income.
- Total income reported = $50 + 60 = $110.
- A has $45 cash distribution from partnership.
- B has $45 cash from partnership plus $10 fee = $55 cash.

Example 5: Disguised Payment for Services – Sec. 707(a)(2)(A)

Same as Example 4, but instead of paying a fee to B, partnership changes allocation. For this year 45/100 of income to A, 55/100 to B. Cash position is same as part (a), but total taxable income is $100 (not $110).

- Section 707(a)(2)(A) will likely recharacterize Example 5 result into Example 4.

Disguised Sales – Section 707(a)(2)(B)

Under § 707(a)(2)(B), disguised sale rule likely to treat certain distributions as sale (extensive regulations under Reg. § 1.707-3 elaborating when there is presumption of sale). The disguised sale rule applies when there is

1. transfer of property by partner to partnership,
2. related transfer of money by partnership to partner, and
3. viewed together more like a sale.

6. Sale & Transfer of a Partnership Interest

Sale & Transfer of Partnership Interest

This topic covers lateral sales and transfers – from one partner to another new or existing partner. Note that redemptions (transfer back to partnership) are covered in distributions topic. It is important to consider the consequences to both the seller and buyer of the partnership interest.

Outline of Code Provisions

- Section 741: Sale of partnership interest is capital, <u>except</u>
  - Section 751: Ordinary income treatment to the extent of "Sec. 751 assets" -- "unrealized receivables" and "inventory."
- Section 754: Partnership can elect to adjust inside basis of property underlying sold interest.
- Section 742: Buying partner has outside basis according to usual "cost" principles, including Section 752 increase for share of partnership liabilities.
- Section 743: Inside basis remains the same unless 754 election. If 754 election, adjust inside basis for *Buyer's* benefit.
- Sec. 755: How to apportion basis adjustment.
- No effect on continuing partners unless there is constructive termination under § 708 (b)(1)(B) sale of 50% or more of profits <u>and</u> capital within 12 month period.

Selling Partner: Gain or Loss Calculation

- Selling partner has gain (loss) determined by § 1001 calculation: amount realized minus basis.
- Note that "amount realized" and "basis" both include partner's share of debt. Simplification is possible.
- The characterization of the gain (loss) is generally capital under § 741; however, § 751 provides ordinary income (loss) for certain components.

Section 751

Section 751(a)

Amounts received in sale of partnership interest are ordinary income / loss to extent underlying assets are "unrealized receivables" or "inventory" under § 751(c).

- Note: "Unrealized receivables" and "inventory" definitions are very broad. Intended to capture any items that would not produce capital gain on sale. Applies to recapture items and collectibles gain.
- Note § 751(c)(2): “Services rendered or to be rendered.”
- Reg. § 1.751-1(a)(2): Determine Seller's ordinary income vs. capital gain by hypothetical sale of all partnership assets.

Selling Partner: Additional Issues

- Outside basis of sold interest must be adjusted for seller's share of profit (loss) through date of sale. Reg. § 1.705-1(a)(1).

- Sale of entire interest closes year for seller, mainly affecting year of inclusion of flow-through income (loss). Section 706(c).

- Sale of partial interest does not close year, but must still adjust basis of sold interest for gain (loss).

Selling Partner: Additional Issues

- What if selling partner has more than one interest in partnership with different bases (Example: a limited partnership where A has 50% interest as G.P., 25% as L.P. and B has 25% interest as L.P.)?
  - For all subchapter K purposes, partner has single outside basis. Rev. Rul. 84-53. gives rules for apportioning basis among sold and retained interests (compare treatment of stock share lots Reg. § 1.1032 -1(c)).

Selling Partner: Additional Issues

- Holding Period for sale of partnership interest measured by partnership interest, not assets. Split holding period for interests acquired at different times. Reg. § 1.1223 – 3(a).
- Installment sales treatment available except for underlying § 751 assets. Rev. Rul. 89-108.

Tax Consequences to Buying Partner

- Section 742. New cost outside basis.
- Section 743. Inside basis unchanged except
  - Actual 754 election
  - “Substantial built-in loss" more than $250,000
- No effect on continuing partners unless deemed termination under § 708(b)(1)(B).

