INCOME TAX ISSUES IN FORMING AND LIQUIDATING PARTNERSHIPS

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FORMATION ISSUES

I. Contribution of Property. Under the rules of Section 721, a contribution of property to a partnership is viewed as a change in the form of ownership of the property and does not result in recognition of immediate taxable gain or loss to either the contributing partner or the partnership. This is true even when the fair market value of the property at the time of its contribution differs from the contributing partner's income tax basis in the contributed property. However, Section 721 contains several exceptions to the general nonrecognition rule.

A. Investment Company. Section 721(b) provides an exception to nonrecognition treatment for taxpayers who contribute appreciated property to a partnership which meets the definition of an investment company. This exception was created to prevent a taxpayer from achieving a tax-free diversification of an investment portfolio by contributing a concentrated holding of a small number of securities to a partnership that pooled the holdings of several taxpayers. Section 721(b) does not define an investment company but incorporates the definition of an investment company used in Section 351(e)(1). An investment company is defined as a corporation in which more than 80% of the value of the corporation's assets consist of stocks, securities, cash, notes, options, foreign currency, certain financial instruments, interests in real estate investment trusts, and ownership interests in entities holding such assets. There are certain exceptions to the investment company definition.

(1) Insignificant Nonidentical Assets. The transfer of certain nonidentical assets is disregarded if they are insignificant in size to the other assets transferred. The regulations provide an example in which $200 worth of one stock is considered insignificant in relation to $19,000 worth of another stock. Treas. Reg. § 1.351-1(c)(6), Example (1).

(2) Diversified Portfolio. Even if a partnership is classified as an investment company, gain is not recognized if the transfer does not result in diversification of the contributing partner's portfolio. Essentially, diversification occurs if other partners contribute different assets to the same partnership. The regulations also provide that a contribution of an investment portfolio which is already diverse will not trigger gain to the contributing partner because the goal of the investment company rules is to prevent diversification. If diversification already exists when the assets are contributed, then no gain is recognized upon the contribution. Section 368(a)(2)(F)(ii) provides that a portfolio is diversified if (i) not more than 25% of the assets are invested in one issuer and (ii) not more than 50% are invested in five or fewer issuers. Section 368(a)(2)(F)(iv) provides that government securities are included in the total assets for purposes of computing the denominator in the 25%/50% test, but are not treated as securities of an issuer for purposes of computing the numerator. There is a look-through rule for investments in mutual funds or other pass-through entities for purposes of the 25%/50% test.

(3) Planning with Investment Companies. Once a partnership is classified as an investment company, the transfer of any appreciated property is not eligible for nonrecognition treatment under Section 721. Because loss is not recognized on the transfer, the gain recognized can exceed the net gain realized and the value of the partnership interest received. Therefore, it is better for the contributing partner to sell loss assets and recognize the loss immediately rather than contribute the loss assets to the partnership, in which case a loss will not be recognized until the partnership disposes of the assets in a taxable transaction.

(4) **Planning to Avoid Investment Company Status**. Because a mechanical 80% test is used to determine whether or not an investment company exists, the best way to avoid the investment company classification is to contribute assets such as real estate or mineral interests, which are not listed as investment company assets, so that more than 20% of the assets held by the partnership are not of the type listed.

B. **Contribution of Encumbered Property**. If a partner contributes encumbered property to a partnership, the contributing partner may recognize gain to the extent that that amount of debt associated with the contributed property exceeds the partner's basis in the partnership. Section 752(b) provides that a reduction of an individual liability of a partner on account of an assumption of the liability by the partnership is treated as a cash distribution to that partner and Section 731 provides that cash distributions to a partner which exceeds a partner's basis in the partnership interest is currently taxable to the partner. The question of whether or to what extent an individual liability of a partner has been reduced depends upon the characterization of the liability as recourse or nonrecourse.

(1) **Recourse vs. Nonrecourse Liabilities**. Under Section 752, partnership liability is either recourse or nonrecourse. A partnership obligation is recourse to the extent that one or more partners bears the economic risk of loss associated with the obligation which may occur through a direct guarantee to a partnership creditor or an obligation to contribute funds to a partnership. An obligation for which no partner or related party bears the economic risk of loss is nonrecourse. The Section 752 regulations provide a three tier system for allocating nonrecourse liabilities among the partners.

