QUIZ INSTRUCTIONS

PARTNERSHIP TAXATION - PART II

There are 7 true-false quiz questions and 23 multiple-choice questions at the end of the course. Choose the **best** answer based on the limited facts of each question, and record your answer on the enclosed answer sheets. An extra answer sheet below is enclosed for your personal records. The answer sheet to be turned in is on the next page. **If you would like to complete the test on-line, go to [www.cpelite.com](http://www.cpelite.com) and click “On-Line Testing.”**

You must score 70% to receive continuing professional education credit for this course. You may take the quiz two additional times without incurring additional expense.

**If your zip code is below 56000**, please return your completed answer sheet to CPElite, P. O. Box 721, White Rock, SC 29177-0721. **If your zip code is above 55999**, please return your completed answer sheet to CPElite, P.O. Box 1059, Clemson, SC 29633-1059. After you successfully complete the quiz, your quiz results, a complete set of solutions, and a certificate of completion will be mailed to you within 10 working days of our receipt of your answer sheet. The **completion date** on your answer sheet will be the date designated on your certificate. **The latest recommended completion date is within one year of purchase.**

**ANSWER SHEET FOR YOUR RECORDS**

PARTNERSHIP TAXATION - PART II

6 HOURS OF CPE

(Based on 50 Minutes of Average Completion Time Per Hour)

Delivery Method – Self Study

(Latest Recommended Completion Date: Within one year of purchase)

Please record your answers below and **retain this copy for your records.**

1. _______    7. _______    13. _______    19. _______    25. _______
2. _______    8. _______    14. _______    20. _______    26. _______
3. _______    9. _______    15. _______    21. _______    27. _______
4. _______    10. _______    16. _______    22. _______    28. _______
5. _______    11. _______    17. _______    23. _______    29. _______
6. _______    12. _______    18. _______    24. _______    30. _______

We appreciate your business and hope that you were satisfied with the course.

**COMPLETION DATE** ________________________________
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We appreciate your business and hope that you were satisfied with the course. Please express below your comments on course quality, other topics you would like, or our other products and services.

1. _______ 7. _______ 13. _______ 19. _______ 25. _______
2. _______ 8. _______ 14. _______ 20. _______ 26. _______
3. _______ 9. _______ 15. _______ 21. _______ 27. _______
4. _______ 10. _______ 16. _______ 22. _______ 28. _______
5. _______ 11. _______ 17. _______ 23. _______ 29. _______
6. _______ 12. _______ 18. _______ 24. _______ 30. _______

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COMPLETION DATE ________________________________

PURPOSE OF CPE ________________________________ PTIN (if applicable) ___________

(Course Evaluation) (Answer Yes, No, or N/A)

1. The stated learning objective was met. _______ 2. Handout or advance preparation materials were satisfactory._______ 3. The materials were accurate._______ 4. The materials were relevant and contributed to the achievement of the learning objective._______ 5. If applicable, prerequisite requirements were appropriate._______ 6. The time allotted to the learning activity was appropriate._______ 7. Additional Comments ____________________________
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Recommended CPE Credit: 6 HRS [B]

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**QUIZ QUESTIONS**  
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ONGOING DEVELOPMENTS

CPElite™ CONTINUES TO MONITOR LEGISLATIVE, ADMINISTRATIVE, AND JUDICIAL DEVELOPMENTS AS THEY OCCUR, AND OUR COURSES ARE UPDATED AT LEAST ANNUALLY TO REFLECT TAX LAW CHANGES.
PARTNERSHIP TAXATION - PART II

The primary objectives of this course are to provide an explanation of the special topics involving partnership operations and the tax implications of sales of partnership interests, partnership distributions, redemptions of a partner’s interest as well as other changes in partnership interests. This course reflects legislative changes made through the "Middle Class Tax Relief and Job Creation Act of 2012," signed by President Obama on February 22, 2012.

The level of knowledge expected to be imparted by this course is basic. Our courses comply with the enhanced standards required of providers of continuing professional education (the Statement of Standards for Continuing Professional Education (CPE) Programs, issued jointly by the AICPA and NASBA). Specifically, the pass rate percentage for our courses is 70%, our courses contain the required minimum number of quiz questions per CPE hour (5), and our courses contain the required minimum number of review questions per CPE hour (5).

A. PARTNERSHIP OPERATIONS – SPECIAL TOPICS

Section C of the first partnership taxation course covered basic concepts of partnership operations. Most of the partnership rules governing the preparation of a partnership income tax return were explained. In Section A of this course, we cover less common transactions that will either effect the computation of partnership income or the allocation of partnership income to its partners.

A.1 Mandatory Allocations With Respect to Contributed (Section 704(c)) Property

Normally, a partner’s share of partnership income or loss equals the total amount of the partnership income or loss times the partner’s percentage interest in income or loss as specified in the partnership agreement. One major exception to this rule involves property contributed by a partner to the partnership.

When a taxpayer contributes property to a partnership, seldom does the fair market value of the property equal its basis at the time of contribution. Since the contributing partner generally recognizes no gain or loss from the property contribution and the basis of the property carries over
to the partnership, there exists a built-in gain or loss at the time of the contribution. If there were no specific provision to allocate any pre-contribution gain or loss recognized from the sale of this property by the partnership, each partner would report his pro rata share of gain or loss in the year the partnership disposed of the property.

Example 1

Gregory Gaines contributes land worth $60,000 to a partnership in exchange for a one-third partnership interest. The basis of the land at the time of contribution was $45,000. Three years later, the partnership sells the land for $69,000.

Since the partnership's basis in the land equals $45,000 (carryover basis), the partnership realizes a $24,000 ($69,000 - $45,000) gain from its sale. Without Section 704(c), Gaines's distributive share of the gain would equal $8,000 ($24,000/3). The remaining $16,000 would be allocated to the other partners.

The remaining partners might be quite surprised to find out that they had to report $16,000 of gain at the time of sale when only $9,000 of appreciation had occurred since the land was transferred to the partnership. To correct for this potential inequity, as well as to close the potential for high bracket taxpayers to shift income to low bracket taxpayers by contributing highly appreciated property to the partnership, Section 704(c), requires that income, gain, loss, and deduction must be shared among the partners so as to take account of the variation between the basis of the property and its fair market value at the time of contribution. As a result of this provision, partnerships must account separately for partner contributions of property. Implicit in this provision is that the fair market value of the property has been established at the time of contribution. As the following example illustrates, any pre-contribution gain or loss must be allocated to the contributing partner.

Example 2

Assume the same facts as Example 1. Of the $24,000 of gain realized by the partnership, $15,000 ($60,000 - $45,000) represents pre-contribution gain and $9,000 ($24,000 - $15,000) represents post-contribution gain. As a result of the sale, Gaines' distributive share of income under Section 704(c) equals $18,000, computed as follows:

| Pre-contribution Gain (100% x $15,000) | $15,000 |
| Post-contribution Gain (33 1/3% x $9,000) | 3,000 |
| Total Gain Recognized by Gaines | $18,000 |

TAX SAVER!! Valuation of the property at the time of contribution is the key in determining pre-contribution gain or loss. Since valuation is subjective and has a range of values that would be deemed to be reasonable, some shifting of gain or loss from the contributing partner to the other partners is still possible.
Tangible property is not the only type of property subject to Section 704(c). Income and deduction items also must be allocated to take into consideration the disparity between basis and fair market value at the time of contribution. For example, if the taxpayer contributes accounts receivable with a zero basis, all of the income arising from the collection of the accounts receivable must be allocated to the contributing partner. Similarly, if the partnership assumes a cash basis partner's trade accounts payable, any deductions attributable to the partnership's payment of the accounts payable must be allocated to the contributing partner.

The Treasury regulations refer to pre-contribution gains and losses as built-in gains and losses. Built-in gain on section 704(c) property is defined as the excess of the property's book value over the contributing partner's adjusted tax basis upon contribution. If the property is depreciable property, the built-in gain is reduced each year by the difference between the property's book depreciation and tax depreciation. Built-in losses are similarly defined as the excess of the contributing partner's adjusted tax basis over the property's book value upon contribution. As discussed above, it includes accounts payable and accrued liabilities contributed by a partner who reports on the cash basis of accounting.

Example 3

Gene Manning, who reports on the cash basis of accounting contributes accounts receivable valued at $20,000 and depreciable equipment valued at $25,000 (basis $15,000) to the ABC Partnership. He also contributes $12,000 pf accounts payable.

Because Gene reports on the cash basis of accounting, the basis of the accounts receivable is zero. Therefore, he has $20,000 of built-in gain from the accounts receivable. He also has $10,000 ($25,000 - $15,000) of built-in gain from the equipment and a $12,000 built-in loss from the accounts payable. His net built-in gain is $18,000 ($20,000 + $10,000 - $12,000).

A.11 Traditional Method

The Treasury regulations provide three methods of allocating gain, losses, income and deduction from Section 704(c) property. The two most popular – the traditional method and the traditional method with curative allocations – are covered in this course. In general, the traditional method requires that when the partnership has income, gain, loss, or deduction attributable to Section 704(c) property, it must make appropriate allocations to the partners to avoid shifting the tax consequences of the built-in gain or loss. Under this rule, if the 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. If the partnership sells a portion of, or an interest in, Section 704(c) property, a proportionate part of the built-in gain or loss is allocated to the contributing partner.\(^4\)

The ceiling rule limits the amount of built-in gain or loss to the contributing partner to the gain or loss actually realized from the disposition of the property.\(^5\) In addition, as discussed later, the ceiling rule limits the maximum amount of depreciation that can be allocated to noncontributing partners to the actual depreciation expense claimed by the partnership.

