SOUTHERN FEDERAL TAX INSTITUTE

EXITING A PARTNERSHIP THE "RIGHT" WAY: HOW TO EXIT A PARTNERSHIP IN A TAX EFFICIENT MANNER

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This outline describes the various exceptions to nonrecognition treatment when receiving a liquidating partnership distribution. It also discusses alternative transactions that allow a partner to effectively redeem its interest from an economic perspective when a normal liquidating distribution would fall under one of the exceptions.

I. Introduction: Distributions in Liquidation of a Partnership Interest

A. General Nonrecognition Treatment of Partnership Distributions

1. When a partnership distributes cash or property to a partner, subject to certain exceptions, section 731 of the Code[2] generally provides nonrecognition treatment (*i.e.*, no gain or loss recognized for U.S. federal income tax purposes) for both the partner (as distributee of the cash or property) and also the partnership (as distributor of the cash or property).

2. Section 731(b) provides that, subject to exceptions, a partnership generally does not recognize gain or loss on a distribution of property to a partner, whether the distribution is a current distribution or in liquidation of the partner's interest in the partnership (each as defined below).

3. Similarly, section 731(a) provides that, subject to exceptions, a partner generally does not recognize gain on a distribution from a partnership, except to the extent that any money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.

(a) As discussed below, however, loss may be recognized by a partner under section 731(a) in the case of a liquidating distribution consisting of money, unrealized receivables, or inventory (each as defined below), or a combination thereof.

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

[2] Unless otherwise indicated, all references to "section" or "§" are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), and all references to "Treas. Reg. §" are to regulations promulgated under the Code by the U.S. Department of Treasury ("Treasury"), as most recently adopted or amended as of the date hereof.

4. The general nonrecognition treatment provided in section 731 complements the section 721 nonrecognition treatment of contributions by a partner to a partnership. Both sections are consistent with the passthrough nature of partnership taxation in general and the principles of permitting taxpayers the flexibility of using the partnership form without tax recognition on the transfers to and from a partnership. However, as discussed herein, the Code provides a plethora of exceptions to this general nonrecognition treatment of distributions. The legislative history and regulatory preambles issued by Congress and Treasury, respectively, in conjunction with such exceptions evidence an intent that taxpayers not inappropriately benefit from the nonrecognition principles of section 731 and 732 in a variety of situations, including equivalents of transactions that general federal income tax principles would suggest be otherwise taxable, as well as inappropriate avoidance or shifting of tax items (or the character thereof) between partners.

B. Current versus Liquidating Distributions

1. Distributions by a partnership to a partner may consist of cash, property, or both. Distributions are either considered "current" distributions or "liquidating" distributions. If, after a distribution or series of distributions, the partner no longer holds any interest in the partnership, the distribution is considered a liquidating distribution. Note here that a liquidating distribution refers to the complete liquidation of the distributee partner's *interest* the partnership, not the liquidation of the *partnership* itself. Pursuant to Treas. Reg. § 1.761-1(d), any distribution that is not a liquidating distribution (*i.e.*, does not terminate the partner's entire interest in the partnership) is instead considered a current distribution. Current distributions include distributions in partial liquidation of a partner's interest as well as distributions of a partner's distributive share of partnership items.

2. Like current distributions, a distribution by a partnership to a partner in liquidation of the partner's interest is generally tax-free to both the distributee (the partner) and the distributor (the partnership) pursuant to the rules of section 731. However, several important exceptions apply, including if the partner receives cash in excess of the adjusted basis of their partnership interest.

3. The tax treatment of liquidating distributions differs from the treatment of current distributions in two key ways. Unlike a current distribution, (1) a partner may recognize a loss in connection with a liquidating distribution under section 731(a)(2), and (2) the transferred basis of the property distributed in a liquidating distribution may be increased under section 732(b).

(a) Loss Recognition. Unlike a current distribution, the distributee partner of a liquidating distribution may recognize a loss, but only if the property distributed consists solely of money (but not section 731(c) marketable securities) and section 751(b) property—and no other property. The recognized loss is equal to the excess of the distributee partner's basis in the liquidated partnership interest over (1) the amount of any money distributed plus (2) the distributee partner's basis in distributed unrealized receivables and/or inventory.

(b) <u>Basis Increase</u>. Under section 732(b), the basis of property (other than money) distributed to a partner by a partnership in liquidation of the partner's interest equals the adjusted basis of the partner's interest just before the distribution, reduced by any money distributed in the same transaction. Therefore, to the extent that the partner's adjusted basis in its partnership interest exceeds the inside basis of the partnership property distributed, the property can receive a basis step-up under section 732(b).

C. Series of Liquidating Distributions

1. Liquidating distributions can be effected as either a single distribution that terminates a partner's interest or a series of distributions culminating in such termination (*e.g.*, a redemption in exchange for an installment note under which the partnership makes payments over several years in liquidation of the redeemed partner's interest). In the latter case, under Treas. Reg. § 1.761-1(d), the partner's interest is not considered liquidated until the final distribution of such series, and each distribution in such series is treated as a partial liquidating distribution, not a current distribution.

2. Although a liquidation carried out through a series of payments may cause a partner to no longer be a partner in the partnership for state law purposes, the distributee will continue to be treated as a partner for U.S. federal income tax purposes until it receives the last payment in liquidation of the partnership interest, in accordance with Treas. Reg. § 1.736-1(a)(6) and Treas. Reg. § 1.761-1(d). Likewise, in the case of a partnership with only two partners, the partnership will not be considered terminated under section 708 until such final payment.

3. Because of this, a distributee partner will not recognize any gain in respect of such series of liquidating distributions until the cumulative amount of distributions exceeds its total outside basis in the partnership, leading to a deferral of such gain recognition until such year in which total distributions exceed basis.

4. Note that this treatment is different from the traditional installment sale treatment of property under section 453, which provides that gain is recognized on each installment payment in the series to the extent such payment exceeds the allocable portion of the partner's basis.