(2) **Impact on Basis**. A partner's basis in his or her partnership interest is increased by the partner's share of recourse and non-recourse liabilities. A partner can agree to guarantee all, or a portion of, an otherwise nonrecourse liability in order to turn it into a recourse liability in order to avoid gain recognition upon the contribution of an appreciated asset to a partnership if the contributing partner would otherwise recognize gain. However, Section 752(c) provides that a partner's basis in his partnership interest is limited to the value of property contributed in the event that the debt exceeds the value of the property.

C. **Disguised Sale**. If a partner contributes property to a partnership and then receives a distribution from the partnership, Section 707(a)(2) may treat the transaction as a sale of property from the partner to the partnership in certain circumstances. The intent of this provision is to prevent taxpayers from utilizing the partnership tax rules to extract equity from property on a tax-free basis. There is a two part test to determine whether the contribution and distribution should be recast a disguised sale. First, if a partner contributes property to a partnership and there is a simultaneous distribution to the contributing partner which would not have been made absent the contribution of property, then the transaction will be treated as a disguised sale. Second, if the distribution is not made simultaneously, then the contribution and distribution will be recast as a disguised sale if the subsequent distributions are not subject to "entrepreneurial risk". The regulations provide a safe harbor in the event that the distribution occurs more than two years after the contribution in question. Section 707 and the disguised sale rules are also discussed below in Section II(A) of the "Liquidation Issues" section of these materials.

(1) **Contributions of unencumbered property**. There are exceptions to the presumption that distributions made within two years should be recharacterized as a sale which include:

a. Guaranteed payments for capital;
b. Operating cash flow distributions;
c. Reimbursement of preformation expenditures.

(2) **Contribution of Encumbered Property**. The disguised sale rules can also apply to the contribution of encumbered property if the property was encumbered in anticipation of the contribution to the partnership unless the debt is one of four types of "qualified liabilities" as defined in the Treas. Reg. §1.707-5.

a. Debt incurred more than two years prior to contribution. If debt was incurred more than two years prior to the contribution of the property, then it is presumed to be a qualified liability.

b. Debt incurred within two years. If a taxpayer can demonstrate that the liability was not incurred in contemplation of the contribution to the partnership, then the debt will be considered a qualified liability.

c. Capital Expenditures. If the debt was incurred to acquire, improve, or construct the property, then it is considered a qualified liability.

d. Trade Payable. If the liability is a trade payable incurred in the ordinary course of business and the property was used in the trade or business and all of the other assets used in the trade or business were transferred to the partnership, then the trade payable is considered a qualified liability.

(3) **Debt-Financed Distribution**. A distribution made to a partner with the proceeds of debt which is made to a partner within ninety (90) days of the date on which the debt

is incurred is permissible if the liability is allocable to the distributee partner under Temp. Treas. Reg. § 1.163-8T.

II. Contribution of Services in Exchange for a Partnership Interest.

A. Section 83. Section 83 governs the treatment of property transferred to a service provider in connection with the performance of services. The service provider recognizes ordinary income equal to the fair market value of the property received in connection with the performance of services after deducting any payments made by the service provider for the property. The term property is defined in the negative as any real or personal property other than (i) money, (ii) an option, or (iii) an unfunded and unsecured promise to pay money or property in the future. Section 83 by its terms does apply to the issuance of partnership interests to a partner in exchange for services and Prop. Treas. Reg. §1.721-1(b)(1) states a service partner's receipt of a capital interest is taxable under Section 83, but is silent about whether Section 83 applies to a profits interest.

B. Profits Interest vs. Capital Interest. A partnership interest transferred to partner in exchange for services may be either an interest in partnership capital or an interest in partnership profits or some combination thereof. Rev. Proc. 93-27 defines a capital interest is as a partnership interest that would entitle the partner to a share of the value of the partnership's assets upon a liquidation of the partnership if it sold its assets for their fair market value and distributed the proceeds to the partners. A profits interest is a partnership interest other than a capital interest.