Operation of Sections 754, 743, & 755

1. Partnership makes § 754 election for year in which § 743 (or § 734) adjustment is to apply. Election is permanent for life of partnership.
2. Section 754 "turns on" basis adjustment of sec. 743 (or § 734).
3. Amount of § 743 adjustment determined under Reg. § 1.743 – 1(b): give Buyer a "full" inside basis, as if Buyer had bought his share of assets.
4. Sec. 755 prescribes allocation of inside basis adjustment among assets.

Simplified analysis. Basis adjustment for each asset is the gain or loss to Seller on hypothetical sale of all assets for FMV (FMV is implied by the actual sale transaction). Note: Buyer can have offsetting gains and losses in various asset classes.

Sections 754 & 743 Example

ABC Partnership is owned equally by A, B, and C. C sells to N for $100.

	BK/TX	FMV
Accts. Receivable	0	300

	BK/TX	FMV
A	0	100
B	0	100
C	0	100

Consequences (if no Section 754 election):

1. C has $100 of ordinary income through § 751.
2. N has new $100 outside basis.
3. ABC Partnership still has zero inside basis.

When ABC partnership collects full accounts receivable:

1. Each of A, B, and N are allocated $100 of ordinary income.
2. N has outside basis of $200, implying potential $100 capital loss on liquidation.

Sections 754 & 743 Example

Uneconomic tax treatment to N cured by § 743 if ABC Partnership makes a § 754 election.

1. ABC Partnership gets $100 inside basis step-up for accounts receivable <u>allocable solely to N.</u>
2. On collection, N's additional § 743 basis offsets his share of account receivable income.
3. A and B still have $100 ordinary income upon ABC Partnerships full collection of accounts receivable.

Sections 754 & 743 Example

Could also be analyzed under § 704(c) principles.

	BK/TX	FMV		BK/TX	FMV
Accts. Receivable	100	300	A	0	100
			B	0	100
			C	100	100

Note: regulations under § 743 do not apply because a § 743 adjustment should not affect capital account. It has tax effect, not economic effect.

Section 708(b)(1)(B) – Termination on 50% Sale

If 50% or more of capital and profits interests are sold within a 12-month period, the partnership is deemed terminated and a new partnership is deemed to have formed.

- Reg. § 1.708-1(b)(1)(iv):

1. Old partnership deemed to contribute all assets and liabilities to new partnership in exchange for new partnership interests, and
2. Old partnership deemed to liquidate, distributing new partnership interests to continuing and new partners.

Section 708(b)(1)(B) – Termination on 50% Sale

Consequences:

1. Tax year of old partnership terminates,
2. Elections of old partnership terminate,
3. Depreciable property is treated as newly-acquired,
4. Inside – outside basis disparities continue, but old partnership can make § 754 election so § 743 applies to acquiring partners.
5. In general does not cause "mixing bowl" issues.

7. Distributions & Retirement of a Partner

Distributions

We divide analysis

1. "Simple" distributions do not alter partners' interests in § 751(a) property; i.e., § 751(b) does not apply, and other anti-abuse provisions do not apply (e.g. mixing bowl).
2. "Complex" distributions alter interests in "hot assets," implicating. Section 751(b).
3. Mixing bowl and other anti-abuse provisions.
4. Distributions to retiring or deceased partner. Section 736.

Distributions – Outline of Code Section

- Sec. 731: Gain or loss on distribution.
- Sec. 732: Basis of distributed property.
- Sec. 733: Outside basis of distributee partner.
- Sec. 734: Inside basis adjustment from § 754 election.
- Sec. 735: Post-distribution sale of property.

Distributions Definitions

- “Liquidating distribution” is one (including one of a series) that results in complete termination of a partner’s interest in the partnership.
- “Current distribution” is a non-liquidating distribution.

Rules for Simple Distributions

1. No gain or loss to partnership. Section 731(b).
   - Note: there are different results for complex distributions and anti-abuse provisions.
2. Gain to distributee partner <u>only</u> if cash distribution exceeds outside basis; then excess is capital gain.
3. Loss to distributee partner <u>only</u> in liquidating distribution with no Tier 3 assets; then loss equals outside basis minus cash minus inside basis of ordinary income assets distributed.