Example 4

Arlene contributed land worth $40,000 to a partnership in exchange for a 40% partnership interest. The basis of the land at the time of contribution was $30,000. Two years later, the property was sold for $35,000.

Had Arlene been required to recognize the built-in gain at the time of the property contribution, she would have recognized $10,000 of gain ($40,000 - $30,000) and the basis of the land would have been $40,000. The sale would have resulted in a loss of $5,000 ($35,000 - $40,000) of which a $2,000 (40% x $5,000) loss would be allocated to Arlene and a $3,000 loss would be allocated to the remaining partners.

Because no gain was actually recognized at the time of the contribution, the partnership's basis of the property equals $30,000. Consequently, the sale results in a $5,000 gain. Under the ceiling rule, the amount of built-in gain allocated to Arlene is limited to the realized gain of $5,000. A more equitable allocation is an $8,000 gain to Arlene ($10,000 built-in gain less a $2,000 loss to Arlene reflecting the decline in value of the property after the contribution) and a $3,000 loss to the remaining partners. The ceiling rule prevents such an allocation under the traditional method of allocation. As discussed in Section A.12, the traditional method with curative allocations allows additional allocations of income and loss to be made to correct for the disparities caused by the ceiling rule.

With respect to the allocation of depreciation, the regulations require that all partners other than the contributing partner be allocated depreciation based on the fair market value of the property at the time of contribution.\(^6\) If there is any depreciation in excess of this amount, it is allocated to the contributing partner. The amount of built-in gain for depreciable property is reduced each year generally by the amount of depreciation that the contributing partner is "giving up." The amount of the built-in gain each year is calculated by subtracting the basis of the property from the book value of the asset (fair market value of the property at the time of contribution less depreciation based on its original fair market value).

Example 5

Assume that Lefty contributes equipment (depreciable property) to a partnership in exchange for a 25% interest in the LA partnership. The equipment is worth $40,000 and its basis is $32,000. Assume that the remaining recovery period of the asset is four years and straight-line depreciation is used. The other partner Angie, contributes $120,000 in cash for a 75% interest in the LA partnership.
For each year, the partnership holds the equipment, $8,000 ($32,000/4) of tax depreciation would be deducted by the partnership and allocated to the partners. Absent any special provision, Lefty would be allocated $2,000 ($8,000 x 25% interest) of depreciation expense and Angie would be allocated $6,000 ($8,000 x 75%). However, the regulations require the allocation of depreciation to the noncontributing partners as if the basis were equal to the fair market value of the property at the time of contribution. Annual depreciation based on book value would be $10,000 ($40,000/4 years) and Angie’s share of the depreciation is $7,500 ($10,000 x 75%). While Lefty’s book depreciation equals $2,500 ($10,000 x 25%), his tax depreciation allocation equals $500 ($8,000 - $7,500). Thus, regardless of whether the property appreciates or depreciates, Lefty’s share of depreciation is whatever is left after allocating the "fair market value or book" depreciation to the other partners.

The built-in gain at the time of contribution was $8,000 ($40,000 - $32,000). After one year of depreciation, the book value is $30,000 ($40,000 - $10,000) and the basis is $24,000 ($32,000 - $24,000). Thus, the built-in gain after year one is $6,000 ($30,000 - $24,000). This corresponds to the $2,000 of depreciation that Lefty has "given up." That is, if the property contribution would have been a taxable exchange, its basis would be $40,000 and the tax depreciation each year would be $10,000 of which Lefty’s share would be $2,500. Assuming that the first year’s income before depreciation is zero, the partner’s capital accounts and basis in partnership interest would look as follows:

<table>
<thead>
<tr>
<th></th>
<th>Lefty</th>
<th>Angie</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>Basis</td>
<td>Book</td>
</tr>
<tr>
<td>Capital Contribution</td>
<td>$40,000</td>
<td>$32,000</td>
</tr>
<tr>
<td>Year 1 depreciation</td>
<td>( 2,500)</td>
<td>( 500)</td>
</tr>
<tr>
<td>Ending Balance</td>
<td>$37,500</td>
<td>$31,500</td>
</tr>
<tr>
<td>Book Value Less Basis</td>
<td>$6,000</td>
<td>-0-</td>
</tr>
</tbody>
</table>

Notice that after year 1, the difference between Lefty’s book value and basis of his capital interest is $6,000, which is equal to the equipment’s built-in gain after Year 1. In essence, the $8,000 built-in gain is being "amortized" over a four-year period. That is, in lieu of recognizing $8,000 of gain at the time of contribution, Lefty is allocated $2,000 less of depreciation deductions for four years.

**Example 6**

Assume the same facts as Example 5 except the value of the equipment is $48,000 and that Angie’s cash contribution is $144,000. Book depreciation is $12,000 ($48,000/4) and tax depreciation is still $8,000 ($32,000/4). Angie’s share of book depreciation is $9,000 ($12,000 x 75%). However, under the ceiling rule, her share of tax depreciation is limited to $8,000. The book value and basis of each partner’s capital accounts at the end of year 1 are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Lefty</th>
<th>Angie</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book</td>
<td>Basis</td>
<td>Book</td>
</tr>
<tr>
<td>Capital Contribution</td>
<td>$48,000</td>
<td>$32,000</td>
</tr>
<tr>
<td>Year 1 depreciation</td>
<td>( 3,000)</td>
<td>( 8,000)</td>
</tr>
<tr>
<td>Ending Balance</td>
<td>$45,000</td>
<td>$32,000</td>
</tr>
<tr>
<td>Book Value Less Basis</td>
<td>$13,000</td>
<td>-$1,000</td>
</tr>
</tbody>
</table>

At the end of year one, the remaining built-in gain is $12,000 (Book value of $36,000 less $24,000 of basis). However, the difference between Lefty’s book value and basis of his capital interest is $13,000. The $1,000 difference is due to the ceiling rule which restricted Angie’s tax depreciation to $8,000. In essence, $1,000 of built-in gain has been shifted from Lefty to Angie.
A.12 Traditional Method With Curative Allocations

The traditional method with curative allocations involves the allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item. For example, if a noncontributing partner is allocated less depreciation than book depreciation because of the ceiling rule, the partnership may make a curative allocation to that partner of tax depreciation from another item of partnership property to make up the difference. Alternatively, the partnership could adjust the amount of sales income or other item of the same character to make up the difference.

Example 7

Assume the same facts as in Example 6 except that the company used the cash to purchase $144,000 of inventory which it sold during the year for $164,000.

If the partnership decided to make curative allocations, it could allocate an additional $1,000 of sales income to Lefty. This would bring the partners’ book and tax accounts into balance as follows:

<table>
<thead>
<tr>
<th></th>
<th>Lefty Book</th>
<th>Lefty Basis</th>
<th>Angie Book</th>
<th>Angie Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Contribution</td>
<td>$48,000</td>
<td>$32,000</td>
<td>$144,000</td>
<td>$144,000</td>
</tr>
<tr>
<td>Year 1 depreciation</td>
<td>(3,000)</td>
<td>(            )</td>
<td>(9,000)</td>
<td>(8,000)</td>
</tr>
<tr>
<td>Sales income</td>
<td>5,000</td>
<td>6,000</td>
<td>15,000</td>
<td>14,000</td>
</tr>
<tr>
<td>Ending Balance</td>
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<td>$38,000</td>
<td>$75,000</td>
<td>$75,000</td>
</tr>
<tr>
<td>Book Value Less Basis</td>
<td>$12,000</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
</tbody>
</table>

A.13 Certain Property Distributions Which Trigger Built-in Gain Recognition

For partner's with built-in gain or loss, the recognition of built-in of gain or loss is triggered if the property is distributed to another partner within seven years of the contribution date. The contributing partner must recognize built-in gain or loss in the amount that would have been allocated had the property been sold at its fair market value at the time of distribution. The character of the gain or loss is also based on a hypothetical sale to the distributee. In addition, the recognized gain or loss is taken into consideration in adjusting the basis of the partner's interest in the partnership and in the adjusted basis of the property distributed.

Example 8

As in the case of Example 1, Gregory Gaines contributes land worth $60,000 to a partnership in exchange for a one-third partnership interest. The basis of the land at the time of contribution was $45,000. Three years after its contribution, the land is distributed to another partner at a time when the value of the property was $69,000. Gaines must recognize the $15,000 built-in gain. The basis of the property distributed as well as Gaines' basis in his partnership interest are increased by $15,000. Note that no part of the post-contribution appreciation of $9,000 is recognized by any of the partners at the time of the distribution.
The above rule does not apply if either the property is distributed to the contributing partner or like-kind property (within the meaning of IRC Section 1031) is distributed to the contributing partner no later than the earlier of (1) 180 days after the date of distribution or (2) the due date of the contributing partner's tax return in which the distribution occurs.\(^\text{10}\)

Built-in gain also must be recognized by the contributing partner to the extent that the fair market value of property distributed to the contributing partner exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution (reduced by any cash that also is received in the distribution).\(^\text{11}\) As in the preceding case involving distributions of built-in gain property to another partner, this rule applies only for seven years beginning on the date that the built-in gain property was contributed to the partnership. The basis of the property contributed by the partner to the partnership is increased by the gain recognized (thereby reducing the remaining built-in gain). Except for determining the amount of gain recognized under this rule, the gain is treated as occurring immediately before the distribution.