5. Therefore, a liquidating distribution effected through a series of distributions can essentially resemble, in effect, a redemption of a partner's interest in the partnership through a liquidating distribution by the partnership to the partner of a note receivable, the future payments of which only trigger gain upon cumulatively exceeding basis (rather than triggering gain on each portion under section 453 like an installment sale).

D. Distributions versus Guaranteed Payments

1. Generally, payments received by a partner from a partnership for services or the use of capital that are determined without regard to the income of the partnership are treated as "guaranteed payments" under section 707(c) and are taxed as ordinary income pursuant to section 61(a).

2. Given the ordinary income treatment of guaranteed payments, the classification of transfers from a partnership to a partner as either a guaranteed payment or a liquidating or current distribution has important tax implications since the latter (distributions) are generally taxable as capital gain (to the extent they exceed the partner's basis in the partnership) rather than ordinary gain. These determinations between distributions and guaranteed payments can be tricky in cases where the economic arrangement of the partners under the partnership agreement uses complex mechanisms that blur the line between a distribution and a guaranteed payment. For example, it may not be clear whether the payment is made "with regard to the income of the partnership" or "for the use of capital."

3. EXAMPLE:

(a) Partner A is a ten percent partner in partnership ABC. Under the ABC partnership agreement, A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. A's distributive share of partnership items is 10%. After deducting the $10,000 guaranteed payment, ABC has $50,000 of ordinary income for the year. A must include for the year a total of $15,000 of ordinary income ($10,000 guaranteed payment plus A's $5,000 distributive share of the $50,000 of ordinary income).

E. Section 736 Withdrawal Payments

1. Section 736 applies to payments made by a partnership to a retiring partner or to a deceased partner's successor-in-interest in liquidation of such partner's interest in the partnership. Under section 736(b), such payments, to the extent they are considered to be made in exchange for partnership property, are considered liquidating distributions by the partnership. In the case of a retiring/deceased general partner in a partnership where capital is not a material income-producing factor for the partnership, such payments for partnership property will not qualify under section 736(b) to the extent the payment is for section 751(c) receivables or partnership goodwill (unless the partnership agreement provides for such a goodwill payment).

2. However, under section 736(a), all other payments (*i.e.*, those not considered made in exchange for partnership property under section 736(b)) are considered either a distributive share of partnership income to the retiree/successor (if the amount is determined with regard to the income of the partnership) or a section 707(c) guaranteed payment (if the amount is determined without regard to the income of the partnership).

3. Like the distinction between distributions and guaranteed payments discussed above, the treatment of a section 736 withdrawal payment to a retiring partner or successor-in-interest of a deceased partner as either a section 736(b) payment or a section 736(a) payment can have important tax implications for the distributee, as the section 736(b) payment will be taxed under sections 731 and 732 as distributions, generally yielding capital gain to the extent the payment exceeds the partner's basis, while the section 736(a) payment will generally be taxed as ordinary income instead.

II. Recognition of Gain or Loss in Liquidating Distributions – Generally

A. Distributions Resulting in Loss Recognition – Section 731(a)(2)

1. Section 731(a)(2) allows a partner receiving a liquidating distribution to recognize a loss in respect of its partnership interest only if the distribution consists solely of money, unrealized receivables, or inventory (or a combination thereof). If any other property is distributed in connection with the liquidation, no loss may be recognized.

2. If such requirement is met, a partner may recognize loss on its partnership interest upon a liquidating distribution to the extent the partner's adjusted basis in its interest in the partnership exceeds the total amount of money, unrealized receivables, and inventory received.

3. Such losses recognized under section 731(a)(2) are generally characterized as capital losses, except as otherwise provided under the rules of section 736 (withdrawal payments) and section 751 (providing for ordinary treatment of certain "hot assets", discussed further below).

4. EXAMPLES:

(a) *Distribution of Cash and Inventory*. Partner J has a $70,000 adjusted basis in Partnership S. In liquidation of J's partnership interest, S distributes $50,000 in cash and $10,000 of inventory to J. The total distribution is $60,000, which is $10,000 less than J's $70,000 adjusted basis. Because the distribution is liquidating and consists only of cash and inventory, J recognizes a $10,000 capital loss.

(b) *Distribution of Cash, Inventory and Real Estate*. Partner K has a $50,000 basis in Partnership R. In a liquidating distribution to K, R distributes to K $10,000 of cash, $20,000 of inventory, and $15,000 of real property. Though the $45,000 total distribution does not exceed K's adjusted basis in R, no loss is recognized because real property was included in the distribution.

(c) *Distribution of Hot Assets*. Partner L has a $25,000 basis in Partnership M. L receives $20,000 in unrealized receivables in a liquidating distribution from M. L recognizes a $5,000 ordinary loss as attributable to the receivables.

B. Distributions of Money Exceeding the Partner's Basis – Section 731(a)(1)

1. Section 731(a)(1) provides that a partner recognizes gain to the extent that the amount of money distributed in liquidation of the partner's interest exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. No gain, however, is recognized with respect to a distribution of property *other than money* until the partner sells or otherwise disposes of such property (except to the extent otherwise provided by section 736 and section 751).

2. For purposes of determining such amount of gain, the partner's adjusted basis in the partnership interest is determined immediately before the distribution, including any adjustments for its share of income, losses, contributions, and distributions. Because the rules of section 706 provide that a partnership's tax year terminates upon liquidation of a partner's interest, the partner's adjusted basis should include the distributee partner's distributive share of partnership items for the portion of such year ending immediately before the liquidating distribution.

3. The amount of money considered distributed includes cash, marketable securities under section 731(c) (discussed herein), and any liabilities assumed or relieved as part of the distribution under section 752. As discussed below, this final item (liability relief) means that a distributee partner effectively treats the net amount of reduction in their share of partnership liabilities as a deemed distribution of money.

4. Gain is recognized only to the extent that the total money distributed exceeds the partner's adjusted basis. Generally, gain recognized under section 731(a)(1) is capital gain, unless section 751 applies (discussed as one of the nonrecognition exceptions herein). Treas. Reg. § 1.731-1(a)(1) provides several examples illustrating the calculation and recognition of gain, including scenarios involving multiple distributions, adjustments for liabilities, and the impact of marketable securities.