Waterfall rules for Simple Distributions

<u>Tier 1 – Cash</u>

a. Reduce outside basis dollar for dollar to zero.
b. The rest is capital gain.

<u>Tier 2 - Ordinary Income Assets</u>

a. "Carry out" inside basis, limited to outside basis.
b. Reduce outside basis dollar for dollar of distributed basis.

<u>Tier 3 – Other</u>

a. If non-liquidating, same rule as Tier 2.
b. If liquidating, distributed assets take outside basis.
c. If liquidating and no Tier 3 assets, partner has capital loss for remaining outside basis.

Other Issues related to Simple Distributions

- Timing: Distributing property before cash can produce taxable gain when opposite order does not. Distribution of cash prior to recognition of income can produce gain.
- Sec. 752(b) deemed distributions can trigger gain.
    - Distribution may reduce distributee partner's share of liabilities.
    - Rev. Rul. 79-205: Allows partners to consider effect of <u>net</u> change in liabilities.
    - Rev. Rul. 94-4: Section 752(b) deemed distribution is taken into account at year end.

Section 734 Inside Basis Adjustment for Distributions Example

ABC Partnership is owned equally by A, B, and C. A receives $200 cash in complete redemption.

	Tax/Bk	FMV
Cash	200	200
Land	100	400

A	100	200
B	100	200
C	100	200

A has $100 gain. Remaining:

	Tax/Bk	FMV
Land	100	400
+ 734	100	
	200	

B	100	200
C	100	200

Without election, partnership still has $300 built-in gain.

Section 734 steps up basis corresponding to A's gain. The 734 adjustment preserves the aggregate gain/income to be recognized on and after distribution.

Built-in gain (loss) before distribution = gain (loss) recognized + built-in gain (loss) after.

Effect of Section 734

1. Increase inside basis when distributee has gain.
2. Decrease inside basis when distributee has loss.
3. Increase inside basis when distributed property has stepped down basis.
4. Decrease inside basis when distributed property has stepped up basis.
5. Inside basis adjustment affects all continuing partners (including distributee that continues). Contrast § 743.
6. Section 734 adjustment also affects capital accounts. Reg. § 1.704-1(b)(2)(iv)(m)(4). Contrast § 743.
7. Inside basis adjustment is made only to category of assets (capital gain vs. ordinary income) that generated the adjustment.
8. Section 734 adjustment is imposed in the case of "substantial basis reduction," meaning § 734 will reduce basis more than $250,000. Compare the similar result in § 743.

Section 755 Allocation of Section 734 Basis Adjustments

From McKee treatise:

Step 1: Divide partnership into two classes.

- capital gain type
- ordinary income type

Step 2: Determine which class is to be adjusted.

- If § 734 adjustment is the result of change in the basis of certain class, adjust basis of partnership assets of same class.
- If § 734 adjustment is from recognition by distributee of gain or loss, adjust only capital gain assets.

Step 3: Allocate adjustments to specific assets within class:

- First, to reduce difference between FMV and basis,
- Next, according to FMV (if increase) or according to basis (if decrease).
- If there is insufficient basis or property to complete the adjustment, suspend remainder for subsequently acquired property.

Section 751(b): Distributions altering interests in ordinary income items

Section 751(b) applies when a distribution increases or decreases the distributee's interest in

- "unrealized receivables" as defined in § 751(c), or
- "substantially appreciated" – 120% of basis – "inventory" as defined in § 751(d).

<u>This creates the issue of a disproportionate distribution.</u>

For § 751(b) to apply, the distributee must receive a distribution of either § 751(b) property or other property in exchange for relinquishing an interest in the type of property not received.

- For example, § 751(b) does not apply to distribution to partner of inventory when the partner's interest in partnership inventory is reduced by the same amount.

Section 751(b): Distributions altering interests in ordinary income items

Section 751(b) divides the distribution into two imaginary steps; each is given tax effect.

- Step 1: recast the "excess" part of distribution as imaginary distribution of the other class, making this step proportional (taxed under "simple" waterfall as non-liquidating distribution);
- Step 2: imaginary taxable exchange to get from Step 1 proportional to actual distribution.

Section 751(b) Example

ABC Partnership is owned equally by A, B, and C. A receives $60 cash in complete redemption.