**Example 9**

Fred contributed land worth $60,000 to a partnership in exchange for a 20% partnership interest. The basis of the land at the time of contribution was $20,000. Four years later, he receives a property distribution at a time when the basis of his partnership interest is $25,000. The fair market value and basis of the property distributed are $40,000 and $30,000 respectively.

Fred's built-in gain is $40,000 ($60,000 - $20,000). The value of the property distributed in excess of Fred's basis in his partnership interest is $15,000 ($40,000 - $25,000). Therefore, he must recognize $15,000 of the $40,000 built-in gain at the time of distribution. The basis of the contributed property and his basis in the partnership interest are increased by $15,000.

**A.14 Small Disparity Exception**

Section 704(c) may be disregarded if the disparity between the book value of the property and the contributing partner's adjusted tax basis in the property is a small disparity within the meaning of the regulations. A disparity between book value and adjusted tax basis is a small disparity if the book value of all properties contributed by one partner during the partnership taxable year does not differ from the adjusted tax basis by more than 15 percent of the adjusted tax basis, and the total gross disparity does not exceed $20,000.\(^\text{12}\)

In addition to the small disparity exception, each of the following types of property may be aggregated for purposes of making allocations under Section 704(c) and this section if contributed by one partner during the partnership taxable year:
1. Depreciable personal property.
2. Property with a zero basis (primarily unrealized receivables).
3. Inventory.

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

1. Assume Partner A contributes depreciable property to a four-partner equal partnership in exchange for a 25% interest. The basis of the property is greater than the fair market value (FMV) at the time of the contribution. Which one of the statements is true assuming that the partnership adopts the traditional method of allocation?
   a. If the property is later sold for less than its book value at the time of sale, Partner A's share of the taxable loss will be less than the other partners' shares.
   b. Partner A will be allocated a greater amount of tax depreciation deduction than the other partners.
   c. Partner A will be allocated an equal amount of tax depreciation deduction.

2. Jim Sands, a 40% partner in the Equity Partnership, contributes depreciable business property to the partnership. Its fair market value and basis at the time of the contribution are $20,000 and $15,000, respectively. It has five years remaining of depreciation expense under the straight-line method ($4,000 per year for book purposes and $3,000 per year for tax purposes). What is Jim's share of depreciation for the first year assuming that the partnership uses the traditional method of allocation (without curative allocations)?
   a. $600.
   b. $1,200.
   c. $1,600.

3. Bill Cash, contributed to a partnership business property with a fair market value of $20,000 and a basis of $16,000 in exchange for a 20% interest. The property had four years of depreciation remaining under the straight-line method ($5,000 per year for book purposes and $4,000 per year for tax purposes). What is the built-in gain at the end of year 3?
   a. $4,000.
   b. $3,000.
   c. $1,000.

4. Brady Miner is a 25% partner and contributes depreciable equipment with a FMV of $24,000 and a basis of $16,000 at the beginning of 2011. There are 4 years left of depreciation at $6,000 (book) / $4,000 (tax) per year. Jessica Smith is a 75% partner and contributes $72,000 of cash. For 2011, the partnership operating income was $20,000 (not including depreciation). Using the traditional method of allocation with curative allocations, what is the amount of partnership operating income allocated for tax purposes to Brady for 2011 (6 points)?
   a. $5,500.
   b. $5,000.
   c. $4,500.

Solutions

1. **“B” is the correct response.** Because the basis of the property is greater than the book value (FMV at the time of contribution less annual book depreciation), total tax depreciation is greater than total book depreciation. A noncontributing partner’s share of tax depreciation
equals his share of book depreciation. Therefore, the excess depreciation (tax in excess of book) is allocated to the contributing partner or Partner A in this case.

“**A**” is an incorrect response. Because the basis of the property is greater than the book value, there is a built-in loss. When it is later sold below its book value, the tax loss will be greater than the book loss. Partner A’s share of the loss equals the built-in loss plus his share of the book loss. Therefore, Partner A’s share of the loss is greater than the share of the loss of each noncontributing partner.

“**C**” is an incorrect response. As noted in Response B, Partner A’s share of the tax depreciation is greater than the share of tax depreciation of each noncontributing partner.

2. **“A” is the correct response.** The tax depreciation is $3,000. The share of tax depreciation for the noncontributing partner’s equals their book depreciation which is $2,400 (60% x $4,000 of book depreciation). The remaining tax depreciation of $600 ($3,000 - $2,400) is allocated to Jim.

“**B**” is an incorrect response. $1,200 equals 40% of $3,000 of depreciation, which would be his share absent the requirement in Section 704(c) to allocate tax depreciation to the noncontributing partners in an amount up to their book depreciation.

“**C**” is an incorrect response. $1,600 equals Jim’s share of book depreciation (40% x $4,000 of book depreciation).

3. **“C” is the correct response.** Built-in gain (BIG) equals the property’s book value less basis at the end of the third year. Book value equals $5,000 ($20,000 less three years of depreciation of $15,000). Basis equals $4,000 ($16,000 - $12,000). Therefore, the built-in gain at the end of year 3 equals $1,000 ($5,000 - $4,000).

“**A**” is an incorrect response. $4,000 was the BIG at the time of the contribution ($20,000 - $16,000).

“**B**” is an incorrect response. $3,000 is the amount of BIG that has been reduced over three years ($1,000 of book depreciation less zero tax depreciation allocated to Bill for 3 years).

4. **“A” is the correct response.** Jessica’s share of book depreciation for 2011 is $4,500 (75% x $6,000). Since the total tax depreciation for the year is only $4,000, Jessica is allocated all of the tax depreciation leaving an imbalance of $500 ($4,500 - $4,000) between her book and tax depreciation. To make up for this shortfall, Brady is allocated $500 more partnership operating income for tax purposes. Since his book share of operating income is $5,000 (25% x $20,000), his tax share of operating income is $5,500 ($5,000 + $500).

“**B**” is an incorrect response. $5,000 is Brady’s share of book income.

“**C**” is an incorrect response. $4,500 would be correct if his tax share of operating income were reduced by $500 rather than increased by $500.

**A.2 Partner/Partnership Transactions**

In accordance with the entity concept, the law generally allows the partner and partnership to transact as if they were unrelated. There are, however, limitations pertaining to certain losses and deductions and to the character of certain gains.

Internal Revenue Code classifies payments to partners into one of three categories:

1. Payments to a partner who is **not acting in the capacity** of a partner.

2. Guaranteed payments.
3. Distributive share of income.

In the first category, the partner is treated as a third party. The partner and partnership may engage in loans, lease transactions and sales of property. Thus, subject to a *substance over form* analysis, a partner may lease, sell, or contribute property to a partnership. It was noted in Section B.7 of the first partnership course (PART I) that property contributions, followed by cash distributions shortly thereafter, may be classified as a sale.\[^{14}\] Because the tax effects of these three alternatives may be quite different, the tax adviser should review the transaction with the client, and determine whether the facts and circumstances are consistent with the form of the transaction.

In addition to the above transactions, category one payments may include payments for services *not customarily* provided by partners in the partnership. These services are those other than services with respect to the general operations or management of the partnership.

**Example 10**

Larry Lawton, Barry Brady, and Opie Rathborn are partners of the Investment Realty Partnership. The partnership is a rental realty partnership. During the year, Larry provided legal services to the partnership and Barry provided investment counseling services to the partnership. Larry is an attorney by trade while Barry is an investment broker. Opie manages the rental projects.

The payments to Larry and Barry for their services rendered to the partnership would be treated as payments to partners in a capacity other than a partner of the partnership. On the other hand, the payments to Opie represent services which are within the normal operations of the partnership. They would not represent category one payments. Depending on how the payments are structured, the payments to Opie represent either guaranteed payments or a distributive share of partnership income.

With respect to the second category, if a partner performs services for the partnership in his capacity as a partner, the payments will be characterized as guaranteed payments if they are determined *without regard to the income of the partnership*.\[^{15}\] Otherwise, they will be considered a distributive share of partnership income (third category).

**Example 11**

Under the ABC partnership agreement, Partner A is entitled to a fixed annual payment of $10,000 for services, without regard to partnership income. In addition, his partnership profits interest is 10%. The $10,000 payment is considered a guaranteed payment. If the partnership's income were $50,000, after deducting the $10,000, Partner A would have a $10,000 guaranteed payment and a $5,000 (10% x $50,000) distributive share of income.

**Example 12**

Partner C is to receive 30% of partnership income as determined before taking into account any guaranteed payments. However, C is to receive no less than $10,000. Partnership income is $60,000. Since his distributive share of income of $18,000 (30% x $60,000) encompasses the $10,000 minimum, the *entire* amount is considered a distributive share of income.
Example 13

Assume the same facts as in Example 12 except that the partnership income is only $20,000. Per the terms of the agreement, he receives $10,000. In this case, $6,000 (30% x $20,000) is considered a distributive share of income and $4,000 ($10,000 - $6,000) is considered a guaranteed payment.