5. EXAMPLES:

(a) *Capital Gain Recognized*. Partner A has an adjusted basis of $50,000 in Partnership X. Upon liquidation, Partnership X distributes $60,000 in cash to Partner A. Under section 731(a)(1), Partner A must recognize a $10,000 gain ($60,000 cash minus $50,000 basis). This gain is generally treated as capital gain unless section 751 applies (as discussed further below).

(b) *Liability Relief as Money*. Partner B has a $25,000 basis in Partnership Y and has been allocated $20,000 of partnership liabilities. Upon liquidation of B's interest, B receives $10,000 in cash and is relieved of its $20,000 of liabilities. The total "money" distributed is deemed to be $30,000 ($10,000 cash plus $20,000 liabilities), so B recognizes a $5,000 capital gain.

(c) *Series of Distributions*. Partner C has an adjusted basis in Partnership D of $40,000. As part of a series of liquidating distributions, Partner C receives $20,000 in cash in year one, $15,000 in cash in year two, and $10,000 in cash in year three. C only recognizes gain in year three, when the cumulative distributions of $45,000 exceed C's outside basis of $40,000.

III. Basis of Distributed Property upon Liquidating Distribution

A. Basis of Distributee-Partner

1. Under section 732(b), which governs the determination of the basis of property distributed in liquidation of a partnership interest, if no gain or loss is recognized on a liquidating distribution, the partner's aggregate basis in the property received

equals the basis in the partner's partnership interest immediately prior to the distribution, reduced by the amount of cash and marketable securities distributed.

2. Section 732(c) governs the allocation of basis among distributed properties where (1) multiple properties are distributed in a liquidating distribution by a partnership or (2) the total aggregate basis of the properties distributed exceeds the partner's outside basis in their partnership interest. In the latter case, the partner's basis is allocated proportionately among the properties received, with special rules for inventory and unrealized receivables. In general, basis is allocated across the various distributed properties as follows:

- **(a)** First, the partner's outside basis in their partnership interest is reduced by the amount of cash and marketable securities received in the liquidating distribution. The remaining amount of basis is allocated across the distributed properties.

- **(b)** Next, any remaining outside basis is allocated to unrealized receivables and inventory distributed in an amount equal to the partnership-distributor's inside basis in each such asset.

- **(c)** Next, any further remaining outside basis is allocated to the other distributed assets (*i.e.*, those other than the unrealized receivables and inventory) in amounts equal to the partnership's adjusted basis in such assets.

- **(d)** Then, any basis increase (*i.e.*, the distributee partner's outside basis in excess of the partnership's inside basis in the distributed assets) is allocated to appreciated assets (other than unrealized receivables and inventory) in proportion to each asset's amount of unrealized appreciation, but not in excess of the fair market value of each asset.

- **(e)** Finally, any remaining basis increase is allocated to assets (other than unrealized receivables and inventory) in proportion to their fair market values.

3. Where a partner receives depreciable property as part of a liquidating distribution, the partner "steps into the shoes" of the distributor-partnership with respect to the remaining depreciation of such property. As such, the partner continues to depreciate such property according to its remaining useful life and depreciation method. This depreciation of basis only applies, however, to the extent the partner's basis in the property does not exceed the partnership's basis. Any amount of the distributee-partner's basis in such property that exceeds the distributor-partnership's basis is instead treated as newly-acquired property that has been placed in service at the time of the distribution and begins depreciation as such.

4. Under section 735(b), when receiving a distribution of property from a partnership (except for inventory items), the distributee partner adds (or "tacks") the partnership's own holding period with respect such property onto its own holding period going forward.

5. EXAMPLES:

(a) *Carryover of inside basis*. R is a partner in RST partnership with an adjusted basis in its partnership interest of $5,500. In liquidation of R's interest, RST distributes to R $1,500 cash plus real property with a fair market value of $5,000 that RST purchased. RST has an inside basis in the property of $3,000.

(i) R reduces its $5,500 adjusted basis in RST by the $1,500 of cash received. The remaining outside basis of $4,000 ($5,500 minus $1,500) becomes R's basis in the real property distributed. Even though the real property has a FMV of $5,000, R does not recognize any gain or loss under section 732.

(b) *Allocation of basis across properties received*. A is a 25% partner in partnership ABCD with an adjusted basis in its partnership interest of $650. In liquidation of A's partnership interest, ABCD distributes Asset X, Asset Y, and inventory to A. Asset X has a fair market value of $400 and inside basis to the partnership of $50. Asset Y has a fair market value of $100 and an inside basis to the partnership of $100. The inventory has a fair market value of $200 and inside basis to the partnership of $100.

(i) A does not reduce its basis for any cash received, Thus, A allocates its entire adjusted basis of $650 across Asset X, Asset Y, and the inventory. Under the ordering rules, A's $650 basis is allocated first to the inventory items in an amount equal to its inside basis (*i.e.*, $100). Then, A allocates its remaining basis of $550 to Asset X and Y. First, such basis is allocated in amounts equal to the inside bases of the assets - that is, $50 to Asset X and $100 to Asset Y. This leaves $400 left of A's basis to allocate. Next, basis is allocated to unrealized appreciation in the assets - here, $350 (FMV of $400 minus inside basis of $50) to Asset X. Finally, the remaining $50 of A's basis ($400 minus $350) is allocated between Asset X and Asset Y relative to their fair market values—here, $40 to Asset X and $10 to Asset Y (as Asset X is worth four times more than Asset Y). In sum, after the distribution A has an adjusted basis of $440 in Asset X and $110 in Asset Y (in addition to an adjusted basis of $100 for the inventory).