	Tax/Bk	FMV
Cash	**90**	**90**
Inventory	**45**	**90**

A	**45**	**60**
B	**45**	**60**
C	**45**	**60**

Before distribution, C had 1/3 interest in inventory; after C has only cash. Therefore, the distribution is disproportionate and § 751(b) applies.

Section 751(b) Example

Step 1: Treat C as receiving current distribution of $30 inventory with $15 basis and $30 cash. Analyze as simple distribution. C has no gain or loss, takes inventory with $15 basis.

Partnership:

	Tax/Bk	FMV
Cash	~~90~~ 60	~~90~~ 60
Inventory	~~45~~ 30	~~90~~ 60

A	45	60
B	45	60
~~C~~	~~45~~	~~60~~

C:

	Tax/Bk	FMV
Cash	30	30
Inventory	15	30

Section 751(b) Example

Step 2: C exchanges with partnership the imaginary $30 inventory for $30 cash. C has $15 ordinary income from exchange, and partnership has $15 step-up in inventory basis.

End

Partnership:

	Tax/Bk	FMV
Cash	30	30
Inventory	60	90

A	45	60
B	45	60

C:

	Tax/Bk	FMV
Cash	60	60

Misc. Anti-abuse Provisions

- Section 731(c): distribution of marketable securities is treated like distribution of cash. Several exceptions. Appropriate basis adjustment.
- Section 732(d): treatment of basis where distributed property would have been subject to 743 adjustment (due to prior transfer) but election was not in effect. Elective by distributee partner and mandatory in certain situations.
- Section 735: character of gain on subsequent sale by distributee. Prevent conversion of ordinary income to capital gain.
- Section 704(c)(1)(B): contributed property distributed to another partner. Prevent shifting of gain among partners.
- Section 737 "mixing bowl" transaction: Partner contributes property and receives distribution of other property. Again, to avoid shifting gain among partners.

Section 736 – Payments in Liquidation to Retiring or Deceased Partner

Section 736 treats payments to a departing partner that may not correspond to the value of distributee's underlying partnership assets.

- E.g., payments may have "severance" or "retirement" benefit, usually some share of future income.
- Can be a single payment or a series.
- Does not apply to liquidation of entire partnership.
- Reg. § 1.736-1(a)(6) applies to a two person partnership.
  - Section 736 can apply to retirement of one partner; partnership is deemed to continue for duration of payments.
  - For death of a partner, partnership year closes for deceased partner; then successor treated as partner.

Section 736 Operation

Divide payment(s) into two categories:

1. Section 736(a) payments are treated as guaranteed payments or distributive share; all payments that are not § 736(b).
    - These are generally payments not corresponding to retiring partner’s share of underlying assets.
2. Section 736(b) payments are payments for retiring partner's share of underlying assets.
    - Taxed under the previously discussed waterfall rules for sales, distributions, and anti-abuse rules.

Section 736 Operation

Special treatment for categorizing payments for:

- unrealized receivables,
- goodwill, and
- payments in excess of partner’s share of partnership assets (“premium payments”).
  - Note that premium payments are always § 736(a) payments. Reg. § 1.736-1(a)(3).

Section 736 Operation

Generally unrealized receivables and goodwill are § 736(b) payments. However,

- If capital is not a material income-producing factor (e.g., service partnership),
- retiring/deceased partner is general partner,

then treat as § 736(a) payments

- unrealized receivables, and
- goodwill
  - unless agreement provides for payment for goodwill (in which case § 736(b) applies).

Section 736 Example

ABC Partnership is owned equally by A, B, and C. Partner A retires. Per the agreement, A gets:

1. A's share of liabilities assumed by partnership,
2. $9,000 in Year 1,
3. $10,000 in each Year 2, 3.

[No express allocations to goodwill]

