



Taxation of Partnership Distributions and Sales of Partnership Interests

PDS4/25/F1



Types of Partnership Distributions

- There are four types of distributions that partnerships can make to partners:
 - Nonliquidating distributions of cash and other property that do not result in the liquidation of the distributing partner's interest i.e. the partner remains a partner
 - Liquidating distributions of cash and other property that eliminate a partner's interest in the partnership
 - Disproportionate distributions that affect the partner's share of ordinary income property of the partnership
 - Disguised sale taking the form of a partnership distribution
- Different sets of rules govern the income tax consequences of each type of distribution



Current Proportionate Distributions

- A current distribution is one in which the partner's interest in the partnership continues after the distribution
- In a current proportionate distribution:
 - The partnership will not recognize a gain or loss because of the distribution [Section 731(b)]
 - The distributee partner will not recognize gain unless the money distributed to him or her exceeds the partner's outside basis in his or her partnership interest [Section 731(a)]
 - The distributee partner will never recognize a loss [Sections 731(a) and 732(a)] (but may in a liquidating distribution)
 - The distributee partner's basis in property received will generally be equal to the partnership's basis in the property distributed (i.e., the partner takes a "carryover" basis)
 - If a Section 754 election is in effect, the distribution may impact the basis of undistributed property remaining in the partnership



Carryover Basis to Distributed Property

- Assuming that the partner has enough outside basis, property distributed will have a straight carryover basis
- The exception to this general rule occurs when the partnership's adjusted basis in the property, the inside basis, exceeds the distributee partner's outside basis
- When this happens, the distributee partner's basis in the distributed property is limited to the partner's outside basis reduced by any money received in the same transaction
- In such a case, the presence of a 754 election and a Section 734(b) adjustment would equalize the inside and outside basis



Order of Partnership Distributions

- The distributee partner's outside basis is allocated to the distributed items in the following order:
 - Cash, including relief of liabilities, and the fair market value of marketable securities
 - Section 751 assets (hot assets), and
 - Non-section 751 property (capital gain property)



Liquidating Distributions

- If the sum of cash, the relief of liabilities, and the fair market value of marketable securities exceeds the partner's outside basis, no basis will remain to allocate to either Section 751 ordinary income assets or capital gain property
- It is possible for a partner to remain a partner and have a zero outside basis
- A liquidating distribution will always result in a \$0 outside basis because after a liquidating distribution the partner is no longer a partner



Section 731(a)(1) Distributions and Disguised Sales

- The contribution of property or money to a partnership is generally nontaxable under Section 721 to the contributing partner
- Distributions of property or money to a partner are also generally nontaxable, except as provided in Section 731(a)(1)
- Section 707(a)(2)(B) is a “substance over form” provision that provides that if a related contribution and distribution are properly characterized as a sale or exchange of property, the substance controls, and the transaction are to be recharacterized as a sale for tax purposes

Example 1



Distribution of Property Subject to a Liability

- Section 752(a) provides that an increase in a partner's share of partnership liabilities, or an increase in a partner's individual liabilities because of his or her assumption of partnership liabilities, is treated as if he or she contributed money to the partnership
- Therefore, when a partner takes on liabilities of or on behalf of the partnership, he or she increases his or her outside basis just as if he or she contributed cash to the partnership
- Section 752(b) provides that a decrease in a partner's share of the liabilities of a partnership or a decrease in a partner's individual liabilities because of the assumption by the partnership of such individual liabilities is treated as if he or she had received a cash distribution from the partnership
- This would have the effect of reducing the partner's outside basis



Distribution of Property Subject to a Liability

- Under Section 731(b), a partner's assumption or relief of partnership liabilities or the individual liabilities he or she incurred on behalf of the partnership has no effect on the partnership
- Section 741 treats the sale of a partnership interest as the sale of a capital asset
- Therefore, the sale or exchange of a partnership interest generally gives rise to capital gain except in the case of partnership interests involving "hot assets" under Section 751

Liquidating Partnership Distributions

Liquidating Distributions

- The treatment of proportionate (pro rata with respect to hot assets) liquidating distributions is similar to that of current distributions
- Gain is only recognized if the amount of money distributed (including relief of liabilities and the fair market value of marketable securities) exceeds the partner's basis in his or her partnership interest just prior to the distribution
- Just as with current distributions, the liquidating partner's outside basis is allocated to the distributed items in the following order:
 - Cash, including relief of liabilities, and the fair market value of marketable securities
 - Section 751 assets (hot assets) and
 - Non-section 751 property (capital gain property)



Liquidating Distributions

- In a liquidating distribution, a partner's interest in the partnership is terminated in exchange for his or her share of the partnership's value
- When the liquidating distribution concludes, the partner is no longer a partner
- Unlike current distributions, losses can be recognized in a liquidating distribution when the partner receives assets in one or both of the following asset classes:
 - Cash, or
 - Unrealized receivables or inventory
- The receipt of a capital asset will prevent the recognition of any loss by the distributee until the distributed property is sold
- The amount of loss recognized is the difference between the partner's outside basis in the partnership immediately before the distribution and the sum of money and the partnership's adjusted basis in distributed unrealized receivables and inventory



Tax Consequences of a Liquidating Distribution

- Section 751(b) applies to a partnership distribution to the extent the distribution reduces a partner's interest in Section 751 property
- If a partner's interest is completely liquidated in exchange for a distribution of property only, without any distribution of money, then the partner recognizes no gain, assuming the distribution of ordinary income assets is proportionate
- The distributee partner has a basis in the distributed property equal to his or her prior basis in the partnership interest
- The partnership itself does not recognize any gain or loss on the distribution as would a corporation making a liquidating distribution of appreciated property



Nonliquidating Distributions

- If a partnership distributes property to a partner, but not in liquidation of his or her interest, then the distribution is tax-free assuming the distribution is proportionate
- The partner ends up with a basis in the distributed property equal to the lesser of the partnership's prior basis in that property or the partner's basis in his interest
- The partner's basis in his or her interest is reduced by the basis in the property distributed, but not below \$0
- There is no such thing as a negative basis in a partnership — basis can only be either \$0 or a positive amount