While Example 11 is fairly straightforward, Examples 12 and 13 are more controversial. It could be argued that the full $10,000 is "guaranteed" and that any amount that the partner received in excess of $10,000 is considered a distributive share of income. However, because the overall tax treatment of guaranteed payments and distributive shares is the same in most cases, few taxpayers have challenged the Treasury Regulations.

A.21 Tax Treatment of Compensatory Payments to Partners

If a partnership pays a partner for services rendered in a capacity other than as a partner, the tax treatment generally follows the method of accounting employed by the partnership and partner. Thus, the partnership deducts the payments when the services are rendered if it is on the accrual basis of accounting, or when paid if the partnership is on the cash basis of accounting. Similarly, the partner reports the income when the services are rendered if reporting on the accrual basis, or when received if reporting on the cash basis.

There is an exception to the general rule where the partner is on the cash basis of accounting and the partnership is on the accrual basis of accounting. If the partner does not recognize the service income by the close of the partnership taxable year, the partnership is not allowed the deduction until it is includible in the partner's gross income. This rule applies to any person who owns any interest in partnership profits or capital. The intent of this provision is to match the time period in which the income and deduction are recognized by the partner and partnership respectively.

Example 14

Dee, an attorney, is a cash basis partner of the accrual basis Matchless Partnership. Both the partnership and partner report on the calendar year. On December 31, 2011, the partnership accrues $10,000 of legal expense for services rendered by Dee in a capacity other than a partner. The actual payment is made in early January 2012.

The law prohibits the deduction by the partnership until the income is recognized by Dee. Thus, the deduction by Matchless is not allowed until 2012.

If the services rendered to the partnership are capital in nature, the payment for services must be capitalized. For example, if a partner provides architectural services to the partnership in connection with the construction of a new building, the services are added to the cost of the building and depreciated over the allowable recovery period.
Guaranteed payments are deducted by the partnership at the end of the partnership taxable year. They are reported by the partner in the same manner that the partner reports his distributive share of partnership income. All guaranteed payments during the partnership year are reported by the partner for his taxable year in which the partnership year closes.

Example 15

The ABC Partnership reports on the June 30 fiscal year. For the fiscal year ended (FYE) June 30, 2011, the partnership's net income from operations was $30,000. Not included in the above were guaranteed payments to Partner A of $1,000 per month. For the FYE June 30, 2012, the partnership increased Partner A's guaranteed payments to $1,500 per month. In both years, Partner A shared in one-third of the net profits of the partnership.

After deducting the guaranteed payments to Partner A, the taxable income of the partnership for FYE June 30, 2011 is $18,000 ($30,000 - $12,000). For 2011, Partner A reports $6,000 of partnership income ($18,000/3) and $12,000 of guaranteed payments.

Note that Partner A actually received $15,000 of guaranteed payments during the period January 1 to December 31, 2011 (($1,000 x 6) + ($1,500 x 6)). However, the latter six payments during 2011 are not reported by the partner until 2012 because they are included in the partnership's results for its taxable year ending June 30, 2012.

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**TAX SAVER!!** As noted in Example 15 above, guaranteed payments made in one year may not have to be reported until the following year if the partner reports on the calendar year and the partnership reports on a fiscal year. Thus, if Category 1 payments (payments to a partner for services rendered in a capacity other than as a partner) can be shifted to guaranteed payments, a deferral of income may be achieved.

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A.22 Limitations on Certain Sales and Exchanges

If a sale or exchange of property involves a controlled partnership, two limitations apply. First, any loss from the sale is disallowed. Second, if the property sold is not a capital asset to the buyer, any recognized gain is ordinary income.

A controlled partnership may take two forms. First, it is one in which a person owns, directly or indirectly, more than 50% of the capital or profits of the partnership. Second, where two partnerships engage in sales or exchanges of property, a controlled partnership exists if the same persons own, directly or indirectly, more than 50% of the capital or profits in each partnership.

Example 16

Buddy Baker owns a 55% interest in Partnership A and a 30% interest in Partnership B. Bubba Green owns a 20% interest in Partnership A and a 25% interest in Partnership B. No other partners have common ownership interests in Partnerships A and B.

If Buddy sold business equipment to Partnership A at a loss, he would not be able to recognize the loss since he owns greater than a 50% interest. Likewise, if
Partnership A sold property to Buddy, the partnership would not be able to recognize the loss. If the property were sold at a gain, all of the gain would be ordinary income if the equipment were used in the partnership's business.

Partnerships A and B are considered controlled partnerships since the common ownership by Buddy and Bubba (75% of A and 55% of B) exceeds 50%. Thus, the two limitations described above would be imposed if the two partnerships engaged in sales or exchanges of certain property.

Note that Buddy and Partnership B or Bubba and partnerships A or B could exchange property without falling under the above limitations.

The disallowed loss is never recognized by the seller. It may be used later by the purchaser upon the eventual sale of the property to an unrelated third party. Any gain realized on the second sale (i.e., by the related purchaser) is recognized only to the extent that it is in excess of the previously disallowed loss.\(^{23}\)

**Example 17**

On March 1, Buddy sold land to Partnership A for $100,000. The basis of the property at the time of sale was $150,000. Assuming that Buddy owned a 55% interest in the partnership at the time of sale, the entire $50,000 loss would be disallowed to Buddy.

Two years later, Partnership A sold the property to an unrelated third party for $160,000. The gain realized by the partnership is $60,000 ($160,000 - $100,000 basis). However, the gain recognized is only $10,000 ($60,000 - $50,000 previously disallowed loss).

Assume instead that Partnership A sold the land for $130,000. The gain realized would be $30,000 and the gain recognized would be zero since the amount of gain realized in excess of the previously disallowed loss is zero ($30,000 - $50,000).

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**TAX SAVER!!** Note that in the latter case of Example 17, $20,000 of loss ($50,000 loss realized by Buddy less the $30,000 loss used to offset the partnership gain) is lost permanently. Thus, in general, it is not prudent to sell depreciated property to a related party, such as in the case of a partner owning more than 50% of a partnership.

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In determining the ownership of a capital or profits interest in a partnership, the IRC Section 267(c) rules for constructive ownership apply. Thus, partnership interests held by family members are treated as owned by the partner for determining the partner's total interest. Family members include brothers and sisters, spouse, ancestors, and lineal descendants.\(^{24}\)

**Example 18**

Tom Banks, owns a 30% interest in the ABC Partnership. Other partners in the ABC Partnership include Tom's brother (10% interest), Tom's father (15% interest), and an unrelated third party (45% interest). As a result of the constructive ownership rules, Tom is deemed to own 55% (30% + 10% + 15%). For that matter,
Tom's brother and father also are deemed to own 55%. Any property sold for a loss by either of the three partners to the ABC Partnership (or by the ABC partnership to either of the three partners) will be disallowed.

A loss resulting from the sale of property to a partnership by one who is not a partner but related to a partner also is limited. In this case, the regulations treat the transaction as occurring between the other person and the members of the partnership separately. If IRC Section 267 applies to the nonpartner (partner related to him/her owns more than 50% of the partnership), the loss will be denied to the extent of the related party's interest in the partnership.

Example 19

Mrs. Jones sells property to the ABC Partnership. Her realized loss is $20,000. Mrs. Jones is not a partner in ABC but her son owns a 60% interest. The sale is treated as if Mrs. Jones sold a 60% interest in the property to her son and a 40% interest in the property to the other partners of ABC Partnership. Consequently, $12,000 (60% x $20,000) of the realized loss is disallowed.

Example 20

Assume the same facts as Example 19 except it is the ABC partnership that sells the property to Mrs. Jones. The $12,000 loss allocated to her son is disallowed. However, the partners who own the remaining 40% interest in the ABC partnership are allowed to deduct their share of the loss.

The character of gain may alter a taxpayer's tax liability in two ways. First, if a taxpayer had large capital losses, such losses could offset capital gain income whereas only $3,000 of capital loss may offset ordinary income. Second, the maximum individual income tax rate on capital gain income is 15% (versus 35%). Thus, the second exception involving related parties may affect a partner's overall tax liability. The basic thrust of this limitation is to prevent the capital gain treatment of trade or business gains resulting from the sale of property between a controlled partnership. The major reason for this limitation is to prevent the "trading" of current capital gain income for future depreciation deductions. The seller would be subject to a 15% tax rate while the purchaser's basis included the full purchase price, including the step-up in basis due to the appreciation enjoyed by the seller. The purchaser could then claim depreciation deductions and reduce income taxes by as much as 35 cents for each dollar of depreciation deduction.

Example 21

Bart is a 90% partner of Empire Partnership and has a marginal tax rate of 35%. On January 2, he sold residential property to Empire for $125,000 (net of the land). His basis in the property was $25,000. The property will be used in Empire's business operations.
Bart's gain realized on the sale is $100,000. Absent the rule above, the gain would qualify for capital gain tax rates (15% or 25% on nonrecaptured gain from depreciation). If there is no 25% gain, he would pay only $15,000 of taxes. Empire's depreciable basis is $125,000 or $100,000 more than if Bart had contributed the property. If the partners’ marginal tax rates were 35%, they would save $35,000 in income taxes over the depreciable period. The net benefit would be $20,000 ($35,000 - $15,000) without the related party rule. With it, there is no tax benefit to selling depreciable property to a related party.

Tax advisers should examine the potential tax implications of sales between related parties before the transaction is completed.