The IRS published Rev. Proc. 93-27 to provide a safe harbor with respect to the issuance of a profits interest from a partnership to someone in exchange for services and provides that such issuance will not be taxable unless (i) the profits interest relates to a substantially certain and predictable stream of income; (ii) the service provider disposes of the profits interest within two years of receipt; or (iii) the profits interest is an interest in a publicly-traded partnership.

The IRS subsequently published Rev. Proc. 2001-43 in which it addressed the income tax consequences of the receipt of an unvested profits interest. The Rev. Proc. provides that the recipient will not be taxed either upon receipt of the profits interest, nor at the time the profits interests vests. The partnership must treat the recipient as a partner from the date of grant and the partnership may not take a compensation deduction and the recipient is not required to make a Section 83(b) election.

C. Proposed Regulations. The IRS published proposed regulation (REG 105346-03) and Notice 2005-43 which attempt to further resolve the applicability of Section 83 to the issuance of compensatory partnership interests. The proposed regulations provide that Section 83 principles generally govern the issuance and receipt of compensatory partnership interests, except that the partnership does not recognize gain in the event that the partnership has appreciated assets at the time for issuance and the partnership and partners may elect to use a liquidation valuation of the partnership for purposes of computing the value of the partnership interest issued.

D. Carried Interest Legislation. Several bills have been introduced in Congress which would substantially alter the current treatment of profits interests issued in connection with the performance of services. The bills generally would deny favorable capital gains treatment to services partners who receive profits interests when the partnership recognizes capital gain.

III. Basis Issues.

A. Determining Partner's Basis in Partnership Interest. A partner's basis in his partnership interest acquired by a contribution of property (including cash) to the partnership shall be:

- the amount of such cash; and
- the adjusted basis of such contributed property to the contributing partner at the time of the contribution, increased by
- the amount (if any) of gain recognized under Section 721(b) to the contributing partner at such time.

(1) Debt for Equity. A creditor of a partnership that exchanges its loan for equity in the partnership will not recognize a loss if the liquidation value of the partnership interest is less than the outstanding principal balance of the debt. The creditor's basis in the equity interest received in the debt-for-equity exchange is increased by the adjusted basis of the debt, and the creditor's holding period would include the holding period in the debt under the Section 1223(1) tacking rule.

(2) Assumption of Liability. Generally, if a partnership assumes a liability of a partner, this is treated as a cash distribution by the partnership to the partner which will reduce the partner's basis in his partnership interest. If a partner contributes property to a partnership which is subject to debt, the contributing partner's basis in his interest is increased by his basis in the property contributed and the partner is also deemed to receive a cash distribution in the amount of the debt on the property which is allocated to the other partners. The deemed cash distribution decreases the contributing partner's basis in his partnership interest. To the extent the deemed distribution exceeds the partner's basis, the partner realizes gain on the contribution of the property. See Rev. Rul. 84-15. Also see Section I(B) above for discussion on this topic. Also, the other partners will be treated as making cash contributions to the partnership in the amount of their allocable share of the debt on the contributed property which increases their basis in their partnership interests in the amount of the deemed contributions. See Rev. Rul. 84-15.

Applying these rules, if the contributing partner's basis in the contributed property is less than the indebtedness assumed by the partnership, the contributing partner will realize capital gain to the extent such indebtedness exceeds his basis in the property contributed. Section 731(a). For example, if a 20% partner contributes property worth $10,000, with a basis of $4,000 and a mortgage of $6,000, the partner's basis in his partnership interest is reduced to zero [$4,000 basis in property—$4,800 (80% of $6,000 mortgage assumed by other partners)]. The contributing partner will also realize an $800 capital gain, as if the partnership distributed $800 to him. The other partners get an aggregate $4,800 increase in their bases from the contribution/debt assumption.

B. <u>Partnership's Basis in Contributed Assets</u>. The basis of property contributed to a partnership by a partner is the contributing partner's adjusted basis in the property at the time of the contribution, increased by the amount (if any) of gain recognized under Section 721(b) at the time of contribution. The holding period of such property for the partnership will include the holding period of the contributing partner. See Section 1223(2).