Receipt of Disproportionate Share of Hot Assets

- If there are "unrealized receivables" or "substantially appreciated inventory items," and the partner does not receive his or her pro rata distribution of the hot assets, then the distribution will be treated as a sale or exchange by either the partner or the partnership
- Whoever is treated as selling hot assets must recognize ordinary income
- It is possible that both the partner and the partnership will recognize ordinary income



Impact of Liquidating Distribution on Partnership and Partner

- When a partnership liquidates and distributes all assets to all partners in a liquidating distribution, the partnership does not recognize any gain or loss
- When a partnership liquidates, a partner does not recognize gain, except to the extent he or she receives money (including relief from indebtedness) that exceeds his or her basis
- Receipt of proportionate share of Section 751 property does not generate income regardless of fair market value of property received



Types of Partnership Distributions

- Partnership distributions include the following transactions:
 - A withdrawal of cash or other property by a partner
 - A distribution of the current year's or prior years' earnings not needed for working capital
 - A partial liquidation of a partner's interest
 - A distribution to all partners in a complete liquidation of the partnership



Partnership Distributions

- A partnership distribution is not taken into account in determining the partner's distributive share of partnership income or loss, as reflected on the partnership Form 1065 K-1
- If any gain or loss from the distribution is recognized by the partner, it must be reported on his or her income tax return (Schedule D as a sale with no basis) for the tax year in which the distribution is received
- Money or property withdrawn by a partner in anticipation of the current year's earnings is treated as a distribution received on the last day of the partnership's tax year



Partnership Distribution Impact on Partner Basis

- A partner's adjusted basis in his or her partnership interest is decreased (but not below zero) by the money and adjusted basis of property distributed to the partner
- The partnership may make a Section 754 election to adjust the basis of its undistributed property when the partnership distributed property with an inside basis that is larger than the partner's outside basis



Partnership Distributions Treated as a Sale or Exchange

- When a partnership distributes the following items, the distribution may be treated as a sale or exchange of property rather than a distribution:
 - Unrealized receivables or substantially appreciated inventory items distributed in exchange for any part of the partner's interest in other partnership property, including money
 - Other property (including money) distributed in exchange for any part of a partner's interest in unrealized receivables or substantially appreciated inventory items



Partnership Distributions Treated as a Sale or Exchange

- This treatment does not apply to the following distributions:
 - A distribution of property to the partner who contributed the same property to the partnership
 - Payments made to a retiring partner or successor in interest of a deceased partner that are the partner's distributive share of partnership income or guaranteed payments



Substantially Appreciated Inventory Items

- Inventory items of the partnership are considered to have appreciated substantially in value if, at the time of the distribution, their total fair market value is more than 120% of the partnership's adjusted basis for the property
- If a principal purpose for acquiring inventory is to avoid ordinary income treatment by reducing the appreciation to less than 120%, that property is excluded from the calculation



Partner Gain Resulting From a Partnership Distribution

- A partner generally recognizes gain on a partnership distribution only to the extent any money (and marketable securities treated as money) included in the distribution exceeds the adjusted basis of the partner's interest in the partnership
- Any gain recognized is generally treated as capital gain from the sale of the partnership interest on the date of the distribution
- If partnership property other than money or marketable securities treated as money is distributed to a partner, he or she generally does not recognize any gain until he or she sells or otherwise disposes of the property and recognizes a gain on the sale

Example 2



New IRS Compliance Campaign

- The Large Business and International Division of the IRS recently announced it will initiate a campaign to address taxpayer noncompliance related to distributions in excess of a partner's basis
- See <https://www.irs.gov/businesses/corporations/lbi-active-campaigns>
- Partners that report distributions from partnerships must have adequate outside basis, as determined pursuant to Section 731(a), in order to receive liquidating or non-liquidating distributions not subject to gain recognition
- The IRS has been concerned for many years that partnerships and their partners are not properly tracking and reporting the recognition of inside gain specially allocable to particular partners under Section 704(c)(1)(A)
- Similarly, the IRS has been concerned about the tracking of outside basis and the reporting of distributions in excess of outside basis that result in the recognition of gain under Section 731(a)

When Marketable Securities are Treated as Money



A Partnership Distributes Marketable Securities

- Generally, a marketable security distributed to a partner is treated as money in determining whether gain is recognized on the distribution
- Marketable securities are financial instruments and foreign currencies that are, as of the date of the partnership distribution, actively traded
- A partner cannot recognize a loss on a distribution of marketable securities in liquidation of the partner's interest in the partnership even though the partner would be entitled to a loss if actual money were distributed



Marketable Securities

- The amount treated as money is the security's fair market value when distributed, reduced (but not below zero) by the excess (if any) of:
 - The partner's distributive share of the gain that would be recognized had the partnership sold all its marketable securities at their fair market value immediately before the transaction resulting in the distribution, over
 - The partner's distributive share of the gain that would be recognized had the partnership sold all such securities it still held after the distribution at the fair market value



Loss on Partnership Distribution

- A partner does not recognize loss on a partnership distribution unless all the following requirements are met:
 - The adjusted basis of the partner's interest in the partnership exceeds the distribution
 - The partner's entire interest in the partnership is liquidated
 - The distribution is in money, unrealized receivables, or inventory items
 - A distribution of a capital asset or a Section 1231 asset would prevent a partner from recognizing a loss



Distribution of Partner's Debt

- If a partnership acquires a partner's debt and extinguishes the debt by distributing it to the partner, the partner will recognize capital gain or loss to the extent the fair market value of the debt differs from the basis of the debt
- The partner is treated as having satisfied the debt for its fair market value
- If the issue price (adjusted for any premium or discount) of the debt exceeds its fair market value when distributed, the partner may have to include the excess amount in income as cancellation of debt income
- A deduction may be available to a corporate partner if the fair market value of the debt at the time of distribution exceeds its adjusted issue price