** REVIEW QUESTIONS AND SOLUTIONS ** (based on Sections A.2 - A.23).

Questions

5. True or False. James, a partner with ABC Partnership manages the operations of the partnership. For these services, he receives $50,000 plus 10% of partnership income computed after the $50,000 payment. The combined payments are treated as guaranteed payments by the partnership.

6. AB Partnership agrees to pay Partner B $12,000 for his services to the partnership during 2011. Assume (1) the partnership's year end and B's year end are 12/31/11, (2) $10,000 was paid during 2011 and $2,000 is paid in 2012, (3) the partnership reports under the accrual basis, and (4) the partner reports on the cash basis. Which one of the following statements is false?

   a. If the payment is a guaranteed payment, the partner will have income of $12,000 in 2011.
   b. If the payment is a guaranteed payment, the partnership will deduct $12,000 in 2011.
   c. If the payment is considered a payment for services rendered in a capacity other than as a partner, the partnership will deduct $12,000 in 2011.

7. On December 15, the ABC Partnership sold land to Partner A's mother for $100,000. The basis of the land was $150,000. Partner A owns a 40% interest in the partnership. Partners B and C each own a 30% interest in the partnership. B is A's son and C is unrelated to A, B, and A's mother. As a result of the sale, what is the amount of loss which will be disallowed?

   a. $20,000.
   b. $35,000.
   c. $50,000.

Solutions

5. **False is the correct response.** A guaranteed payment is determined without regard to income. The part of his compensation based on a 10% of partnership income is considered a distributive share of income.

   **True is the incorrect response.** Only the fixed amount of payment (the amount “guaranteed”) is considered a guaranteed payment.

6. **“C” is the correct response.** If the payment is considered a payment for services to a partner not acting in the capacity of a partner, the matching of income and deduction rules pertaining to related parties apply. In this case, Partner B would include in income $10,000 of the payment in 2011 and $2,000 in 2012 since he reports on the cash basis of accounting. Therefore, the partnership may only deduct $10,000 in 2011.
“A” is an incorrect response. A partner receiving a guaranteed payments reports it in the year the partnership taxable year closes. Since the year closes on 12/31/11, he will report the full guaranteed payment of $12,000 as a income in 2011.

“B” is an incorrect response. Since the partnership reports on the calendar year, the entire guaranteed payment for 2011 is deducted by the partnership in 2011.

7. “B” is the correct response. The realized loss on the sale is $50,000 ($100,000 - $150,000). Since the buyer of the property is related to two partners (A and B) in the partnership, part of the loss will be denied if the combined ownership of the related parties exceeds 50%. In this case, the related party ownership is 70% (40% for A and 30% for B) so 70% of the loss is disallowed or $35,000 ($50,000 x 70%).

“A” is an incorrect response. $20,000 is 40% of the loss or the loss attributed to Partner A’s ownership. If B were unrelated to the buyer, none of the loss would be disallowed since the related party ownership would not exceed 50%.

“C” is an incorrect response. $50,000 would be correct of the entire loss were disallowed. However, only the amount of the loss attributed to the related party ownership is disallowed.

A.3 Loss Limitations

Notwithstanding the limitations imposed by certain related party transactions (Section A.22 above), the deductibility of partnership losses generally is constrained by three limitations: (1) basis limitation, (2) at-risk limitation, and (3) passive activity loss limitation.

A.31 Basis Limitation

A partner's distributive share of partnership loss is allowed only to the extent of the adjusted basis of the partner's partnership interest at the end of the partnership year in which the loss occurs. This limitation applies to all types of losses (capital loss, ordinary loss, passive activity loss). No ordering of losses is imposed by the Internal Revenue Code. However, the Treasury regulations indicate that if a partner's distributive share of partnership losses exceeds the basis in his partnership interest, the loss limitation is allocated proportionately among the various components, e.g., ordinary losses, capital losses, and trade or business losses. Any unused losses are allowed as a deduction at the end of the first succeeding partnership taxable year in which there is sufficient basis.

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**TAX SAVER!!** Methods for the partner to free up suspended losses include: (1) make additional capital contributions, (2) incur additional partnership debt, and (3) realize additional partnership income.

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**Example 22**

For the current year ended December 31, Partner A's distributive share of ABC Partnership's loss is $26,000. His basis immediately prior to the loss allocation is $20,000. Thus, he may deduct only $20,000 of partnership loss in the current year. His ending basis in the partnership is zero and a $6,000 suspended loss is carried forward indefinitely.
Example 23

Refer to the facts of Example 22. For the following year ended December 31, assume that Partner A's distributive share of partnership income is $2,000. In addition, his share of partnership liabilities increased by $3,000. Partner A's basis is increased by $5,000 for these items. As a result, he may deduct $5,000 of the $6,000 suspended loss and his basis again is reduced to zero. A $1,000 suspended loss remains.

A.32 At-Risk Limitation

Section 465 allows losses arising from activities only to the extent of the aggregate amount with respect to which the taxpayer is at-risk. A taxpayer's at-risk amount consists of the following:

1. The amount of money contributed to the activity.
2. Plus, the adjusted basis of property contributed to the activity.
3. Plus, the partner's distributive share of income.
4. Plus, amounts borrowed for use in the activity to the extent that the taxpayer is personally liable for repayment or the taxpayer has pledged property outside the activity as security.
5. Less, distributions.
6. Less, the partner's distributive share of loss.29

Note that the amount at-risk is very similar to the partner's basis in his partnership interest. The only difference relates to item four. If the taxpayer is not considered personally liable for a particular debt, it is not included in the partner's at-risk amount, even though it would be included in the basis. Typically, these debts involve nonrecourse debt. The major purpose of the at-risk rule is to prevent the deduction of losses arising from activities financed heavily by nonrecourse debt where the taxpayer is exposed to little economic risk of loss.

For pledged property, the at-risk amount equals the property's fair market value less any debt on the property.30

Example 24

Refer to the facts of Example 22. Included in Partner A's basis is a nonrecourse debt of which his share is $12,000. Assume Partner A had pledged property owned outside the partnership against the nonrecourse debt. The property is worth $8,000 and it is encumbered by a $3,000 debt. Based on the above information, Partner A's at-risk amount is $13,000, computed as follows:

<table>
<thead>
<tr>
<th>Basis in Partnership Interest</th>
<th>$20,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less Nonrecourse Debt</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Plus Debt In Which the Taxpayer Has Pledged Property Outside the Activity ($8,000 - $3,000)</td>
<td>5,000</td>
</tr>
<tr>
<td>Amount At-Risk</td>
<td>$13,000</td>
</tr>
</tbody>
</table>
Thus, Partner A would be able to deduct only $13,000 of the $26,000 loss the current year. His at-risk amount would be reduced to zero.

As with the basis limitation rules, suspended losses are carried forward indefinitely and can be used when the taxpayer has sufficient amounts at-risk.31

Nearly all trade or business or income-producing activities are covered by the at-risk provision. However, for real estate activities, nonrecourse financing by qualified third parties is not covered by the at-risk rules.32 In other words, such financing increases the taxpayer's at-risk amount. Third parties include commercial banks, government loans, and certain commercially reasonable financing from related persons.

A.33 Passive Activity Loss Limitation

The at-risk limitation was not effective in eliminating many loss deductions where taxpayers did not really suffer true economic losses. In part, this failure was due to clever financing arrangements. Congress believed that the ability for taxpayers to offset their income with "artificial" tax losses from other activities was contributing to the erosion of confidence in the Federal income tax system. As a result, the Tax Reform Act of 1986 established the passive activity loss limitation rules. These rules are complicated and a detailed analysis is beyond the scope of this course. Thus, only a brief summary of these rules is provided below.

Losses (tax credits) arising from passive activities are allowed only against income (tax liability) from other passive activities.33 Any unused losses can be carried forward indefinitely.34 In an attempt to prevent the transfer of certain income-producing activities to typical tax loss entities, Congress partitioned income and loss items into three categories -- (1) active income, (2) portfolio income, and (3) passive activity income. Each partnership or other affected taxpayer must break down the income and deduction items into these categories when applying the passive activity limitation.

Example 25

For the year ended December 31, 2011, Pat had wages of $30,000, interest income of $2,000, a passive activity loss from Partnership A of $15,000, and income from Partnership B of $6,000. For the latter, $4,000 of the income is considered passive income, and $2,000 is considered portfolio income. Paul had invested in both partnerships in 2011.

In computing Pat's taxable income, the passive activity loss from Partnership A is deductible only against passive activity income. None of the loss is deductible against his wages, interest income, or portfolio income from Partnership B. Thus, only $4,000 of the loss is deductible in 2011.
A passive activity generally is defined as:

1. Any trade or business in which the taxpayer does not **materially participate**.
2. Any **rental activity**, regardless of the level of participation.\(^{35}\)

Under the real estate professional rule regarding rental activities, a taxpayer's rental real estate activities in which the taxpayer materially participates are not subject to the passive activity loss rules if 2 requirements are met:

a. More than one-half of the taxpayer's personal services are performed in real property trades or businesses in which the taxpayer materially participates; and,

b. The taxpayer performs more than 750 hours of services during the taxable year in real estate trades or businesses in which the taxpayer materially participates.\(^{36}\)

Generally, each interest in rental real estate is considered a separate activity. However, a taxpayer can elect to treat all interests in **rental real estate** as one activity.\(^{37}\)

Material participation is satisfied generally if the taxpayer is involved in the operations of the activity on a **regular, continuous, and substantial basis**. The IRS has issued a substantial number of regulations on the passive activity loss rules. The regulations cover the definition of rental activity, the definition of material participation, and many more topics. With respect to material participation, the regulations provide seven ways in which a taxpayer can satisfy the material participation test. In brief, they are as follows:

1. The taxpayers performs more than 500 hours of participation in the activity.
2. The taxpayer's participation constitutes substantially all of the participation in the activity for the year.
3. The taxpayers performs more than 100 hours of participation providing it is no less than any other individual for the year.
4. The taxpayer satisfies the material participation rules in 5 of the 10 preceding years.
5. The activity is a significant participation activity (greater than 100 hours of participation) and the total participation in such activities exceeds 500 hours.
6. The activity is a personal service activity in which the taxpayer materially participated for any 3 preceding taxable years.
7. Based on all of the circumstances, the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis.