IV. <u>Allocations Related to Contributed Property</u>. Section 704(c) is designed to prevent the shifting of tax consequences among partners with respect to pre-contribution gain or loss on contributed property. Treas. Reg. §1.704-3(a)(1). A partnership is required to allocate income, gain, loss and deduction for property contributed by a partner to a partnership to take into account any variation between the adjusted tax basis of the property and its fair market value (FMV) at the time contributed. The allocations must be made using a reasonable method consistent with Section 704(c).

If any property contributed to a partnership is distributed (directly or indirectly) by the partnership to a partner other than to the contributing partner within 7 years of being contributed (See additional discussion on this topic below in Section II(B) of the "Liquidation Issues" of these materials):

- the contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner if the property had been sold at its fair market value at the time of the distribution,
- the character of such gain or loss shall be determined by reference to the character of the gain or loss which would have resulted if such property had been sold by the partnership to the distributee, and
- appropriate adjustments shall be made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized.

A. <u>Property Contributed with a Built in Loss</u>. If any property is contributed to a partnership that has a built-in loss, such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution. In determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership is treated as being equal to its fair market value at the time of contribution. This means a partner contributing built-in loss property to a partnership cannot transfer the loss to another person by transferring his partnership interest. If the partnership interest is transferred, the built-in loss is eliminated.

B. Special Rule for Distributions Where Gain or Loss Would not be Recognized Outside Partnerships. If property contributed by a partner is distributed by the partnership to another partner, and other property of a like kind (within the meaning of Section 1031) is distributed by the partnership to the contributing partner not later than the earlier of:

- the 180th day after the date of the distribution , or
- the due date (determined with regard to extensions) for the contributing partner's tax return, then the contributing partner (up to the value of the property received) will be treated as if they had contributed that property to the partnership.

C. Methods Used for Making Allocations Relating to Property Contributed to Partnership. There are three methods used for making the allocations relating to property that was contributed to a partnership:

(1) Traditional Method. The traditional method generally requires that when the partnership has income, gain, loss, or deduction that is attributable to Section 704(c) property, that it is required to make appropriate allocations to the particular contributing partners to avoid the shifting of built-in gain or loss. So that if a partnership sells Section 704(c) property and recognizes gain or loss, built-in gain or loss on the property is allocated to the contributing partner, and if the partnership only sells a portion of Section 704(c) property a proportionate part of the built-in gain or loss is allocated to the contributing partner. However, the total income, gain, loss, or deduction allocated to the partners for a taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (the ceiling rule).

(2) The Traditional Method with Curative Allocations. To correct distortions caused by the ceiling rule a partnership using the traditional method can make reasonable "curative allocations" to reduce or eliminate disparities between book and tax items of noncontributing partners. A curative allocation is defined in Treas. Reg. §1.704-3(c)(1) as an allocation of income, gain, loss or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item. A partnership may limit its curative allocations to allocations of one or more particular tax items even if the allocation of those available items doesn't fully offset the ceiling rule. However, a partnership must be consistent in applying its curative allocations with respect to each item of Section 704(c) property from year to year.

(3) Remedial Allocation Method. A partnership can adopt the remedial allocation method to eliminate distortions caused by the ceiling rule. The remedial allocation method involves the partnership's creation of notional tax items and isn't dependent on the actual tax items recognized by the partnership. The partnership eliminates the distortions by creating remedial items and allocating them to the partners. Under the remedial allocation method the partnership determines the amount of book items under Treas. Reg. §1.704-3(d)(2) and determines the distributive share of these items under Section 704(b). The partnership then allocates the corresponding tax items recognized by the partnership, if any, using the traditional method set out in Treas. Reg. §1.704-3(b)(1).

If the ceiling rule causes the book allocation of an item to a noncontributing partner to differ from the tax allocation of the same item to the noncontributing partner, the partnership creates a remedial item of income, gain, loss or deduction equal to the full amount of the difference and allocates it to the noncontributing partner. The partnership simultaneously creates an offsetting remedial item in an identical amount and allocates it to the contributing partner. Treas. Reg. §1.704-3(d)(1).