Basis of Property Distributed by a Partnership



Partner's Basis for Distributed Property

- Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution
- However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction

Example 3

Example 4



Basis of Property Received in a Complete Liquidation

- The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership reduced by any money distributed to the partner in the same transaction
- A partner's holding period for property distributed to the partner includes the period the property was held by the partnership
- If the property was contributed to the partnership by a partner, then the period it was held by that partner is also included in the partner's holding period



Basis Divided Among Multiple Properties

- If the basis of property received is the adjusted basis of the partner's interest in the partnership (reduced by money received in the same transaction), it must be divided among the properties distributed to the partner in accordance with the following rules:
 - Allocate the basis first to unrealized receivables and inventory items included in the distribution by assigning a basis to each item equal to the partnership's adjusted basis in the item immediately before the distribution
 - If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess



Basis Divided Among Multiple Properties

- Allocate any remaining basis to properties other than unrealized receivables and inventory items by assigning a basis to each property equal to the partnership's adjusted basis in the property immediately before the distribution
 - Rule 1: If the allocable basis exceeds the total of these assigned bases, increase the assigned bases by the amount of the excess
 - Rule 2: If the total of these assigned bases exceeds the allocable basis, decrease the assigned bases by the amount of the excess



Allocating a Basis Increase

- Allocate any basis increase required in Rule 2 first to properties with unrealized appreciation to the extent of the unrealized appreciation
- If the basis increase is less than the total unrealized appreciation, allocate it among those properties in proportion to their respective amounts of unrealized appreciation
- Allocate any remaining basis increase among all the properties in proportion to their respective fair market values

Example 5



Allocating a Basis Decrease

- Use the following procedures to allocate any basis decrease required in Rule 1 or Rule 2, as discussed earlier
- Allocate the basis decrease first to items with unrealized depreciation to the extent of the unrealized depreciation
- If the basis decrease is less than the total unrealized depreciation, allocate it among those items in proportion to their respective amounts of unrealized depreciation
- Allocate any remaining basis decrease among all the items in proportion to their respective assigned basis amounts as decreased

Example 6

Special Basis Adjustments Under Section 732(d)



When Section 732(d) Applies to a Partnership Distribution

- A partner who acquired any part of his or her partnership interest in a sale or exchange or upon the death of another partner may be able to elect a special basis adjustment for property distributed by the partnership under Section 732(d)
- Section 732(d) applies to situations in which a partnership does not have a Section 754 election in effect and a partner who would have a positive Section 743(b) adjustment if the partnership had a Section 754 election in effect receives a current or liquidating distribution of property from the partnership
- When Section 732(d) applies, the adjusted partnership basis of the property distributed to the transferee partner is treated as the adjusted partnership basis the property would have if a Section 754 election is in effect and an adjustment under Section 743(b) were made



Making a Section 732(d) Adjustment

- To make the special adjustment under Section 732(d):
 - The partner must have received the distribution within 2 years after acquiring the partnership interest and
 - The partnership must not have chosen the Section 754 optional adjustment to basis when the partner acquired the partnership interest
- If a partner elects the Section 732(d) special basis adjustment, the partner's basis for the property distributed is the same as it would have been if the partnership had chosen the Section 743(b) optional adjustment to basis
- The assigned basis is not reduced by any depletion or depreciation that would have been allowed or allowable if the partnership had previously chosen the Section 754 optional adjustment



Making the Section 732(d) Adjustment

- A taxpayer must make the Section 732(d) election with the partner's tax return for the year of the distribution if the distribution includes any property subject to depreciation, depletion, or amortization
- If the choice does not have to be made for the distribution year, it must be made with the tax return for the first year in which the basis of the distributed property is pertinent in determining the partner's income tax
- A partner making the Section 732(d) special basis adjustment must attach a statement to his or her tax return to adjust the basis of property received in a distribution which must show the computation of the special basis adjustment for the property distributed and list the properties to which the adjustment has been allocated

Example 7



Mandatory Section 732(d) Adjustment

- At times, the Section 732(d) special adjustment to basis is mandatory
- The Section 732(d) special adjustment to basis must be made for a distribution of property (whether or not within 2 years after the partnership interest was acquired) if all the following conditions existed when the partner received the partnership interest:
 - The fair market value of all partnership property (other than money) was more than 110% of its adjusted basis to the partnership
 - If there had been a liquidation of the partner's interest immediately after it was acquired, an allocation of the basis of that interest under the general rules would have decreased the basis of property that could not be depreciated, depleted, or amortized and increased the basis of property that could be
 - The optional Section 743(b) basis adjustment, if Section 754 had been elected by the partnership, would have changed the partner's basis for the property actually distributed



Mandatory Section 732(d) Adjustment

- Section 732(d) applies to situations in which a partnership does not have a Section 754 election in effect and a partner who would have a positive Section 743(b) adjustment if the partnership had a Section 754 election in effect receives a current or liquidating distribution of property from the partnership
- When Section 732(d) applies, the adjusted partnership basis of the property distributed to the transferee partner is treated as the adjusted partnership basis the property would have if the adjustment in Section 743(b) were in effect following a Section 754 election



Section 732(d) Statement

- If a partner elects to make a Section 732(d) special basis adjustment and notifies the partnership or if the partnership makes a distribution for which the Section 732(d) special basis adjustment is mandatory, the partnership must provide a statement to the partner that provides information necessary for the partner to calculate the special basis adjustment

Abandoned and Worthless Partnership Interests



Revenue Ruling 93-80

- A loss incurred from the abandonment or worthlessness of a partnership interest is an ordinary loss only if both of the following tests are met:
 - The transaction is not a sale or exchange
 - The partner has not received an actual or deemed distribution from the partnership
- Even a de minimis actual or deemed distribution makes the entire loss a capital loss. *Citron v. Commissioner*, 97 T.C. 200, 216n.14 (1991)