	Tax/Bk	FMV
Cash	13,000	13,000
Accts. Rec.	0	30,000
Capital type	20,000	23,000

Liab	3,000	3,000
A	10,000	21,000
B	10,000	21,000
C	10,000	21,000

Section 736 Example

- Step 1 – determine total received: A receives a total of $30,000 ($29,000 cash + $1,000 liability discharge).
- Step 2 – determine § 736(b) payment: 1/3 times ($13,000 cash + $23,000 capital) = $12,000
- Step 3 – determine § 736(a) payments (Step 1 – Step 2): $30,000 – $12,000 = $18,000.
- Step 4 – determine the portion of each year's payment: Reg. § 1.736-1(b)(i) determines that each annual payment consists of proportionate part § 736(a) and § 736(b).
  - Note that year 1 is a $10,000 total payment as A receives $9,000 cash and $1,000 of liability relief. Therefore, each year A receives a total payment of $10,000.
  - The pro-rata calculation: § 736(a) = $18,000/$30,000 = 60%; § 736(b) = $12,000/$30,000 = 40%.
  - <u>Therefore, each year has $6,000 guaranteed payment (Section 736(a)) and $4,000 § 736(b) payment</u>.
- Step 5 – specific determination of each years payment:
  - <u>Year 1 and Year 2 has $6,000 of ordinary income.</u>
  - <u>In Year 3, has $6,000 ordinary income + $1,000 capital gain, because outside basis was $11,000 and A receives a total of $12,000 under § 736(b).</u>
  - In Year 1, the $4,000 received reduces his outside basis to $7,000. In Year 2, the $4,000 received reduces his outside basis to $3,000. In Year 3, the $4,000 received reduces his outside basis to 0 and the remainder is the capital gain of $1,000.

Incorporation of Partnership

Different methods of incorporation given tax effect according to their form. Rev. Rul. 84-11 provides some guidance:

1. Partnership transfers all assets and liabilities to Corporation; Partnership liquidates distributing Corporation stock.
2. Partnership liquidates, distributing all assets and liabilities; partners then transfer assets and liabilities to Corporation.
3. Partners transfer all partnership interests to Corporation; Partnership now has one partner and terminates, distributing assets and liabilities to Corporation.

There also other methods developed since Rev. Rul. 84-11:

4. LLC check the box to be taxed as a corporation.
5. LLC merges into wholly owned subsidiary of Corporation.

Problem 3. Connie, Dallas, and Eddie are partners in the CDE partnership. CDE is a calendar year partnership. For the current year, the partnership expects to realize no taxable income. The assets and partners' capital accounts of the CDE Partnership are as follows:

Assets				Capital		
Assets	Adjusted Basis	FMV		Partners	Adjusted Basis	FMV
Cash	$360	$360		Connie	$425	$400
Mauveacre (real property)	$110	$190		Dallas	$210	$300
Whiteacre (real property)	$20	$100		Eddie	$25	$200
Blackacre (real property)	$140	$100				
Greenacre (real property)	$20	$80				
Brownacre (real property)	$10	$70				
Total	**$660**	**$900**		**Total**	**$660**	**$900**

All of the properties owned by the partnership are other than cash are § 1231 real property assets. To reduce Eddie's interest from two-ninths to one-eighth, the partnership plans to distribute $100 worth of property to him on July 1st. What would be the tax consequences of the following alternatives to Eddie and the CDE Partnership (make sure to discuss all relevant tax considerations including all issues related to sales of partnership interests and distributions)?

a. The partnership distributes Whiteacre to Eddie.

The first step is to determine what kind of distribution is involved. Because there are no Section 751 hot assets, this will be a pro-rata distribution. Further, this is a pro-rata operating distribution since Eddie is not liquidating his entire interest in the partnership.

Under 731(a) neither gain nor loss is recognized on the current distribution of property. The distribute partner takes the partnership's basis in the property (transferred basis) up to the amount of the distributee partner's basis in the partnership interest. § 732(a). The partner's outside basis is reduced by the amount of basis assigned to the distributed property. § 733(2).

Treas. Reg. § 1.704-1 (b)(2) (iv)(e) requires that the distribute partner's capital account be reduced by the fair market value of the distributed property. In order to do that, the property must be revalued and the partnership and partner capital accounts adjusted to reflect the gain or loss that would be realized if the property were sold for its fair market value.

Eddie receives Whiteacre without recognizing gain or loss. § 731(a).

Eddie's basis in Whiteacre will be $20. § 732(a)(1).

Eddie's basis in his partnership interest is reduced to $5 ($25 - $20). § 733(2).

b. The partnership distributes Blackacre to Eddie.