B. Basis of Distributor-Partnership & Remaining Partner: Sections 734 & Section 754

1. Upon a distribution of property by a partnership to a partner in liquidation of their interest, both the partnership itself and the remaining partners may be entitled to a basis adjustment to the remaining property owned by the partnership under section 734(b) to reflect the liquidated partner's share of the gain or loss inherent in the partnership's assets (inside basis). Such adjustment is permitted in order to prevent the redeemed partner's share of gain from being allocated inappropriately to the other remaining partners.

2. Such basis adjustment under section 734(b) *increases* the inside basis of the partnership's remaining assets for the benefit of the remaining partners by an amount equal to any *gain* recognized by the distributee partner and any basis decreases the distributee partner makes under section 732(b) (described above) to the assets distributed.

3. Conversely, the section 734(b) basis adjustment *decreases* the inside basis of the partnership's remaining assets by an amount equal to any *loss* recognized by the distributee partner and any basis *increases* the distributee partner makes under section 732(b) to the assets distributed.

4. The total amount of such basis increase or decrease to remaining partnership property is allocated among the bases of the partnership's remaining assets in accordance with the rules of Treas. Reg. § 1.755-1(c), which considers, among other things, the character of the remaining partnership property and the unrealized appreciation therein.

5. A partnership may generally only make such adjustments to the bases of its remaining property if it has made a section 754 election in effect for the tax year of the liquidating distribution. Under the rules of Treas. Reg. § 1.754-1, a section 754 election is made by filing a written statement with the partnership's tax return for the year in which the election shall take effect, and it remains in effect for all subsequent years unless revoked with IRS consent.

   (a) However, a negative section 734(b) basis adjustment is required under section 734(d), even if the partnership does not have a section 754 election in effect, if such downward adjustment would exceed $250,000.

6. EXAMPLES:

   (a) *Gain Recognition and Basis Increase*. Partnership T has a section 754 election in effect. Partner M receives a liquidating distribution and recognizes a $15,000 gain. Partnership T increases the basis of its remaining assets by $15,000 under section 734(b) and allocates such basis in accordance with the fair market values of such assets.

   (b) *Loss Recognition and Basis Decrease*. Partner N receives a liquidating distribution and recognizes a $300,000 loss. Partnership U decreases the basis of its remaining assets by $300,000, regardless of whether it has a section 754 election in effect by operation of section 734(d), and allocates such decreases in accordance with the remaining assets' fair market values.

IV. Exceptions to General Nonrecognition Treatment of Liquidating Distributions

A. Distributions of Marketable Securities – Section 731(c)

1. Section 731(c) treats distributions of "marketable securities" as distributions of money for purposes of determining gain recognition under section 731. This rule essentially creates parity between distributions of cash and of cash equivalents in order to prevent partners and partnerships from using section 731 to avoid ordinary

gain recognition by distributing items that can immediately be sold for cash instead of distributing actual cash.

2. Marketable securities are defined broadly in section 731(c)(2) to include stocks, bonds, and other readily tradable instruments, while certain securities held for business purposes are excluded from the definition of marketable securities under Treas. Reg. § 1.731-2(d). Treas. Reg. § 1.731-2(b) provides a comprehensive list of what constitutes marketable securities, including exceptions for certain partnership interests and business-use securities.

3. The amount of fair market value of marketable securities treated as "money" under section 731(c) is added to the amount of cash and other money distributed to determine the total amount of money distributed, and gain is recognized if the total exceeds the partner's basis.

4. However, the amount of marketable securities treated as money is reduced (but not below zero) by the distributee partner's share of the partnership's unrealized gain in the securities. Under this rule, the reduced amount of marketable securities included as money reflects the reduction in the distributee partner's share of partnership gain. This rule essentially serves to only treat as money the partner's disproportionate or non-pro rata share of the gain in the partnership's marketable securities.

(a) Under section 731(c)(3)(B), such reduction is the excess of (1) the distributee partner's share of net gain that would be realized if all the partnership's marketable securities held immediately *before* the distribution were sold, over (2) the distributee partner's share of the net gain that would be realized if all the partnership's marketable securities held immediately *after* the distribution were sold.

5. When gain is recognized in connection with the distribution of marketable securities under section 731(c), the basis of the distributed securities is equal to the basis that the distributee partner would have had under section 732 plus the amount of gain recognized. This basis is allocated among the distributed marketable securities in proportion to the unrealized appreciation thereof.

6. Treas. Reg. § 1.731-2 provides several exceptions to marketable securities rules, including the following:

(a) A distributee partner does not recognize gain on receipt of marketable securities that the partner itself contributed to the partnership.

(b) Certain securities which were not considered "marketable securities" for purposes of section 731(c) when they were acquired by the partnership are exempted if they later become "marketable securities" under the rules.

(c) Marketable securities are not treated as money under section 731(c) if (1) the marketable securities were acquired by a partnership in a nonrecognition transaction, (2) less than 20% of the property exchanged by the partnership in such transaction consisted of marketable securities, and (3) the marketable securities acquired are distributed within five years of the acquisition date (or date the securities became marketable).

(d) Section 731(c) does not apply to the distribution of marketable securities by an investment partnership (as defined in section 731(c)(3)(C)(i)) to an eligible partner (as defined in section 731(c)(3)(C)(iii)).

7. <u>EXAMPLES</u>:

(a) *Distribution of Marketable Securities*. Partner D has a $40,000 basis in Partnership Z. In liquidation of D's interest, Z distributes to D $30,000 in cash and marketable securities with a fair market value of $20,000. For purposes of section 731(a), the total "money" distributed is $50,000 ($30,000 cash plus $20,000 marketable securities). Therefore, D recognizes $10,000 of gain.

(b) *Reduction in Amount Treated as Money*. Partner A contributes Property with a fair market value of $500,000 and an adjusted basis of $125,000 to a partnership in exchange for a one-third partnership interest in ABC. Partners B and C contribute a combined $1,000,000 cash for the remaining two-thirds interest. ABC uses the cash to purchase three marketable securities. Several months later, Security #1 has a basis of $200,000 and a value of $250,000. Security #2 has a basis of $150,000 and a value of $200,000. Security #3 has a basis of $175,000 and a value of $150,000. Therefore, if the three securities were sold, the net partnership gain would be $75,000.