Revenue Ruling 93-80

- The loss will be ordinary only if the transaction is not otherwise in substance a sale or exchange
- For example, a partner's receipt of consideration from another partner (or a party related thereto) may, depending upon the facts and circumstances, establish that a purported abandonment or worthlessness of a partnership interest is in substance a sale or exchange
- For information on how to report an abandonment loss, see IRS Publication 544, Sales and Other Dispositions of Assets

Section 751(a) Exchanges



Section 751(a) Exchange

- A Section 751(a) exchange occurs when money or any property is exchanged for all or part of a partnership interest that is attributable to unrealized receivables or inventory items
- Generally, any sale or exchange of a partnership interest (or any portion) at a time when the partnership has any unrealized receivables or inventory items is a Section 751(a) exchange
- Section 751 prevents the use of a partnership distribution to convert ordinary income into capital gain



Payments for Unrealized Receivables and Inventory Items

- If a partner receives money or property in exchange for any part of a partnership interest, the amount due to his or her share of the partnership's unrealized receivables or inventory items results in ordinary income or loss
- This amount is treated as if it were received for the sale or exchange of property that is not a capital asset
- This treatment applies to the unrealized receivables part of payments to a retiring partner or successor in interest of a deceased partner only if that part is not treated as paid in exchange for partnership property



Unrealized Receivables

- Unrealized receivables include any rights to payment not already included in income for the following items:
 - Goods delivered or to be delivered to the extent the payment would be treated as received for property other than a capital asset and
 - Services rendered or to be rendered



Unrealized Receivables

- These rights must have arisen under a contract or agreement that existed at the time of sale or distribution, even though the partnership may not be able to enforce payment until a later date
- For example, unrealized receivables include accounts receivable of a cash method partnership and rights to payment for work or goods begun but incomplete at the time of the sale or distribution of the partner's share
- The basis for any unrealized receivables includes all costs or expenses for the receivables that were paid or accrued but not previously taken into account under the partnership's method of accounting



Other Items Treated as Unrealized Receivables

- Unrealized receivables include potential gain that would be ordinary income if the following partnership property were sold at its fair market value on the date of the payment
 - Mining property for which exploration expenses were deducted
 - Stock in a domestic international sales corporation (DISC)
 - Certain farmland for which expenses for soil and water conservation or land clearing were deducted
 - Franchises, trademarks, or trade names
 - Oil, gas, or geothermal property for which intangible drilling and development costs were deducted
 - Stock of certain controlled foreign corporations
 - Market discount bonds and short-term obligations
 - Property subject to recapture of depreciation under Sections 1245 and 1250



Determining Gain or Loss Upon the Sale or Exchange of Its Interest in Unrealized Receivables and Inventory Items

- The income or loss realized by a partner upon the sale or exchange of its interest in unrealized receivables and inventory items is the amount that would have been allocated to the partner if the partnership had sold all of its property for cash at fair market value, in a fully taxable transaction, immediately prior to the partner's transfer of interest in the partnership
- Any gain or loss recognized that is attributable to the unrealized receivables and inventory items will be ordinary gain or loss

Example 8



Inventory Items as Broadly Defined

- Inventory items are not limited to stock-in-trade of the partnership but also include the following property:
 - Property that would properly be included in the partnership's inventory if on hand at the end of the tax year or that is held primarily for sale to customers in the normal course of business
 - Property that, if sold or exchanged by the partnership, would not be a capital asset or Section 1231 property (real or depreciable business property held more than 1 year)
 - For example, accounts receivable acquired for services or from the sale of inventory and unrealized receivables are inventory items
 - Property held by the partnership that would be considered inventory if held by the partner selling the partnership interest or receiving the distribution



Tiered Partnerships

- In determining whether partnership property is an unrealized receivable or an inventory item, the partnership is treated as owning its proportionate share of the property of any other partnership in which it is a partner



Notification Required of Partner (751 Statement)

- If a partner exchanges a partnership interest attributable to unrealized receivables or inventory for money or property, he or she must notify the partnership in writing
- There is no set format for a Section 751 Statement but a letter providing the following is required by the IRS:
 - The transfer date
 - The amount of gain or loss attributable to the Section 751 property (ordinary income/loss)
 - The amount of gain or loss attributable to capital gain or loss on the sale of the partnership interest
 - Taxpayer's name as it appears on his or her tax return
 - Taxpayer's SSN
 - The tax form and year (ex: 2022 Form 1040)
 - Name of partnership interest that was sold (optional but helpful)
- This must be done within 30 days of the transaction or, if earlier, by January 15 of the calendar year following the calendar year of the exchange
- A partner may be subject to a \$50 penalty for each failure to notify the partnership about such a transaction, unless the failure was due to reasonable cause and not willful neglect



Form 8308, Report of a Sale or Exchange of Certain Partnership Interests

- Section 6050K provides that when a partnership is notified of an exchange of partnership interests involving unrealized receivables or inventory items, the partnership must file Form 8308, Report of a Sale or Exchange of Certain Partnership Interests
- The partnership has such notice when either:
 - 1. The partnership receives written notification of the exchange from the transferor that includes the names and addresses of both parties to the exchange, the identifying numbers of the transferor and (if known) of the transferee, and the date of the exchange; or
 - 2. The partnership has knowledge that there has been a transfer of a partnership interest and, at the time of the transfer, the partnership had any unrealized receivables or inventory items



Form 8308, Report of a Sale or Exchange of Certain Partnership Interests

- No returns or statements are required under Section 6050K if the transfer was not a Section 751(a) exchange
- For example, a transfer, which in its entirety constitutes a gift for federal income tax purposes is not a Section 751(a) exchange
- A partnership may rely on a written statement from the transferor that the transfer was not a Section 751(a) exchange unless the partnership has knowledge to the contrary
- If a partnership is in doubt whether partnership property constitutes unrealized receivables or inventory items or whether a transfer constitutes a Section 751(a) exchange, the partnership is allowed to file Form 8308 to avoid the risk of incurring a penalty for failure to file