Portfolio income generally is equivalent to investment income, including interest, dividends, royalties, and gains from the sales of investment assets. Active income typically includes wages,
commissions, and business income from an activity in which the taxpayer is considered a material participant.

Upon the complete disposition of a passive activity, any unused losses are fully deductible in the following order:

1. Net income from the passive activity disposed of, including any gain on disposition.
2. Net income from all other passive activities.
3. Any other income or gain.38

Example 26

In 2011, a taxpayer invests in two partnerships. Assume that each partnership has invested in only one activity, and that all income and deductions from these activities are considered passive. In 2011, Activity 1 incurs a $100,000 loss and Activity 2 incurs a $40,000 gain. In 2012, the taxpayer sells Activity 1, realizing a profit of $20,000. Activity 2's income for 2012 is $10,000. The taxpayer's other income in each year is $100,000.

In 2011, only $40,000 of the loss from Activity 1 is deductible (against the income from Activity 2). The remaining loss ($60,000) is carried forward to 2012. In 2012, the full $60,000 is deductible as follows:

- $20,000 against the gain from the sale.
- $10,000 against the income from Activity 2.
- $30,000 against other taxable income.

For real estate activities in which individuals actively participate, up to $25,000 of rental losses may be deducted each year against non-passive income.39 However, the $25,000 allowance is reduced by 50% of the taxpayer's "modified" adjusted gross income (AGI) in excess of $100,000.40 As a result, this $25,000 offset is not available to taxpayers whose "modified" AGI exceeds $150,000. For low income housing and rehabilitation tax credits, the allowance is not reduced until "modified" AGI exceeds $200,000, being phased out at $250,000 of "modified" AGI. The rental loss deductions first must be netted against rental income and other passive income to determine the rental deduction allowed to offset nonpassive income.

** REVIEW QUESTIONS AND SOLUTIONS ** (Based on Sections A.3 - A.33)

Questions

8. At the beginning of the year, Mary's basis in the XYZ Partnership including her share of debt was $10,000. Her share of recourse debt was $4,000 and her share of nonrecourse debt was $3,000. During the year, her share of recourse debt increased by $5,000 (to a total of $9,000). Additionally, she pledged property held outside the partnership which had a $3,000 FMV, $2,000 basis, and $1,000 of underlying debt. For the year, her distributive share of loss is $20,000. How much of the loss (disregarding the passive activity loss limitations) may she deduct on this year's individual income tax return?
9. Concerning the passive activity loss rules, which one of the following statements is true?

a. One way to remove rental real estate property from the passive activity loss rules is to perform more than 500 hours of participation.

b. $5,000 of passive activity losses from activity A may be deducted against $6,000 of passive activity income from activity B.

c. A taxpayer with modified AGI of $120,000 may deduct up to $10,000 of rental losses from real estate provided they are an active participant in the rental activity.

Solutions

8. “B” is the correct response. Mary’s deductible share of her loss is limited to the lower of her basis or at-risk amount immediately before the loss. At the end of the year, her basis equals $15,000 (10,000 + 5,000 debt increase). Her at-risk amount equals $14,000 (basis of $15,000 - $3,000 of nonrecourse debt + $2,000 ($3,000 FMV - $1,000 debt) for the pledged property. The lower of the two amounts is $14,000.

“A” is an incorrect response. $15,000 would be correct if her basis were less than her at-risk amount.

“C” is an incorrect response. $13,000 would be correct if her at-risk amount were increased by the pledged property’s basis rather than FMV (less any underlying debt).

9. “B” is the correct response. While net passive activity losses are not deductible against nonpassive activity income, passive activity losses from one passive activity are deductible against income from another passive activity. Therefore, all $5,000 of the loss from activity A are allowed against the $6,000 of income from activity B.

“A” is an incorrect response. There are several hurdles before rental real estate property are removed from the passive activity loss rules. While one hurdle is to meet the material participation test, which is met if more than 500 hours of participation are performed, the taxpayer must also qualify for the real estate professional exception which requires two additional requirements (participation in real property activities must exceed 750 hours and be more than 50% of the personal services performed during the year).

“C” is an incorrect response. Under the active participation exception for rental real estate activities, the $25,000 disallowance is reduced by 50% of modified AGI in excess of $100,000. In this case, the reduction is only $10,000 (50% x ($120,000 - $100,000)) so the allowable amount is $15,000 ($25,000 - $10,000).

B. SALE OF PARTNERSHIP INTERESTS

Gain or loss from the sale of a partnership interest is measured by subtracting the partner's basis in the partnership interest from the sales price. Sales price is also termed amount realized. It not only includes the cash or other property received by the selling partner but also includes the partnership liabilities assumed by the purchasing partner.41
Example 27

Partner A owns a 1/3 interest in the ABC Partnership. Currently, the fair market value (FMV) of the assets owned by the partnership is $90,000 and the liabilities total $30,000. The basis of the partnership assets is $60,000. A breakdown of the fair market value and basis of the assets is as follows:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>A/R</td>
<td>9,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Inventory</td>
<td>24,000</td>
<td>21,000</td>
</tr>
<tr>
<td>Building</td>
<td>15,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Land</td>
<td>27,000</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$90,000</strong></td>
<td><strong>$60,000</strong></td>
</tr>
</tbody>
</table>

The building has been depreciated on the straight-line basis. Therefore, there is no depreciation recapture potential. Assume that the partner's basis in his partnership interest (also referred to as outside basis) equals $20,000 and that his capital and profit interests are each 33 1/3%.

Individual D purchases A's interest for $20,000 cash and assumes A's 1/3 share of partnership liabilities. As a result, the amount realized is $30,000 ($20,000 + $10,000). Note that amount realized also equals Partner A's 1/3 share in the FMV of the assets. The total gain realized equals $10,000 ($30,000 - $20,000 basis).

B.1 Character of the Gain or Loss

The general rule is that the character of the gain realized from the sale of a partnership interest is capital gain. However, ordinary income will result to the extent of the partner's interest in (1) unrealized receivables and (2) inventory items.

Unrealized receivables for the most part consist of accounts receivable from rendering services or from selling goods for which the partnership has not yet recognized the income from the service or sale. Accounts receivable of a cash basis partnership is the most common example of an unrealized receivable. Another common example would be sales for which the partnership had been reporting under the installment method of accounting. A few other items, which are not customarily considered receivables, also are included under the unrealized receivable classification. For example, depreciation recapture is an unrealized receivable.

Example 28

Refer to the facts of Example 27. The $9,000 of accounts receivable represent unrealized receivables since their basis is zero and the partnership has not yet recognized income from the accounts receivable. Since Partner A's interest in the accounts receivable is $3,000, the portion of the gain attributable to the accounts receivable is ordinary income.

Example 29

Refer to the facts of Example 27 and assume the building had been depreciated under the modified accelerated cost recovery system. For depreciable real estate property, depreciation recapture equals accumulated depreciation less
accumulated depreciation if the straight-line method had been used. Since the straight-line method has been required for property placed into service since 1987, it is likely that most real estate property held by partnerships today would have little or no depreciation recapture potential.

The term inventory item is very broadly defined. There are two categories. First, it includes goods primarily held for resale in the ordinary course of the taxpayer's trade or business. Second, it includes any other property which is other than a capital asset or a trade or business asset. Thus, any other partnership asset, the disposition of which would result in ordinary income, is defined as an inventory item. Since the collection of an unrealized receivable would result in the recognition of ordinary income, it also is considered an inventory item.

When a shareholder sells stock of a regular corporation or an S Corporation, the entire gain or loss is considered capital gain or loss. However, if the partnership has either unrealized receivables and/or inventory items, the law treats the sale of the partnership interest as a sale of two categories of assets – the partner's share of (1) unrealized receivables and inventory items (termed Section 751 assets), and (2) other assets (termed Section 741 or capital/trade or business assets). Computationally, the amount realized from the sale is reduced by the partner’s share of unrealized receivables and inventory items. Similarly, the adjusted basis of the partner's interest in his partnership is reduced by the partner’s share of the basis of the unrealized receivables and inventory items. This requirement is unique to partnership taxation and is an example of the aggregate concept of partnership taxation.