(i) In connection with a liquidating distribution of A's interest, ABC distributes Security #1 to A. The net gain in Security #2 and Security #3 after the distribution is $25,000 ($50,000 gain for Security #2 and $25,000 loss for Security #3). A's share of the net gain on the securities before the distribution was $25,000 (1/3 of $75,000), and A's share after the distribution is $0 (as its interest is liquidated). The distribution of Security #1 is treated as a distribution of money in an amount equal to its $250,000 fair market value reduced by the $25,000 reduction in Partner A's share of the net gain in the partnership's marketable securities—that is, $225,000. Partner A recognizes $100,000 of gain on the liquidating distribution (the excess of the $225,000 distribution of marketable securities treated as money over A's $125,000 adjusted basis in its interest).

B. Distributions of "Hot Assets" – Section 751

1. Section 751 addresses the distribution of so-called "hot assets," which generally include unrealized receivables (defined in section 751(c)) and inventory items (defined in section 751(d)) of the partnership. Such items are generally taxed at ordinary, not capital, rates.

(a) Unrealized receivables include rights (contractual or otherwise) to payment not otherwise previously included in income for goods (to the extent the proceeds therefrom would not be considered received from a sale or exchange of a capital asset) or services, or other enumerated items in section 751(c).

(b) Inventory items include section 1221(a)(1) property and other partnership property which is not a capital asset or section 1231 property.

2. Section 751(b) provides that for a partner receiving a distribution of partnership property which is unrealized receivables or substantially appreciated inventory (together, "section 751(b) property"), in exchange for or all of a part of the partner's interest in other partnership property (including money), or vice versa (*i.e.*, receives partnership property or money in exchange for section 751(b) property), such distribution will be treated as a sale or exchange of such property between the partner and the partnership.

(a) Formally, Treas. Reg. § 1.751-1(b)(3) deems that first, the partner is treated as receiving a non-liquidating distribution of their share of the receivables, then the partner is deemed to sell the receivables back to the partnership in exchange for cash, with such cash being taxed as ordinary income. Note that proposed regulations issued in 2014 (but never finalized) provide more flexibility than the exiting final regulations.

3. Essentially, therefore, section 751(b) operates to require sale treatment on a distribution where the partner receives more than its pro rata share of hot assets in exchange for receiving a lesser share in all other assets, or vice versa (receives more than the pro rata total share of other assets for a lesser share of hot assets).

4. The purpose of the section 751 rules is to prevent the shifting of ordinary income between partners (as the "hot asset" items defined in section 751 are considered equivalent to ordinary items), and therefore the rules apply to recharacterize the portions of distributions attributable to such "hot assets" as a sale or exchange generating the ordinary gain underlying such ordinary items.

5. When a liquidating distribution includes both hot assets and other property, gain must be allocated based on the relative fair market values of each type of property (section 751 and non-section 751 property) and the respective partnership bases of the assets.

6. When a partner receives a distribution of hot assets as part of a liquidating distribution, any gain attributable to such assets is recognized by the partners as ordinary income rather than capital gain, regardless of the partner's holding period or basis in such item. Treas. Reg. § 1.751-1 provides rules for calculation of the ordinary gain amounts, and allocation of such gain among distributed assets.

7. Subsequent sales of distributed property.

(a) Section 735(a) generally provides rules for the tax treatment of gain associated with sales of certain hot asset items after such items are distributed by a partnership to a partner. Specifically, gain or loss on a subsequent sale of section 751(c) unrealized receivables received by a distributee partner will be treated as ordinary income. Section 751(d) inventory items are treated in the same way, regardless of any holding period, but only if sold or exchanged within five years of the original distribution to the partner.

(b) In both cases, if such property is subsequently disposed in a nonrecognition transaction, such ordinary gain rules will apply to any substituted basis property received in exchange in the nonrecognition transaction (except for corporate stock received in a section 351 transaction).

8. EXAMPLES:

(a) *Disproportionate Distribution of Cash*. Partnership XYZ is owned equally by Partners X, Y, and Z. Each partner has an adjusted basis in their partnership interest of $1,000. XYZ owns $3,000 of cash and a $3,000 unrealized receivable (a "hot asset") with a zero basis. XYZ distributes $2,000 cash to Z in liquidation of Z's interest.

(i) Because Z receives $2,000 of cash instead of his proportionate share of property (i.e., $1,000 of cash and $1,000 of receivable), Z is deemed to, in effect, be exchanging his proportionate $1,000 receivable for $1,000 cash.

(ii) Under Treas. Reg. § 1.751-1(b)(3)(iii), Z is deemed to receive a current distribution of Z's share of the receivable (*i.e.*, $1,000). Since the basis of such receivable is zero, Z's outside basis is not reduced.

(iii) Then, Z is deemed to sell back the receivable to XYZ for $1,000 of cash (what Z actually received in the liquidating distribution instead of the $1,000 receivable). Z recognizes $1,000 of ordinary income on such deemed taxable exchange.

(iv) Then, the remaining $1,000 of cash distributed to Z reduces Z's $1,000 outside basis in XYZ to zero, with no gain or loss recognized in addition to the $1,000 of ordinary income.

(b) *Distribution of Inventory*. Partnership ABC is owned equally by partners A, B, and C. Partner A's adjusted basis in the partnership interest is $1,000. In liquidation of A's interest, ABC distributes to A $500 in cash and $500 of inventory with inside basis to the partnership of $300. The $500 of inventory is A's pro rata share of ABC's section 751(b) property, so that there is no deemed exchange under section 751(b). The $500 cash distribution reduces A's outside basis from $1,000 to $500. A's basis in the inventory is limited to the ABC's pre-distribution inside basis of $300. Therefore, there is $200 of excess basis after A's adjusted basis of $1,000 is reduced by $500 of cash and $300 basis of inventory. Thus, A recognizes a capital loss of $200. A subsequent sale of the inventory by A will generate ordinary income, just as the gain on the inventory when distributed to A was ordinary in character as section 751(b) property.