V. **Allocations**.

A. Impact of Deficit Capital Accounts. A partner is entitled to deduct his or her share of partnership losses. To determine the amount of basis available to deduct the current year's loss, a partner's outside basis is adjusted for any contributions, distributions, and the partner's share of allocable partnership items. The amount of loss deductible is limited by the adjusted basis of the partner's partnership interest. In some cases – usually because of allocated losses and partnership debt - a partner made have a deficit capital account. Partnership agreements often require that partners restore deficit capital accounts existing when a partnership is liquidated. Failing to restore a deficit capital account when a partnership is liquidated may result in the partner realizing gain in the amount of the deficit.

Example: Partner C has a beginning outside basis of $1,000. During 2008, C's distributive shares of partnership income and loss are as follows: partnership long-term capital loss under Section 702(a)(2), $4,000; short-term capital loss under Section 702(a)(1) , $2,000; and income under Section 702(a)(8), $4,000. As adjusted under Section 705(a)(1)(A) , C's basis is increased from $1,000 to $5,000 to reflect his share of partnership income before application of his share of partnership losses. Since the aggregate of his loss shares is $6,000, five sixths of each loss item is allowable. Hence, C 's deductible share of partnership long-term capital loss is $3,333, while his deductible share of short-term capital loss is $1,667. C 's basis is reduced to zero, and he is entitled to carry forward $667 as a long-term capital loss and $333 as a short-term capital loss to 2009 and subsequent years.

B. **Special Allocations of Losses, the Limitation and "Substantial Economic Effect**." Although the statute provides for the disallowance and carryforward of a portion of a partner's share of partnership losses, pursuant to Section 704(b), a partner's distributive share of income, gains and losses are determined in accordance with their partnership interest unless the partners agree among themselves to a different allocation. The partners may agree to allocate losses to those partners with sufficient basis to utilize the losses currently so long as the allocation has substantial economic effect.

Treas. Reg. §1.704-1(b)(2) provides three requirements to determine if a partnership allocation of losses has economic effect:

- Maintenance of the partnership capital accounts within the rules laid out in the regulations;
- Upon liquidation, all liquidating distributions are required to be made in accordance positive capital account balances of the partners; and
- If any partner has a deficit in his or her capital account balance following the liquidation that he or she is required to restore the amount of such deficit balance to the partnership.

Upon liquidation of a partnership, liquidating distributions are to be made in accordance with the partner's capital account balances after taking into account all capital account adjustments for the partnership taxable year during which the liquidation occurs. If a partnership agreement meets these three allocation tests/provisions the allocations made will be deemed to have substantial economic effect and be respected. This is often referred to as the substantial economic effect "safe harbor". If the allocation provisions in a partnership agreement, however, do not explicitly meet these requirements, however, the allocations made should still be respected by the IRS if the result of the allocations would be the same as where the above three provisions/tests were satisfied.

LIQUIDATION ISSUES

I. Taxation of Liquidating Distributions from Partnerships – General Rule. Given the flow-through approach of partnership taxation, Subchapter K, generally, does not tax the parties as property moves in and out of the partnership. More precisely, per Sections 731(a)(1) and 731(b), distributions from partnerships are non-taxable to both the partnership and the recipient partner except and to the extent that cash is received in excess of the recipient partner's basis in his partnership interest. For these purposes, marketable securities distributed are valued at current market value are treated the same as cash. Section 731(c). To the extent cash/marketable securities received exceeds the recipient's basis, he recognizes gain on the distribution. Section 731(a)(1).

A. Liquidating vs. Nonliquidating Distributions/Loss on Distributions.

(1) The rules governing the taxation of distributions made as part of the liquidation of a partnership differ in some areas from the rules governing the taxation of nonliquidating distributions (also called operating or current distributions). A liquidating distribution terminates a partner's entire interest in the partnership by way of a distribution or a series of distributions. Treas. Reg. §1.761-1(d). The series of distributions may occur over a period of more than a year as long as there is a clear plan that the distributions are being made toward the termination of the partner's entire interest in the partnership. Treas. Reg. §1.761-1(d). In contrast, a nonliquidating distribution is any distribution that is not a liquidating

distribution. For instance, a current distribution may be non-pro rata, made out of capital, in-kind, and redeem 75% of a partner interest – as long as it is not being made in termination of a partner's interest, it is a nonliquidating distribution.