Filing Form 8308

- A partnership must file a separate Form 8308 for each Section 751(a) exchange of an interest in such partnership
- Form 8308 is filed with Form 1065 for the tax year that includes the last day of the calendar year in which the exchange took place
- If notified of an exchange after filing Form 1065, the partnership must file Form 8308 separately, within 30 days of the notification



Form 8308

- All partnerships required to file Form 8308 must furnish a copy of the form to each transferor and transferee by January 31 of the year following the calendar year in which the Section 751(a) exchange occurred or, if later, 30 days after the partnership has notice of the exchange
- If the partnership does not know the identity of the beneficial owner of an interest in the partnership, the record holder of the interest is treated as the transferor or transferee
- Form 8308 alerts transferors that they are required to treat a portion of the gain realized from a Section 751(a) exchange as ordinary income



Form 8308

- On Form 8308, the partnership provides its telephone number and states the date of the exchange and the names, addresses, and taxpayer identification numbers of the partnership filing the return and the transferee and transferor in the exchange
- The partnership must provide a copy of Form 8308 (or a written statement with the same information) to each transferee and transferor by the later of January 31 following the end of the calendar year or 30 days after it receives notice of the exchange
- The partnership may be subject to a penalty for each failure to timely file Form 8308 and a penalty for each failure to furnish a copy of Form 8308 to a transferor or transferee, unless the failure is due to reasonable cause and not willful neglect
- If the failure is intentional, a higher penalty may be imposed



Separate Statement Required by Transferor

- The transferor is required to attach a statement to the transferor's income tax return for the tax year of the sale or exchange with the following information
 - 1. The date of the sale or exchange
 - 2. The amount of any gain or loss attributable to the Section 751 property
 - 3. The amount of any gain or loss attributable to capital gain or loss on the sale of the partnership interest



Schedule K-1 (Form 1065) Reporting

- Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Income
- Box 20, code AB will require reporting of Section 751 gain or loss
- Code AB is used to report the partner's share of gain or loss on the sale of the partnership interest subject to taxation at ordinary income tax rates
- Form 8308 Report of a Sale or Exchange of Certain Partnership Interests continues to be a required filing since it is statutorily required under Section 6050K
- A partnership must file a separate Form 8308 for each Section 751(a) exchange of an interest in such partnership
- It appears that the reason for form 8308 is that by quantifying Section 751 gains or losses, the IRS will be able to target partners who recognize income from sales or exchanges of partnership interests but who neglect to properly recharacterize a portion of their gain or loss as ordinary income



Statement Required of Partner

- If a partner sells or exchanges any part of an interest in a partnership having unrealized receivables or inventory, he or she must file a statement with his or her tax return for the year in which the sale or exchange occurs
- The statement must contain the following information:
 - The date of the sale or exchange
 - The amount of any gain or loss attributable to the unrealized receivables or inventory
 - The amount of any gain or loss attributable to capital gain or loss on the sale of the partnership interest



Determining Gain or Loss Upon the Sale or Exchange of Its Interest in Unrealized Receivables and Inventory Items

- In general, any gain or loss on a sale or exchange of unrealized receivables or inventory items a partner received in a distribution is an ordinary gain or loss
- For this purpose, inventory items do not include real or depreciable business property, even if they are not held more than 1 year

Example 9



Exception for Inventory Items Held More Than 5 Years

- If a distributee partner sells inventory items held for more than 5 years after the distribution, the type of gain or loss depends on how these items are being used on the date sold
- The gain or loss is capital gain or loss if the property is a capital asset in the partner's hands at the time sold

Example 10



Substituted Basis Property

- If a distributee partner disposes of unrealized receivables or inventory items in a nonrecognition transaction, ordinary gain or loss treatment applies to a later disposition of any substituted basis property resulting from the transaction

Transactions Between Partners and Their Partnerships



Transactions Between Partner and Partnership

- A partner who engages in a transaction with a partnership other than in his or her capacity as a partner is treated as if he or she were not a member of the partnership with respect to such transaction
- Such transactions include:
 - Loans of money or property by the partnership to the partner or by the partner to the partnership
 - Sale of property by the partner to the partnership, and
 - Purchase of property by the partner from the partnership, rendering of services by the partnership to the partner or by the partner to the partnership



Transactions Between Partner and Partnership

- When a partner retains the ownership of property but allows the partnership to use such separately-owned property for partnership purposes (for example, to obtain credit or to secure firm creditors by guarantee, pledge, or other agreement), the transaction is treated as one between a partnership and a partner not acting in his or her capacity as a partner
- However, transfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not included as transactions between partner and partnership
- In all cases, the substance of the transaction will govern, rather than its form



Guaranteed Payments

- Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership
- A partner must include such payments as ordinary income for his or her tax year within or with which ends the partnership tax year in which the partnership deducted such payments as paid or accrued under its method of accounting



Guaranteed Payments

- Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of Section 61(a) (relating to gross income) and Section 162(a) (relating to trade or business expenses)
- For a guaranteed payment to be a partnership deduction, it must meet the same tests under Section 162(a) as it would if the payment had been made to a person who is not a member of the partnership, and the rules of Section 263 and Section 263A (relating to capital expenditures) must be taken into account

Disguised Sales



Disguised Sales §707(a)(2)(B)

- Transfers to and by a partnership that are more properly characterized as transactions between the partnership and one who is not a partner, or between two or more partners acting other than in their capacity as partners, are treated in accordance with their substance rather than their form
- This rule was adopted as a result of concern that taxpayers were deferring or avoiding tax on sales of partnership property, including sales of partnership interests, by characterizing sales as contributions of property, including money, followed or preceded by related partnership distributions, i.e., nontaxable events



Disguised Sales §707(a)(2)(B)