C. Distributions of Built-In Gain Property – Section 737 and Section 704 Mixing Bowl Rules

1. The mixing bowl rules of section 704(c)(1)(B) and section 737 prevent partners from using a partnership to exchange property between themselves through nonrecognition transactions with the partnership when such exchange would otherwise be taxable. The rules therefore operate to trigger income recognition to a partner receiving certain property distributions from the partnership, including if the distributee partner had previously contributed section 704(c) property (*i.e.*, property which at the time of contribution has a fair market value that differs from the contributing partner's adjusted tax basis) to the partnership.

2. Section 704(c) governs a mixing bowl transaction where built-in gain property contributed by one partner is distributed to a different partner.

(a) Under section 704(c)(1)(B), if section 704(c) property is distributed by the partnership (other than to the contributing partner) within seven years of being contributed, the contributing partner will recognize gain or loss equal to the amount of gain or loss the contributing partner would be allocated under section 704(c)(1)(A) had the partnership sold the section 704(c) property at its fair market value on the date of the distribution. The section 704(c)(1)(A) amount allocable to the contributing partner is equal to the property's remaining built-in gain or loss.

(b) Unlike in most other partnership distribution scenarios, where the partner receiving the distribution is generally the party recognizing gain, section 704(c)(1)(B) requires the partner that contributed the section 704(c) property, not the partner receiving the distribution, to recognize income.

3. Conversely, section 737 governs distributions of *other* property to the *same* partner who contributed built-in gain property.

(a) Section 737 generally provides that a partner who previously contributed built-in gain property to a partnership, upon a distribution of other property to such partner, recognizes any precontribution gain on the original contributed property to the extent that the value of property subsequently distributed to the partner exceeds the partner's adjusted basis.

(b) Section 737 applies whether or not the distribution causes the partner's interest in the partnership to be reduced. However, like section 704(c)(1)(B), section 737 does not apply if the subsequent distribution occurs more than seven years after the partner originally contributed the built-in gain property.

4. Both sections 704(c)(1)(B) and 737 are subject to a number of regulatory exceptions such as:

(a) Partnership incorporations.

(b) Certain partnership divisions.

(c) A complete transfer to another partnership.

5. EXAMPLES:

(a) *Same Property, Different Partner*. Partner A acquires an interest in Partnership ABC by contributing Property X, nondepreciable real property, to the partnership. Property X has FMV of $10,000 and adjusted basis of $4,000 and thus is section 704(c) property. Three years later, when Property X is still worth $10,000 and has an adjusted basis of $4,000, Partnership ABC distributes Property X to Partner C in liquidation of Partner C's interest in the partnership. Partner A would recognize gain under section 704(c)(1)(B) since Property X was distributed to Partner C within seven years. The amount of gain that Partner A would recognize, as determined under section 704(c)(1)(A) is $6,000.

(b) *Different Property, Same Partner*. Partner A acquires an interest in Partnership ABC by contributing Property Y, nondepreciable real property, to the partnership. Property Y has FMV of $10,000 and adjusted basis of $4,000 and thus is section 704(c) property. Partner B contributes Property Z, also nondepreciable real property, that has both FMV and adjusted basis equal to $30,000 (*i.e.*, not section 704(c) property), to Partnership ABC in the same year. Five years later, when Partner A's interest is worth $30,000, Partnership ABC distributes Property Z to Partner A in liquidation of A's partnership interest. At the time of the distribution, Property Z's FMV is still $30,000, and Partner A's adjusted basis in their partnership interest is $20,000. Partner A would be required to recognize a gain of $6,000 under section 737, which is A's net precontribution gain, since that amount is less than the excess distribution amount of $10,000 (*i.e.*, $30,000 minus $20,000).

D. Distributions of Property Subject to Liabilities – Section 752

1. Section 752 governs the treatment of partnership liabilities. In general, section 752(a) provides that any increase in a partner's share of liabilities of a partnership is considered a contribution of money by the partner, thereby increasing the partner's basis under section 705.

2. Section 752(b) provides that any decrease in a partner's share of partnership liabilities (or its share of individual liabilities upon assumption by the partnership) is considered a distribution of money to such partner. To the extent such deemed distribution exceeds a partner's outside basis, gain is recognized under section 731(a). Therefore, as described above, when a partner is relieved of partnership liabilities as part of a liquidating distribution, such amount of liability reduction is treated as a distribution of money, potentially triggering gain recognition under section 731(a).

(a) Treas. Reg. § 1.752-1 provides rules for, among other things, determining the amount of partnership liabilities allocated to each partner and netting increases and decreases in liabilities resulting from the same transaction.

3. The partner's share of partnership liabilities for such purposes is determined immediately before the distribution. The amount of such liability relief is added to cash and other money distributed to determine if gain is recognized under section 731(a).

4. When and how a liability is deemed relived (and therefore is considered a deemed distribution of cash) depends on whether the liability is a "recourse liability" or a "nonrecourse" liability. Treas. Reg. § 1.752-2 and -3 provide rules for allocating recourse and nonrecourse liabilities, respectively, among partners.

5. A deemed distribution of liability relief in respect of a *recourse liability* occurs when the distributee partner no longer bears the "economic risk of loss" for such recourse liability.

(a) Under Treas. Reg. § 1.752-2(b), a partner is generally considered to bear the economic risk of loss for a partnership liability to the extent that, if the partnership were constructively liquidated, the partner would be obligated to make a payment due without entitlement to reimbursement by another partner (or related person). This "constructive" or "hypothetical" liquidation assumes that (1) all partnership's liabilities become payable in full; (2) with the exception of property contributed to secure a partnership liability, all of the partnership's assets, including cash, have a value of zero; (3) the partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to repayment is limited solely to one or more assets of the partnership); (4) all items of income, gain, loss or deduction are allocated among the partners; and (5) the partnership liquidates.

6. On the other hand, a deemed distribution of liability relief in respect of a *nonrecourse liability* occurs when the distributee partner no longer has a share in such nonrecourse liability as computed under the three "tiers" of Treas. Reg. § 1.752-3(a).