(2) The first difference in the taxation of nonliquidating versus liquidating distributions is that a loss can never be recognized by a partner upon the receipt of a nonliquidating distribution but a loss can be recognized by a partner if he receives a liquidating distribution which consists solely of cash and Section 751 property. Section 731(a)(2). In this regard, the recipient partner recognizes loss in the event he receives solely cash and Section 751 property (generally, receivables and inventory) in a liquidating distribution the aggregate bases of which is less than the basis of his liquidated partnership interest. The second difference between liquidating and nonliquidating distributions is that a partner's basis in property distributed to him by a partnership in a nonliquidating distribution is the partnership's basis in such property (i.e., carryover basis). Section 732(a)(1). The basis of property received in a liquidating distribution is equal to the partner's basis in his relinquished partnership interest (i.e., substituted basis). Section 732(b). The third difference between a liquidating and a nonliquidating distribution is that, generally, liquidating distributions may allow a partner to be able to utilize passive losses generated by the partnership and allocated to him but suspended under Section 469 since the investment in the activity has been terminated.

B. Character of Gain/Loss. Any gain or loss recognized by the recipient partner is treated as gain or loss from the sale or exchange of a capital asset. Rev. Rul. 76-189.

C. Decrease in Share of Partnership Liabilities. A partner is also considered to receive a cash distribution whenever his share of partnership liabilities is decreased. Section 752(b). A deemed cash distribution triggered by Section 752(b) is for tax purposes equivalent in all respects to an actual distribution of cash.

II. Exceptions to General Rule of Non-Taxation of Distributions.

A. Section 707 – Disguised Sales. Given property can, generally, be contributed by one partner and distributed to another partner tax-free under Subchapter K, it might be possible to structure a sale as non-taxable which is outside the intent of the Code. Congress enacted Section 707(a)(2) in an attempt to prevent this situation. Under Section 707(a)(2), a contribution of property by a partner to a partnership may be recharacterized as a sale where the contributing partner receives distributions of cash or other property that are, in substance, consideration for the contribution. The regulations under Section 707(a)(2) provide generally that a transfer of property (excluding money) by a partner to a partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if based on all the facts and circumstances:

- The transfer of money or other consideration would not have been made but for the transfer of property; and

- In cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

See Treas. Reg. §1.707-3(b)(1). Treas. Reg. §1.707-3(b)(2) lists several facts and circumstances to be considered when determining if a transaction is a disguised sale. Transfers of property to a partnership made by one partner within two years of a transfer of money to another partner are presumed to be a disguised sale unless the facts and circumstances clearly establish that the transfers did not constitute a sale. Treas. Reg. §1.707-1(b)(3).

The current disguised sales rules are aimed at transfers of property – not cash – to a partnership by one partner and subsequent distributions of cash to another partner. What if one partner contributes cash to the partnership and some of that cash is shortly thereafter distributed to another partner. Is that a disguised sale of a partnership interest? In 2004, proposed regulations were published (and some other IRS guidance has held) that the Section 707 disguised sales rules also apply to situations where one partner contributes cash to a partnership which is then distributed to another partner. In these cases, the transaction can be considered to be a sale of a partnership interest between the partners. However, these proposed regulations were withdrawn earlier this year. See also, Communications Satellite Corp v. U.S., 2 Cl. Ct. 58 (1983) and Jupiter Corp. v. U.S., 625 F.2d 997 (Ct. Cl. 1980) (in both cases new members bought into a partnership for cash and a portion of that cash was used to partially redeem an existing partner's interests. The courts in both of these cases refused to agree with the IRS that what occurred was a disguised sale of a partnership interest).