Example 30

Refer to the facts of Example 27 and assume there is no depreciation recapture on the building. Partner A’s share of Section 751 assets is $11,000 (1/3 of ($9,000 + $24,000)). The basis of the $11,000 of Section 751 assets is $7,000 (1/3 of ($0 + $21,000)). Therefore, the ordinary income portion of the gain is $4,000 and the capital gain portion is $6,000 ($10,000 - $4,000). The partitioning of the gain into ordinary and capital is summarized below:

<table>
<thead>
<tr>
<th>Amount Realized</th>
<th>Share of Total Sec. 751 Assets</th>
<th>Remaining Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner's Basis</td>
<td>$20,000</td>
<td>7,000</td>
</tr>
<tr>
<td>Gain</td>
<td>$10,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>Character</td>
<td>Ordinary</td>
<td>Capital</td>
</tr>
</tbody>
</table>
Note that when partitioning the partner’s basis between the two categories, the basis of the ordinary portion is determined by looking at the partner’s share of the basis of the ordinary income assets. However, for the capital gain portion, it is the partner’s remaining outside basis, not the partner’s share of the basis of the capital assets. In example 30, the partner’s outside basis of $20,000 equals his share of basis of partnership assets (1/3 of $60,000). In this case, the $13,000 remaining outside basis equals his share of the basis of the partnership’s Section 741 (capital/trade or business) assets (1/3 of $39,000 ($15,000 + $9,000 + $15,000)). If the partner's outside basis exceeds the partner’s inside basis, it would be possible to have ordinary income and a capital loss. In the above example, assume Partner A's outside basis is $30,000. The net gain or loss would equal zero ($30,000 - $30,000). However, Partner A would be required to report $4,000 of ordinary income and $4,000 of capital loss ($19,000 - $23,000).

**REVIEW QUESTIONS AND SOLUTIONS**

Questions

10. True or False. An unrealized receivable is also considered to be an inventory item.

11. Partner A owns a 40% interest in the AZ Partnership. Currently, the fair market value (FMV) of the assets owned by the partnership is $125,000 and the liabilities total $25,000. Each of the two partners bear equally the economic risk of loss for the debt. The basis of the partnership assets is $100,000. A breakdown of the FMV and basis of the assets is as follows:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>A/R</td>
<td>5,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Inventory</td>
<td>30,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Land (Capital Asset)</td>
<td>80,000</td>
<td>75,000</td>
</tr>
<tr>
<td>Total</td>
<td>$125,000</td>
<td>$105,000</td>
</tr>
</tbody>
</table>

The land is held for investment. Partner A sells her complete interest in the partnership to Individual C for $40,000 cash plus assumption of her share of liabilities. The basis of her partnership interest equals $40,000. As a result of the sale, what is the amount and character of the gain reported by partner A?

a. $10,000 Capital Gain.
b. $ 6,000 Ordinary Income and $2,000 Capital Gain.
c. $ 6,000 Ordinary Income and $4,000 Capital Gain.

Solutions

10. **True is the correct response.** Inventory items include any other property which is other than a capital asset or a trade or business asset. Since an unrealized receivable is an ordinary income asset, it also is considered to be an inventory item.

**False is the incorrect response.** All receivables, including unrealized receivables are considered to be inventory items.
11. **“C” is the correct response.** Partner A’s gain realized from the sale of her interest is $10,000 (amount realized of $50,000 less her basis of $40,000). Her share of unrealized receivables and inventory items is $14,000 (40% ($5,000 + $30,000)) and her share of the basis of these items equals $8,000 (40% ($5,000 + $30,000)). As a result, $6,000 ($14,000 - $8,000) of the gain is ordinary income. The remaining gain of $4,000 is capital gain. It is computed by subtracting the remaining amount realized of $36,000 ($50,000 - $14,000) from the remaining outside basis of $32,000 ($40,000 - $8,000).

**“A” is an incorrect response.** $10,000 of capital gain would be correct if the partnership held no unrealized receivables and inventory items.

**“B” is an incorrect response.** $2,000 of capital gain would be correct if the gain were calculated by comparing her share of the land appreciation, which is $2,000 (40% x $5,000). Note that her outside basis of $40,000 does not equal her inside basis of $42,000 (40% x $105,000), which is why it would be incorrect to look at her share of appreciation in capital and trade or business assets to determine her remaining gain.

**B.2 Optional Basis Adjustment of Partnership Assets**

Because the taxation of partnerships follows two concepts, the entity and aggregate concepts, many anomalies can occur. The calculation of a new partner's pro rata share of basis of the partnership assets is one example. In this regard, it is helpful to view the partner as owning a pro rata share of each partnership asset rather than owning a partnership interest.

If a taxpayer paid $10 for an asset and the asset were sold later for exactly $10, the taxpayer would expect to recognize no gain or loss. Since a partner's share of partnership income, deduction, gain, or loss is reported directly by the partner, arguably the same reasoning should apply to the purchase of partnership assets.

Suppose that the taxpayer purchased a 10% partnership interest for $10 and the partnership had a single asset worth $100. If the asset were sold for $100, the taxpayer has not benefitted economically. The partner now owns a 10% interest in $100 cash instead of $100 of property. Is the partner required to recognize any gain or loss on this transaction? It depends on the basis of the partnership property which was sold. If the basis were only $80, there would be a gain of $20 and the 10% partner would report his distributive share of the gain of $2. This is inequitable since the taxpayer has not recognized any economic gain. To alleviate this inequity, Section 743(b) allows the partnership to adjust the new partner's share of the basis of partnership assets to fair market value generally at the time the new partner purchases his partnership interest if there is a Section 754 election in effect (see Section B.22 below).

Before describing the details of this provision, a reexamination of the purchase of D's interest by Partner A will be made. Refer to Examples 27 and 30. Recall that Partner A's basis in the
partnership interest was $20,000. The fair market value and basis of the partnership assets at the time of sale were as follows:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>A/R</td>
<td>9,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Inventory</td>
<td>24,000</td>
<td>21,000</td>
</tr>
<tr>
<td>Building</td>
<td>15,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Land</td>
<td>27,000</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$90,000</strong></td>
<td><strong>$60,000</strong></td>
</tr>
</tbody>
</table>

In addition, Partner A's share of basis of the partnership assets also was $20,000 (1/3 of $60,000). As discussed earlier, the basis of the partnership interest also is termed outside basis, and the partner's share of the basis of partnership assets is termed inside basis.

Applying the general rule of basis, Partner D's outside basis will equal his cost of $30,000. Since Partner D is, in essence, replacing Partner A, his inside basis (1/3 share of basis of partnership assets) is $20,000. Thus, without an allowable basis adjustment, his outside basis is $10,000 greater than his inside basis. When the receivables are collected, the partnership will have to recognize $9,000 of income of which Partner D must report his $3,000 share. This clearly is unfair to Partner D since he would be required to recognize 1/3 of the gain when, in fact, Partner A already had recognized the gain when he sold his partnership interest to D (see Example 30). The double recognition of gain also will occur upon the sale of the inventory and land. This result can be avoided if the partnership makes a Section 754 election. Once this election is made, the partnership is required to increase (or decrease) the basis of the partnership assets. The basis increase is calculated as follows:

1. New partner's outside basis, less
2. The partner's proportionate share of the adjusted basis of partnership property.

**Example 31**

Refer to the facts of Example 27. If the partnership had made a proper election under Section 754, the partnership is required to increase the basis of the partnership assets by $10,000, computed as follows:

- New Partner's outside basis $30,000
- Less 1/3 share of the assets' bases 20,000
- Adjustment $10,000

Notice that the adjustment equals Partner A's gain. This will occur only when the selling partner's outside basis equals the partner's inside basis. Because the tax law requires the allocation
of built-in gain and loss to the partner contributing the property (see Section A.1 above), a partner's inside and outside basis will be equal in most general partnerships. Also note that without the adjustment computed in Example 31, Partner D's inside and outside bases would not be equal.

The basis decrease is calculated as follows:

1. The partner's proportionate share of the adjusted basis of partnership property, less
2. The partner's outside basis.

Example 32

Refer to the facts of Example 31 except the purchase price had been $10,000 rather than $30,000. If the partnership had made a proper election under IRC Section 754, the partnership is required to decrease the basis of the partnership assets by $10,000, computed as follows:

\[
\begin{align*}
&\text{1/3 share of the assets' bases} & \text{20,000} \\
&\text{The Partner's outside basis} & \text{10,000} \\
&\text{Adjustment} & \text{10,000}
\end{align*}
\]

In the examples above, the partner’s “share” of basis of partnership property was computed by multiplying the total basis of the assets times the partner’s interest in the partnership ($60,000 x 1/3 = $20,000). If the selling partner had built-in gain property, the rules are more complex and are reviewed in Section B.21 below.

Once the overall basis adjustment is determined, it must be allocated to the individual partnership assets. Although the Treasury regulations are somewhat lengthy and cumbersome (to account for more complicated situations like built-in gain property), for most partnership purchases, the basis allocation to the partnership assets is fairly simple. Essentially, the basis adjustment to each asset is based on the amount of income or loss that would be allocated to the purchaser in a hypothetical sale prior to any basis adjustment. After this adjustment, the partner’s share of the basis of each asset will equal each asset’s fair market value.

Example 33

Refer to the facts of Examples 27 and 31 in which the partnership had the following assets.