(a) In brief, under such rules, a partner's share of partnership nonrecourse liabilities equals the sum of (1) the partner's share of partnership minimum gain (under the rules of section 704(b)), (2) the amount of taxable gain allocated to the partner under section 704(c) (or equivalent) if the partnership disposed of all of its property subject to a nonrecourse liability in a taxable transaction in full satisfaction of such liabilities and no other consideration; and (3) the partner's share of the "excess nonrecourse liabilities" of the partnership as determined in accordance with the partner's share of partnership profits.

7. EXAMPLES:

(a) *Liability Relief as Money*. Partner O has a $30,000 adjusted basis in Partnership W and is allocated $20,000 of partnership liabilities of W. In liquidation of O's interest, W distributes to O $10,000 in cash and O is relieved of its $20,000 of partnership liabilities of W. The total "money" distributed under section 752(b) is $30,000 (*i.e.*, $10,000 cash plus

$20,000 of liability relief). Partner O has no gain or loss on the liquidating distribution.

(h) *Distribution of Encumbered Property*. Partnership ABC owns real property subject a $100,000 mortgage. Partner C is a 50% partner of ABC and has an adjusted basis in ABC of $100,000. ABC distributes the real property subject to the mortgage to C in liquidation of C's interest. Under section 732(b), building takes a substitute basis equal to C's adjusted basis in ABC reduced for any money distributed. Here, C's basis of $100,000 is increased by the assumption of the $100,000 mortgage under section 752(a) (to $200,000). Then, C's has a deemed distribution of $50,000 (*i.e.*, the amount of reduction in C's share of partnership liabilities) under section 752(b), such that the basis of the building is reduced from $200,000 to $150,000 (*i.e.*, the adjustments are netted).

E. Disguised Sales – Section 707

1. As discussed above, with exceptions, both contributions to and distributions from a partnership are generally nonrecognition events for U.S. federal income tax purposes. A contribution of property by a partner to a partnership is generally tax-free under section 721, and a distribution of property from a partnership to a partner is generally tax-free under section 731.

2. Section 707(a)(2)(B) and related regulations address "disguised sales" of property between a partner and partnership, which are generally not afforded such nonrecognition treatment under sections 721 and 731. A disguised sale occurs when a partner contributes money or property to a partnership and receives a distribution of money or other property in exchange, under circumstances that indicate that in substance, a sale or exchange has occurred between the partner and the partnership, (rather than a contribution to and a distribution from the partnership).

3. The purpose of the disguised sale rules is to prevent partners from structuring otherwise taxable sales or exchanges with a partnership as purported contributions to and distributions from a partnership to inappropriately exploit the nonrecognition treatment of sections 721 and 731. The preamble to the section 707 disguised sale regulations highlights that section 707(a)(2) "grants the Secretary broad regulatory authority to identify those transactions that, though structured as contributions and distributions under sections 721 and 731, are more properly treated under section 707(a) as sales or exchanges."

4. In the context of liquidating distributions, therefore, if a liquidating distribution is found, when viewed together with a corresponding contribution to a partnership, to be a sale or exchange of property in substance, the nonrecognition treatment otherwise afforded the liquidating distribution under section 731 does not apply and the transfer is instead treated as a taxable sale of such property.

5. Determining whether a contribution and distribution should be considered a disguised sale is based on the facts and circumstances of each set of facts. Treas. Reg. § 1.707-3 provides a nonexclusive list of facts and circumstances that will be considered, depending upon the situation. Some of these factors include:

(a) Whether the timing and amount of the subsequent transfer to the contributing partner are determinable with reasonable certainty;

(b) Whether the transferor partner has a legally enforceable right to the subsequent transfer by the partnership;

(c) Whether the right to receive the subsequent transfer of money or other consideration by the partnership is secured; and

(d) Whether the transfer of money or other consideration is disproportionately large relative to the partner's continuing interest in partnership profits.

6. Certain transactions have a presumption of disguised sale treatment. For example, a transfer of property from a partnership to a partner that occurs within two years of a prior transfer of money by such partner to the partnership is presumed to be a disguised sale unless the facts and circumstances clearly establish that such transfers do not constitute a sale.

7. Conversely, however, certain transactions are presumed *not* to be a disguised sale unless the facts and circumstances clearly establish otherwise. Treas. Reg. § 1.707-4 provides safe harbors under which certain distributions that are bona fide, legitimate partnership transactions are respected and not implicated in the disguised sale rules. Such exceptions include:

(a) Transfers occurring more than two years apart;

(b) Reasonable guaranteed payments;

(c) Reasonable preferred returns;

(d) Distributions of operating cash flow;

(e) Reimbursements of preformation capital expenditures; and

(f) Debt-financed distributions.

8. Partial disguised sales can be found in certain cases depending on the fair market value of the property contributed to a partnership relative to the amount of money or other consideration received by the partner in a subsequent distribution. A partner deemed to sell only a portion of certain property to the partnership in a disguised sale is considered as contributing the remaining portion under section 721 in a nonrecognition transaction (subject to other exceptions).

9. EXAMPLES:

(a) *Presumed Disguised Sale*. Partner R contributes appreciated property to Partnership T and, several months later, R receives a distribution of other partnership property from T. Because R's contribution and the T's distribution are within two years, the distribution of property is presumed to be a sale unless the facts and circumstances clearly establish otherwise. In such case, the transaction is recharacterized as a sale, and Partner R must recognize gain on the appreciated property. R may be able to rebut such presumption and avoid disguised sale treatment by showing, for example, that its contribution to T was made to supply permanent capital to meet a legitimate business need of the partnership, or that the property distributed by T was an integral part of the partnership's operations at the time of the contribution but unexpectedly became redundant and was therefore distributed to R independent of the initial contribution by R.

(b) *Safe Harbor Exception*. Partner S contributes property to Partnership U and receives a distribution of cash a year later because Partnership U has generated profit from its business operations. Under the operating cash flow distribution presumption of Treas. Reg. § 1.707-4(b), the distribution may not be treated as a disguised sale unless the facts and circumstances clearly establish otherwise.