B. Sections 737 and 704(c)(1)(B). Another exception to the general rule of non-taxable distributions is created by Sections 737 and 704(c)(1)(B). These sections can trigger gain to a partner who contributed appreciated property to a partnership and within seven years of such contribution the partnership makes certain distributions. First, under Section 704(c)(1)(B), if the contributed appreciated property is contributed to another partner within seven years of its contribution, the contributing partner recognizes gain on the distribution in the amount of gain the partner would have been allocated under Section 704(c) had the property been sold for its fair market value. Second, Section 737 is similar to Section 704(c)(1)(B) except that it applies when the partner who contributed the appreciated property receives as a distribution different property from the partnership within seven years of the contribution. Thus, Section 704(c)(1)(B) applies when the same property is distributed to a different partner and Section 737 applies when different property is distributed to the same partner. In either case, the policy it to treat the partner who contributed the appreciated property generally as having sold the property since a "related" distribution was made with a relatively short period of time (within seven years). The amount of gain recognized by the partner if Section 737 applies is the lesser of (a) the excess of the fair market value of the distributed property (other than cash) over the adjusted basis of the partner's interest in the partnership immediately before the distribution reduced by the amount of cash received in the distribution and (b) the net precontribution gain of the partner. The rules under Sections 737 and 704(c)(1)(B) are more mechanical and black letter than the 707 disguised sales rules.

C. **<u>Substance Over Form</u>**. In addition to the specific statutory exceptions to the general non-taxation of distribution section, the "substance over form" doctrine can apply to "distributions" made to partners and cause them to be taxable. For example, a loan made to a partner by a partnership which would have been taxable if characterized as a distribution (since it exceeded the partner's basis) could be characterized by the IRS as a taxable cash distribution instead of a loan if certain facts exist. For example, if the loan is not evidenced by a legally enforceable, unconditional note and/or the loan bears interest and payments are being made on the loan, the IRS might not respect the transaction as a loan. See Rev. Rul. 73-301.

D. **<u>Section 751 – Hot Assets</u>.** Distributions by partnership which have so-called "hot assets" sometimes do not fully qualify for non-taxable treatment. "Hot assets" are inventory, accounts receivables generated in the ordinary course of business and unrealized receivables – generally, assets that would generate ordinary income when sold/collected. Sections 751(d)(1), 1221(a)(1). These rules are designed to (a) prevent a partnership from converting ordinary income to capital gain by distributing hot assets before they are "reduced" to income and (b) prevent the shifting of income to be generated by the hot assets to certain partners. To achieve this objective, Section 751 causes distributions which alter the recipient partner's proportionate interest in the partnership's hot assets to be partially taxable. In these cases, a portion of the distributed property will be treated as received in a taxable exchange for the recipient partner's interest in other partnership assets. Additionally, per Section 735(a), the character of unrealized receivables and inventory distributed to a partner is preserved for at least five years in the recipient's hands.

E. **<u>Section 736 – Guaranteed Payments</u>**. The final major exception to the general rule of non-taxation of distributions is guaranteed payments. Section 736 is complicated and well beyond the scope of this outline. Nonetheless, distributions made to partners under Section 736 usually do not follow the general Section 731 distributions rules. Under Section 736, payments in liquidation of a retiring or deceased partner's partnership interest are bifurcated into (1) payments in exchange for "partnership property" under Section 736(b) and (2) payments that, pursuant to Section 736(a), are treated as either guaranteed payments or distributive shares of partnership income and are not subject to the normal distribution rules. Section 736(a) distributions are liquidating payments in excess of the value of a retired partner's interest in partnership property, excluding certain types of unrealized receivables and goodwill. Thus, they are payments made for reasons other than the partner's indirect interest in the partnership property. A typical example of a Section 736(a) guaranteed payment is a payment made to a retired partner from a law firm. Section 736(a) payments can either be taxed without regard to partnership income – which are classic guaranteed payments – or with regard to partnership income, which are treated as distributive shares of partnership income. Guaranteed payments are ordinary income to the distributee and are deductible by the partnership.

III. Basis in Property Received in Distribution.

A. Distributions of Property not in Liquidation. A partner's basis in property distributed to him from the partnership will equal the partnership's adjusted basis in the property. However, the recipient partner's basis in the distributed property will be limited to his basis in the partnership, less any cash received in the same distribution.