- IRS has authority to identify transactions that, though structured as contributions and distributions under Sections 721 and 731, are more properly treated as sales or exchanges between the partnership and the partner or as payments of compensation
- Regulations under Section 707(a)(2)(B) establish criteria used to identify transactions that when viewed together are more properly characterized as payments of compensation or sales to a person who is not a partner

Example 11



Disguised Sales §707(a)(2)(B)

- Regulations under Section 707(a)(2)(B) provide guidance for purposes of identifying disguised sales of property to a partnership and use a facts and circumstances approach
- Two-year presumption — unless the facts clearly establish otherwise, distributions occurring within two years of a property transfer are presumed to be a part of a disguised sale
- Transfers outside of the two-year window are presumed not to be a part of a disguised sale
- To the extent a transaction results in a disguised sale, the partnership or other partners benefit from a stepped up basis and potentially additional deductions as a result of the sale



Disguised Sale Safe Harbors

- Regulations provide safe harbors from the disguised sale rules for certain reasonable distributions made during the two-year period
- The regulations provide an exception for certain debt-financed distributions to the extent of the recipient partner's share of the liability
- With respect to liabilities assumed in conjunction with a transfer of property to a partnership, regulations distinguish between qualified and unqualified liabilities
- For unqualified liabilities, the assumption is treated as a part of a disguised sale regardless of other factors
- The assumption of qualified liabilities is generally not treated as consideration to support a disguised sale



Disguised Sale Safe Harbors

- Liability incurred within the two years prior to the date of the transfer is an unqualified liability
- Exceptions for the assumption of certain liabilities such as operating trade payables



Two-part Test

- **But-for Test:**
 - The partnership would not have transferred money or property to the partner **BUT FOR** the transfer of the property by the partner to the partnership
- **Facts and Circumstances Test:**
 - When the transfers are not simultaneous, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership's operations



Two-part Test

- For simultaneous transfers, the only relevant factor is whether the money or property transferred to the partner from the partnership would have been transferred regardless of the partner's contribution to the partnership
- For non-simultaneous transfers, determine whether, under all the facts and circumstances, the partner's contribution was insulated from the risks of the partnership's venture



Ten Factors Used To Determine if a Sale Took Place

1. Timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer
2. Transferor had a legally enforceable right to the subsequent transfer
3. Transferor's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured
4. Anyone has made or is legally obligated to make contributions to the partnership in order for the partnership to make the transfer of money or other consideration
5. Someone has loaned or agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such obligation is subject to contingencies related to the results of the partnership operations



Ten Factors Used To Determine if a Sale Took Place

6. Partnership has incurred debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt)
7. Partnership holds money or other liquid assets beyond the reasonable needs of the business that are expected to be available to make the transfer – taking into account the income that will be earned from those assets



Ten Factors Used To Determine if a Sale Took Place

8. Partnership distributions, allocations, or control of partnership operations is designed to affect an exchange of the burdens and benefits of ownership of property
9. Transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits
10. Partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation, but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner



Two-year Presumption

- It must be determined whether the partner's contribution was subject to the business or investment risks of the venture; if not, the contributing partner may have simply "cashed out" his/her interest in the property
- In some cases, the partnership is actually the seller of the property rather than the buyer
- In this situation, the partnership may disguise the sale as a nontaxable distribution under Section 731(a) in exchange for a payment disguised as a contribution under Section 721(a)



Exceptions to the Two-year Presumption

- Certain types of distributions or payments are presumed not to be part of a disguised sale even if they occur within two years of a contribution unless the facts and circumstances clearly establish that the transfer is part of a sale



Exceptions to the Two-year Presumption

- To protect normal periodic partnership distributions from falling within the scope of Section 707(a)(2)(B), the following payments do not trigger the two-year presumption:
 - **Distributions from normal operating cash flow**
 - **Reasonable guaranteed payments** – A guaranteed payment is considered reasonable if it does not exceed the partner's unreturned capital for the year times 150% of the highest AFR
 - **Reasonable preferred returns** – A preferred return is a priority distribution of partnership cash flow to a partner in order to compensate the partner for the use of contributed property. Preferred returns are matched, to the extent available, by an allocation of income or gain



Exceptions to the Two-year Presumption Reimbursements of Preformation Expenditures

- A partnership may reimburse a partner for certain capital expenditures made within two years preceding the transfer of property to the partnership without having the reimbursement subject to the disguised sale rules
- Such expenditures include capitalized partnership organization and syndication costs, and capital costs incurred with respect to property contributed to the partnership by the partner
- In the case of costs incurred with respect to contributed property, the reimbursements generally cannot exceed 20% of the FMV of the contributed property
- 20% limit does not apply if the FMV of the contributed property does not exceed 120% of the partner's adjusted basis in the contributed property at the time of contribution



Qualified and Nonqualified Liabilities

- Any liabilities that are not considered **qualified liabilities** may constitute the proceeds of a disguised sale
- A qualified liability is one that is not incurred “in anticipation of the transfer”
- A **nonqualified liability** is one that was incurred in anticipation of transferring the property to the partnership and is a device used by the partner to “cash out” his or her investment in the contributed property
- The portion of the nonqualified liability shifted from the contributing partner to the other partners constitutes payment for a disguised sale



Qualified Liabilities

- A liability is qualified if it were incurred more than two years prior to the transfer of the property to the partnership
- Qualified liabilities are “old and cold” and outside the scope of the disguised sales rules
- Rationale is that these types of liabilities were probably not incurred in anticipation of the transfer of the property to a partnership
- If a liability was incurred within two years of the transfer, it still can be considered a qualified liability, depending on how the proceeds of the debt were used



Qualified Liabilities

- If proceeds were used to acquire or improve the contributed property, the liability is qualified because the contributing partner has used the loan proceeds to increase his or her investment in the property rather than decreasing the investment, as is the case in a sale
- If the liability is incurred in the ordinary course of the business and substantially all of the business assets are contributed to the partnership, the liability is still qualified
- This rule addresses trade payable and other liabilities whose purpose is not to cash out the contributing partner's interest in the property