The first step is to determine what kind of distribution is involved. Because there are no Section 751 hot assets, this will be a pro-rata distribution. Further, this is a pro-rata operating distribution since Eddie is not liquidating his entire interest in the partnership.

Under 731(a) neither gain nor loss is recognized on the current distribution of property. The distribute partner takes the partnership's basis in the property (transferred basis) up to the amount of the distributee partner's basis in the partnership interest. § 732(a). The partner's outside basis is reduced by the amount of basis assigned to the distributed property. § 733(2).

Treas. Reg. § 1.704-1 (b)(2) (iv)(e) requires that the distribute partner's capital account be reduced by the fair market value of the distributed property. In order to do that, the property must be revalued and the partnership and partner capital accounts adjusted to reflect the gain or loss that would be realized if the property were sold for its fair market value.
Eddie receives Blackacre without recognizing gain or loss. § 731(a).

Eddie's basis in Blackacre is the same as the partnership basis, but limited to Eddie's basis for his partnership interest. § 732(a)(2). Thus, Eddie's basis in Blackacre will be only $25.

Eddie's basis in his partnership interest is reduced to zero. § 733(2).

The partnership's basis in its remaining assets is not changed by the distribution unless a § 754 election is in effect. § 734(a). Note that the limitation of § 732(a)(2) creates a disparity in the partnership inside basis and the aggregate outside bases of the partners.

c. The partnership distributes $20 cash and Greenacre to Eddie.

The first step is to determine what kind of distribution is involved. Because there are no Section 751 hot assets, this will be a pro-rata distribution. Further, this is a pro-rata operating distribution since Eddie is not liquidating his entire interest in the partnership.

Under 731(a) neither gain nor loss is recognized on the current distribution of property. The distribute partner takes the partnership's basis in the property (transferred basis) up to the amount of the distributee partner's basis in the partnership interest. § 732(a). The partner's outside basis is reduced by the amount of basis assigned to the distributed property. § 733(2).

Treas. Reg. § 1.704-1 (b)(2) (iv)(e) requires that the distribute partner's capital account be reduced by the fair market value of the distributed property. In order to do that, the property must be revalued and the partnership and partner capital accounts adjusted to reflect the gain or loss that would be realized if the property were sold for its fair market value.

Distribution of $20 cash does not exceed Eddie's $25 basis for his partnership interest. Eddie recognizes no gain or loss on the distribution of the cash plus Greenacre.

The cash is treated as distributed first, then the property. Treas. Reg. 5 1.732-l(a), Ex. (1). Thus, the cash distribution reduces Eddie's basis in his partnership interest to $5. § 733(1). Eddie's basis for Greenacre is limited to the remaining $5 basis in his partnership interest. § 732(a)(2). Eddie's basis for his partnership interest is reduced to zero. § 733. Again, the reduction in basis for Greenacre from $20 to the partnership to $5 in Eddie's hands creates a disparity between the partnership's inside bases and the partners' outside bases.

d. The partnership distributes $30 of cash and Brownacre to Eddie.

The first step is to determine what kind of distribution is involved. Because there are no Section 751 hot assets, this will be a pro-rata distribution. Further, this is a pro-rata operating distribution since Eddie is not liquidating his entire interest in the partnership.

Under 731(a) neither gain nor loss is recognized on the current distribution of property. The distribute partner takes the partnership's basis in the property (transferred basis) up to the amount of the distributee partner's basis in the partnership interest. § 732(a). The partner's outside basis is reduced by the amount of basis assigned to the distributed property. § 733(2).

Treas. Reg. § 1.704-1 (b)(2) (iv)(e) requires that the distribute partner's capital account be reduced by the fair market value of the distributed property. In order to do that, the property must be revalued and the partnership and partner capital accounts adjusted to reflect the gain or loss that would be realized if the property were sold for its fair market value.

Distribution of $30 cash exceeds Eddie's basis in his partnership interest by $5. Eddie is therefore required to recognize $5 of gain, which is treated as gain from the sale or exchange of his partnership interest. § 731(a)(1). The cash distribution reduces Eddie's basis in his partnership interest to zero. Eddie's basis in Brownacre is, therefore, limited to zero. § 732(a)(2).