B. Distributions of Property in Liquidation. The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

C. The distribution of multiple properties: allocation of basis. The basis of distributed properties shall be allocated among such properties as follows:

- First to any unrealized receivables and inventory in an amount equal to the adjusted basis of each such property to the partnership, and
- if the basis to be allocated is less than the sum of the adjusted bases of such properties to the partnership, then, to the extent any decrease is required in order to have the adjusted bases of such properties equal the basis to be allocated, such decrease shall be allocated first to assets with unrealized depreciation in proportion to their unrealized depreciation before the decrease, and then to the assets based upon their respective basis.
- If the basis to be allocated is greater than the sum of the adjusted basis of such properties, then first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation), and then, to the extent such increase is not allocated, in proportion to their respective fair market values.

IV. Compromising Partnership Level Tax Debt. For partnership level liabilities, like payroll taxes, the IRS will not accept an offer from only one partner in a general partnership. IRM 5.8.4.13.4 states that:

> "When a partnership liability is compromised for any individual general partner our ability to collect from all other general partners may be affected. Therefore, the amount offered to compromise a partnership tax liability must include what we can collect from the partnership plus what can be collected from each of the general partners. No offer should be accepted to compromise only one partner's individual liability for the partnership debt. When investigating offers a CIS should be secured from the partnership and from all general partners."

The IRS has stated that because partners are not joint and severally liable for partnership liabilities that all the partners must either join in the Offer in Compromise or provide their financial information.

The problem with this policy is that in many states partnership liabilities are joint and several. There seems to be little reason why the IRS could not compromise with one partner and proceed against the remaining partners for the balance. In addition, often after a failed partnership often the partners are not speaking to one another, nullifying the idea of having all the partners participate in an Offer in Compromise.

V. Section 754 Election.

A. General. A transfer of an interest in a partnership generally has no effect on the partnership or on the remaining partners. However, in most instances, a taxable transfer will result if a disparity between the transferee partner's adjusted basis in the transferred partnership interest, and his share of the partnership's adjusted basis in its assets, exists. A Section 754 election may eliminate this disparity by adjusting the basis of the partnership assets. The Section 754 election puts the transferee partner in the same tax position as if he had acquired a proportionate share of the partnership assets rather than his partnership interest. A Section 754 election is optional, but it applies to all subsequent transfers and is irrevocable unless IRS consent is obtained.

B. Substantial Built-In Loss. The 2004 American Jobs Creation Act mandates a Section 754 election in certain instances. A partnership must adjust the basis of the partnership assets to eliminate any disparity between inside and outside basis if the partnership has a substantial built-in loss immediately after the transfer of the partnership interest. A substantial built-in loss is defined by Section 743(d) as an adjusted basis in partnership property in excess of the property's fair market value by more than $250,000.

C. Calculation of Basis Adjustment. Two steps are necessary in determining the basis adjustment. First, the amount of the total basis adjustment is determined under Section 743(b). Then the manner in which the basis adjustment is to be allocated among partnership assets is determined under Section 755.

(1) Section 743(b). If the transferee partner's share of basis in partnership assets is less than his basis in his partnership interest, the adjustment is positive. The adjustment is negative for a basis in the partnership interest that exceeds the basis in partnership assets. The transferee partner's basis in his partnership interest is determined under Section 742, while his basis in his share of partnership assets is his interest in the partnership's previously taxed capital plus his share of partnership liabilities. If one or more partners have contributed property in-kind in exchange for an interest in the partnership, the rules of Section 704(c) must be taken into account when determining the amount of the Section 743(b) adjustment.

(2) **Section 755.** Once the amount of the basis adjustment is determined, then the rules of Section 755 are applied to the assets within the partnership.

(3) **Impact of Valuation Discounts**. If a discount is taken for the valuation of a partnership interest held by a decedent, the amount of any Section 743 adjustment will be affected. In a situation where a partnership has a high inside basis in its assets, a valuation discount applied to a partnership interest may result in a negative basis adjustment to the partnership assets if a Section 754 election is made. In such case, it may be advisable not to make the Section 754 election.