Nonqualified Liabilities

- A nonqualified liability is fully subject to the disguised sales rules
- If a liability were incurred less than two years before transferring the property, it is presumed to be nonqualified unless the facts and circumstances clearly indicate that it was not incurred in anticipation of the transfer
- Under the disguised sale rules, the contributing partner is treated as having an amount realized equal to the amount that was shifted to other partners under Section 752(b)
- This is the excess of the total liability contributed over the contributing partner's remaining share of the liability post-contribution



Nonqualified Liabilities

- Thus, to determine the amount realized, it is necessary to apply the rules under Section 752 to determine the post-contribution debt share of each partner
- In the case of recourse liabilities, the normal debt allocation rules under Section 752 apply
- That is, a partner's share of a partnership recourse liability, the portion for which the partner or related person bears the economic risk of loss
- For nonrecourse liabilities, the first two tiers listed in Treas. Reg. §1.752-3 are ignored and only the third tier, excess nonrecourse liabilities, is taken into consideration



Nonqualified Liabilities

- Excess nonrecourse liabilities are generally shared based on the partner's share of profits
- Thus, for determining the amount realized under Section 707(a)(2)(B), a partner's share of nonrecourse debt is computed in the same manner as "excess nonrecourse liabilities"



Debt-financed Distributions

- The amount of money or other consideration distributed to a partner in connection with a transaction that would otherwise be regarded as a disguised sale is reduced by the partner's share of partnership liabilities incurred to finance the distribution



Debt-financed Distributions

- Treas. Reg. §1.707-5(b)(1) provides that for purposes of the disguised sale rules, if:
 - A partner transfers property to a partnership
 - The partnership incurs a liability, and
 - All or a portion of the proceeds of that liability are allocable under Treas. Reg. §1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability. The transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liabilities



Debt-financed Distributions

- If the partnership borrows to make a distribution to the contributing partner, and can legitimately allocate that liability to the contributing partner, the distribution will not be considered part of a disguised sale



Disclosure Requirements

- For certain transfers that are presumed to be sales, the partnership and the partners must comply with the disclosure requirements found in Treasury Regulations under §707
- Generally, disclosure is required when:
 - Certain transfers to a partner are made within 2 years of a transfer of property by the partner to the partnership, and
 - When debt is incurred within 2 years of the earlier of either a written agreement to transfer or of a transfer of the property that secures the debt, if the debt, nevertheless, is treated as a qualified liability
- The disclosure must be made on the partner's return using Form 8275 or 8275-R or a statement providing the same information



Disclosure Requirements

- When more than one partner transfers property to a partnership pursuant to a plan, the disclosure may be made by the partnership rather than by each partner on their individual returns
- Meeting the disclosure requirements does not necessarily satisfy the disclosure requirements for purposes of penalties under §6662
- However, a failure to provide the disclosure when required may increase the likelihood of a penalty assessment
- Similar disclosure rules are contained in the proposed regulations for disguised sales of partnership interests



Contributions and Distributions of Built-in Gain or Loss Property

- Section 704(c) property is property that had a built-in gain or loss at the time that it was contributed to the partnership
- In certain situations, distributions of Section 704(c) property to a noncontributing partner will cause the partner who contributed the property to recognize gain
- Under Section 704(c), a built-in gain or loss must be allocated back to the contributing partner when the property is sold or over time as depreciation or amortization deductions are allocated away from the contributing partner



Distribution Treated as a Sale

- If Section 704(c) property is distributed within a **seven-year period** to any partner other than the contributing partner, Section 704(c)(1)(B) treats the distribution as if it were a sale taking place on the date of the distribution
- This “sale” is deemed to occur at the property’s FMV
- The deemed sale requires the contributing partner to recognize any built-in gain that was inherent in the property at the time of its contribution to the partnership



Distribution Treated as a Sale

- In addition, recognition of gain (or loss) by the partner triggers an adjustment to both the inside basis of the property and to the partner’s outside basis immediately before the distribution
- Other partners are not affected by the deemed sale

Example 12



Seven-year Period

- Section 704(c)(1)(B) only applies to distributions made within the 7-year period following the contribution of the built-in gain or loss property
- Therefore, it is important to ascertain how the partnership obtained the distributed property
- An analysis of the partnership's capital accounts going back 7 years and a review of the original partnership agreement and its amendments may yield important information in determining the source of contributed property
- A balance sheet item, records supporting the calculation of partner capital accounts should be maintained indefinitely



Calculation of Gain or Loss

- The gain or loss allocated to the contributing partner is the amount that would have been allocated to the contributing partner had the partnership sold the property to the distributee partner for its FMV on the date the property was distributed
- Thus, the contributing partner will recognize the lesser of:
 - The built-in gain or loss inherent in the property at time of contribution or
 - The gain or loss that would be allocated to the contributing partner if the partnership sold the property to the distributee for its FMV

Example 13



De Minimis Exception

- A partnership may disregard the application of Section 704(c) if two conditions are met:
 - First, the FMV of the contributed property cannot differ from the tax basis by more than 15% of the adjusted tax basis
 - Second, the total gross disparity between the FMV and tax basis does not exceed \$20,000



Anti-abuse Rule

- If a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of Section 704(c)(1)(B), the IRS can recast the transaction for federal income tax purposes
- This prevents the contributing partner from closing out his or her economic position in the distributed property prior to the end of the seven-year period, but before the distribution actually takes place



Distribution of Property to Contributing Partner Under Section 737

- A contributing partner will sometimes attempt to accomplish a tax-free sale of appreciated property by having the partnership distribute other property to him or her thereby liquidating his or her interest in the contributed property
- Under Section 737, if a partner receives a distribution of other property within a seven-year period of contributing appreciated property, gain, but not loss, may be recognized by the partner
- Section 737 presumes that the distributee partner is effectively “selling” any appreciated property that was contributed during the prior seven years