F. Distributions to Corporate Partners – Section 732(f)

1. A distributee partner that is a corporation may recognize gain under the rules of section 732(f) if such partner receives, in a partnership distribution, stock of another corporation and such corporate partner controls (within the meaning of section 1504(a)(2)) such distributed corporation after the partnership distribution. Specifically, in such case, if the partnership's adjusted basis in the stock of the distributed corporation exceeds the corporate partner's adjusted basis in the same stock, then the basis of the distributed corporation's property is reduced (with certain limitations). If such reduction exceeds the aggregate adjusted bases of the property of the distributed corporation, then the corporate partner recognizes such excess as long-term capital gain, and increases its adjusted basis in the stock of the distributed corporation by the amount of such excess.

2. A distributee corporate partner may also recognize gain under the rules of section 337(d) if such corporate partner receives its own stock in distribution by a partnership.

3. EXAMPLE:

(a) *Distribution of Stock to Corporate Partner*. Partnership L has two partners, M, an individual, and N, a corporation. N's adjusted basis in L is $100,000. L owns, among other assets, stock of corporation O with inside basis to L of $150,000. O's basis in its own assets is $40,000. In liquidation of N's partnership interest, L distributes its O stock to N, and after the distribution., N owns 100% of O.

(i) Section 732(f) applies because N controls O after the liquidating distribution. L's inside basis in O exceeds N's carryover basis in the O stock (*i.e.*, its own adjusted basis of $100,000) by $50,000, and therefore the basis of O's assets are reduced (but only by $40,000), resulting in N recognizing $10,000 of capital gain. N increases its adjusted basis of its O stock by such $10,000 excess.

V. Alternative Nonrecognition Partnership Exit Strategies

A. Leveraged Distributions

1. A leveraged distribution (or debt-financed distribution) by a partnership can be used as an alternative to a taxable distribution to a partner in cases where, for example, the partner does not have enough outside basis to absorb a liquidating cash distribution under section 731(a). When properly structured, a leveraged distribution permits a partnership to distribute cash proceeds of a loan to a partner tax-free, which allows the distributee partner to unlock the value of their partnership interest without recognizing gain.

2. EXAMPLE:

(a) Partner A and Partner B form Partnership AB. A contributes appreciated assets with basis of $1,000 and fair market value of $10,000 in a section 721 nonrecognition transaction in exchange for a 50% interest in AB. B contributes cash of $10,000 in exchange for the other 50% interest in AB.

(b) A wishes to unlock the value of A's appreciated assets contributed to AB without taking a distribution from AB or triggering the disguised sale rules of section 707. A leveraged distribution by the partnership accomplishes this through the following steps:

(i) AB obtains a nonrecourse loan in the amount of $10,000.

(ii) A personally guarantees the full amount of the loan, and therefore A's basis in AB increases by $10,000 (the amount of the loan guarantee). Such guarantee ensures that A bears the "economic risk of loss" for purposes of Treas. Reg. § 1.752-2(b) (as discussed above), which ensures that A may properly take basis credit for the full amount of the loan (as A's allocable share of the partnership liability) and ensures the transaction will not be treated as a disguised sale.

(iii) AB distributes the $10,000 proceeds of the loan to A, decreasing A's basis in AB by a corresponding $10,000. If such distribution is made within 90 days and is traceable to proceeds of the loan pursuant to Treas. Reg. § 1.707-5(b)(1) and Treas. Reg. § 1.163-8T, the distribution qualifies under the debt-financed distribution exception to the disguised sale rules and is tax-free to A. Note that such tax-free treatment is limited to the amount A's basis in AB - if the amount of the loan proceeds distributed to A exceeded A's basis in AB, A would recognize gain in the amount of such excess.

(c) A now has loan proceeds to use for A's own purposes without having to recognize the gain from the appreciated asset A contributed to AB. To maximize the tax deferral, the loan could be structured as an interest-only loan with a balloon payment at the end of the loan term. However, to the extent AB makes principal payments on the loan, such payments are considered deemed distributions to A in the amount of the corresponding debt reduction of such payment. Such deemed distributions would further reduce A’s basis in AB, and would trigger gain to the extent they exceed A’s basis.

B. Purchase and Distribution of Property by Partnership

1. Another gain deferral strategy may be available where a partner seeking redemption from a partnership has identified the asset or property which it ultimately seeks to acquire with the proceeds of the liquidating distribution.

2. Where such item can be identified prior to the liquidating distribution, a direct purchase and distribution of such property by the partnership itself can defer gain recognition by the redeemed partner and allow the partner to transfer its outside basis in the partnership over to the new property rather than recognizing gain (reducing the proceeds available to purchase such property).

3. Note, however, that this asset cannot be a marketable security subject to section 731(c). Also, the IRS has disclaimed this strategy in at least one Chief Counsel Advisory under certain facts.

(a) In CCA 200650014, the IRS determined that a residential home purchased by a partnership pursuant to a redemption agreement with a certain partner and distributed to that partner was not considered “partnership property” for purposes of section 731 and therefore did not qualify for carryover basis treatment. Instead, the home was considered to have been acquired and held for the account of the partner at the time the partnership acquired it.

(b) Specifically, the IRS articulated the principle that under these facts “a carryover basis is not appropriate for a unique parcel of residential property that was apparently selected by the distributee, acquired by the partnership immediately before the distribution, solely for the purpose of the distribution, and was unrelated to the partnership's business activities.”

(c) Therefore, it is important to consider the extent to which the use of this strategy may line up with these factors and risk a finding that the property distributed to the partner in such liquidating distribution is not considered “partnership property” for purposes of section 731.

(d) However, the IRS also noted that here, the partnership was likely never the owner of the house for USFIT purposes, since a significant portion of the purchase price home was provided by borrowed funds and immediately repaid by the Taxpayer. This fact may be helpful to distinguishable when evaluating structuring considerations for this strategy.