Distribution of Property to Contributing Partner Under Section 737

- Gain recognized under Section 737 is in addition to any gain recognized under Section 731
- Thus, a distribution could result in gain recognized under both Sections 731 and 737
- Section 737 does not apply to a distribution to the extent that Section 751(b) applies
- Thus, it is important to determine if the distribution results in a change in the partner’s share of Section 751 (hot assets) and non-section 751 assets
- If the partnership distribution is disproportionate, then Section 751(b) applies before Section 737



Amount of Gain

- The gain recognized will equal the lesser of:
 - The “excess distribution” — this is the amount by which the FMV of the property received (other than money) exceeds the distributee partner’s outside basis reduced by any money received, or
 - The distributee partner’s “net precontribution” gain
- The net precontribution gain is the total amount of built-in gain in all property contributed by the distributee partner during the seven years prior to the distribution that is still held by the partnership at the time of the distribution
- Section 737 rules are similar to those under Section 704(c)(1)(B) and have the similar objective of preventing the contributing partner from escaping taxation on the unrealized gain on the contributed property



Amount of Gain

- In the case of depreciable or amortizable property, the partnership must follow Section 704(c) principles to reduce the disparity between the property’s book value and tax basis
- Therefore, the amount of the net precontribution gain declines over time as cost recovery deductions are shifted away from the contributing partner
- The character of the gain recognized depends on the character of the net precontribution gain
- Precontribution gains and losses are netted according to their character
- The character of a net negative amount is disregarded



Distribution of Previously Contributed Property

- To the extent the distributee partner receives back property he or she previously contributed to the partnership, the precontribution gain associated with that property is not taken into account when calculating the partner's net precontribution gain
- However, an interest in an entity previously contributed to the partnership is not treated as previously contributed property to the extent that the value of the interest is attributable to property contributed to the entity after the interest was contributed to the partnership
- In other words, this rule cannot be used to avoid Section 737 by increasing the value of an entity that is then distributed back to the contributing partner

Section 736(a) and (b) Payments



Liquidation at Partner's Retirement or Death — Section 736

- Section 736 applies to payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of the partner's entire interest in the partnership
- When a partner's interest is to be liquidated by a series of distributions, the interest will not be considered liquidated until the final distribution has been made
- Section 736 does not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law



Liquidation at Partner's Retirement or Death — Section 736

- Section 736 applies only to payments made by the partnership and not to transactions between the partners
- Thus, a sale by partner A to partner B of his or her entire interest in partnership ABCD would not come within the scope of Section 736
- Retirement means the taxpayer is no longer a partner under local law
- A retirement agreement should specify that a person is no longer a partner and has no further right to vote after a certain date



Liquidation at Partner's Retirement or Death — Section 736

- The partnership must allocate payments to a deceased or retiring partner between Section 736(a) and (b) payments
- 736(a) payments are for a partner's distributive share of partnership income or are guaranteed payments
 - These payments are deductible to the partnership and includible in the income of the distributee partner
- Section 736(b) payments are for a partner's share or interest in the partnership's property
- Section 736(b)(2) provides that "property" for Section 736(b) purposes does not include unrealized receivables or unstated goodwill unless the partnership agreement provides for goodwill payments



Liquidation at Partner's Retirement or Death — Section 736

- If the retiring partner is a general partner and capital is not a material producing factor in the partnership (i.e., a service partnership), the treatment of unrealized receivables and un-bargained for goodwill as Section 736(a), rather than Section 736(b) payments, applies
- Thus, for all other retirements, payments for partnership goodwill and unrealized receivables should be treated as Section 736(b) payments (though the partner's share of the receivables will be subject to ordinary income recharacterization under Section 751)



Liquidation at Partner's Retirement or Death — Section 736

- When a partnership makes payments (including assumption of liabilities treated as a distribution of money under Section 752) to a withdrawing partner, the amounts paid may represent several items
- In part, they may represent the fair market value of the withdrawing partner's interest in all the assets of the partnership (including inventory) at the time of his or her death or retirement unreduced by partnership liabilities



Liquidation at Partner's Retirement or Death — Section 736

- When a partnership makes such payments, whether or not related to partnership income, to retire the withdrawing partner's entire interest in the partnership, the payments must be allocated between
 - (i) Payments for the value of his or her interest in assets, except unrealized receivables and, under some circumstances, goodwill (section 736(b)), and
 - (ii) Other payments (section 736(a))



Liquidation at Partner's Retirement or Death — Section 736

- The amounts paid for his or her interest in assets are treated in the same manner as a distribution in complete liquidation under Sections 731, 732, and, where applicable, 751
- The remaining partners are not allowed to deduct the Section 736(b) payments since they represent either a distribution or a purchase of the withdrawing partner's capital interest by the partnership, which is composed of the remaining partners



Liquidation at Partner's Retirement or Death — Section 736

- Payments, to the extent considered as guaranteed payments under Section 736(a)(2), are deductible by the partnership under Section 162(a) and are taxable as ordinary income to the recipient
- The amount of any payments under Section 736(a) is included in the income of the recipient for his taxable year with or within which ends the partnership taxable year for which the payment is a distributive share or in which the partnership is entitled to deduct such amount as a guaranteed payment
- Section 736(b) payments are taken into account by the recipient for his or her taxable year in which such payments are made



Liquidation at Partner's Retirement or Death — Section 736

- The rules regarding Section 736(b) payments only apply when:
 - (i) Capital is not a material income-producing factor for the partnership and
 - (ii) The retiring or deceased partner was a “general partner” in the partnership



Liquidation at Partner's Retirement or Death — Section 736

- This means that any payments for a partner's share of unrealized receivables will be treated as a Section 736(a) payment (and if a specific amount, then ordinary income to the recipient and deductible by the partnership under Section 707)
- If capital is a material income-producing factor, then unrealized receivables are property as is goodwill
- Payments under Section 736(b) may be subject to Section 751(b)
- For example, if cash is paid to a partner under Section 736(b) and is a disproportionate distribution, Section 751(b) applies

Thank You!