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
<th>Basis</th>
<th>D’s Share of Appreciation or Decline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$15,000</td>
<td>$15,000</td>
<td>$0.00</td>
</tr>
<tr>
<td>A/R</td>
<td>9,000</td>
<td>0.00</td>
<td>3,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>24,000</td>
<td>21,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Building</td>
<td>15,000</td>
<td>9,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Land</td>
<td>27,000</td>
<td>15,000</td>
<td>4,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$90,000</strong></td>
<td><strong>$60,000</strong></td>
<td><strong>$10,000</strong></td>
</tr>
</tbody>
</table>
In a hypothetical sale, if no basis adjustments were made to the partnership assets, Partner D would have to recognize $4,000 of ordinary income from the sale of the A/R and Inventory and $6,000 of capital/trade or business income from the sale of the building and land. By adjusting the bases of Partner D’s share of the assets appreciation or decline, any pre-admission gain or loss attributable to the interest which was just purchased is eliminated. This is fair for two reasons: (1) Partner D has not realized any economic gain and (2) most likely the selling partner has recognized this portion of the gain or loss at the time of the sale.

Assuming the basis adjustment is made and assuming all of the A/R is collected, only $6,000 of income will be recognized since its basis after the adjustment is $3,000. All $6,000 income will be allocated to Partners B & C, so no income will be recognized by D. Similarly, when the building, land, and inventory are sold, the gain will be reduced by $1,000, $2,000, and $4,000, respectively, because of the basis adjustments.

The above discussion also applies in the situation where the purchasing partner’s basis in the partnership interest (outside basis) is less than the partner's inside basis. Once an IRC Section 754 election is in effect, it must be followed unless it is revoked with the consent of the IRS.

Example 34

Partner D purchases a 1/3 interest in BCD partnership from Partner A for $30,000. At the time of the purchase, the fair market values and bases of the assets are as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
<th>Basis</th>
<th>D’s Share of Appreciation or Decline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$15,000</td>
<td>$15,000</td>
<td>$-0-</td>
</tr>
<tr>
<td>A/R</td>
<td>9,000</td>
<td>9,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Inventory</td>
<td>24,000</td>
<td>30,000</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Building</td>
<td>9,000</td>
<td>18,000</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Land</td>
<td>33,000</td>
<td>48,000</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$90,000</td>
<td>$120,000</td>
<td>$(10,000)</td>
</tr>
</tbody>
</table>

In this case, Partner D's outside basis ($30,000) is $10,000 less than the inside basis of $40,000 (1/3 of $120,000). If a Section 754 election were in effect, a $10,000 reduction in the basis of the partnership assets would be required. Based on the hypothetical sale analysis discussed above, the bases of the inventory, building, and land will be reduced by $2,000, $3,000, and $5,000, respectively.

B.21 Section 704(c) Property

If the selling partner had Section 704(c) property remaining in the partnership at the time of the sale, the purchasing partner essentially “inherits” the selling partner’s built-in gain or loss. If a Section 754 election is in effect, the built-in gain is removed. The hypothetical sale analysis is used to compute the overall basis adjustment as well as the amount of adjustment to each asset. This next example is taken from the Treasury regulations.

Example 35

A and B form equal partnership PRS. A contributes $50,000 and Asset 1, a nondepreciable capital asset with a fair market value of $50,000 and an adjusted tax basis of $25,000 (built-in gain of $25,000). Partner B contributes $100,000. PRS
uses the cash to purchase Assets 2, 3, and 4. After a year, A sells its interest in PRS to T for $120,000. Immediately after the transfer of the partnership interest to T, the adjusted basis and fair market value of PRS's assets are as follows:

<table>
<thead>
<tr>
<th>Capital Gain Property</th>
<th>FMV</th>
<th>Basis</th>
<th>T's Share of Appreciation or Decline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset 1</td>
<td>$ 75,000</td>
<td>$ 25,000</td>
<td>$ 37,500</td>
</tr>
<tr>
<td>Asset 2</td>
<td>117,500</td>
<td>100,000</td>
<td>8,750</td>
</tr>
<tr>
<td>Ordinary Income Property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset 3</td>
<td>45,000</td>
<td>40,000</td>
<td>2,500</td>
</tr>
<tr>
<td>Asset 4</td>
<td>2,500</td>
<td>10,000</td>
<td>(3,750)</td>
</tr>
<tr>
<td>Total</td>
<td>$240,000</td>
<td>$175,000</td>
<td>$ 45,000</td>
</tr>
</tbody>
</table>

As noted earlier, the overall basis adjustment equals T's outside basis ($120,000), less her proportionate share of the adjusted basis of partnership property. In the previous examples, we calculated the latter amount to be the total basis ($175,000) times T's interest in the partnership (50%). However, in this case this method would be incorrect because Section 704(c) property is present. Namely, Asset 1 was contributed by Partner A when it had a fair market value of $50,000 and a basis of $25,000. If the partnership were to sell it immediately, there would have been a built-in gain of $25,000, all allocated to Partner A. In essence, A’s share of the basis of Asset 1 is zero and B’s share is $25,000 (one-half of the fair market value).

Since Partner T “steps into the shoes” of Partner A, her share of the basis of asset A is likewise zero and if the asset were sold immediately after T’s partnership interest purchase, her share of the gain would be $37,500 ($25,000 built-in gain plus 50% of the $25,000 ($75,000 - $50,000) post-contribution gain. Consequently, T’s share of the basis of the partnership assets at the time of her purchase is only $75,000, which is none of Asset A and 50% of the bases of Assets 2, 3, and 4. As a result, the overall basis adjustment is $45,000 ($120,000 - $75,000) and it is allocated to each asset in accordance with T’s share of appreciation or decline in each asset. As shown above, the $45,000 adjustment equals T’s share of gain or loss in each asset of the partnership. Note that Asset 4 has declined in value since its purchase so the basis adjustment to Asset 4 is a reduction of $3,750. That is, even though the overall adjustment was positive, the adjustments to the individual assets may be positive or negative thereby eliminating the difference between T’s share of the fair market value and basis for each asset.

To illustrate the last point, assume that Asset 4 is sold for $2,500 immediately after T purchases her interest. The basis of Asset 4 after the optional basis adjustment is $6,250. The loss of $3,750 ($2,500 - $6,250) is allocated all to Partner B as follows:

<table>
<thead>
<tr>
<th>Total</th>
<th>Partner B</th>
<th>Partner T</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Price</td>
<td>$2,500</td>
<td>$1,250</td>
</tr>
<tr>
<td>Basis of the Asset</td>
<td>(6,250)</td>
<td>(5,000)</td>
</tr>
<tr>
<td>Gain (Loss) Recognized</td>
<td>(3,750)</td>
<td>(3,750)</td>
</tr>
</tbody>
</table>

B.22 Section 754 Election

The optional basis adjustment rules described in Sections B.2 and B.21 are made only when a Section 754 election is in effect. The election applies to both sales of partnership interests and distributions of partnership property (Section C.23 below). The partnership, not the partner, makes
the election. A written statement must be filed by the partnership on a timely basis (due date of the
return, including extensions, for the year in which a sale or distribution occurs). The following
information must be included in the statement:

1. Name and address of the partnership making the election.
2. Signature of any one of the partners.
3. Declaration that it will apply the provisions of Sections 743(b) and 734(b).

---

**TAX SAVER!!** Since a Section 754 election does not have to be made until the due
date of the tax return, it would be prudent not to make the election until after the first
sale or distribution triggers a potential basis adjustment which favors the purchasing
partner in the case of Section 743(b) or the partnership in the case of a partnership
distribution. If the transaction favors the partnership, the election should be made.
Otherwise, the decision could be postponed until a transaction triggers a positive
basis adjustment of the partnership assets.

---

A revocation must be filed no later than **30 days** after the close of the taxable year for which
the revocation is to take effect. A business purpose is required to revoke the election. Examples of
business purposes include:

1. Change in nature of partnership business.
2. Substantial increase in assets.
3. Change in character of assets.
4. Increase in the frequency of shifts of partnership interests.

Approval to revoke the election will not be granted to avoid reducing the bases of the
partnership assets. As Example 34 above points out, the election is a "two-edged sword." While
most partners are delighted to have a basis increase in the partnership assets, a new partner who had
purchased a partnership with high basis assets would not welcome a downward adjustment in the
basis of partnership assets.

** REVIEW QUESTIONS AND SOLUTIONS ** *(Based on Sections B.2 - B.22)*

**Questions**

12. True or False. Under the optional basis rules related to the purchase of a partnership interest,
it is **not** possible to have an increase in the basis of ordinary income assets (positive
adjustment) and to have a decrease in the basis of capital assets (negative adjustment).

13. Partner L purchases a 10% interest in the LMN Partnership for $12,000 cash. Assume the
partnership has no liabilities and that a Section 754 election is in effect. A schedule of the
fair market value and basis of the partnership assets is presented below.
### Solutions

12. **False is the correct response.** As noted in Section B.2 above, the basis adjustment to each asset is based on the amount of income or loss that would be allocated to the purchaser in a hypothetical sale prior to any basis adjustment. If the ordinary income assets increased in value and the capital assets decreased in value, there would be positive basis adjustments to ordinary income assets and negative adjustments to capital assets.

**True is the incorrect response.** If the hypothetical sale of an asset results in gain, the basis adjustment is positive. If it results in a loss, the basis adjustment is negative.

13. **“A” is the correct response.** The basis adjustment to each asset is based on the amount of income or loss that would be allocated to the purchaser in a hypothetical sale prior to any basis adjustment. The sale of the inventory for $40,000 would result in a $10,000 gain of which $1,000 ($10,000 x 10%) would be allocated to Partner L. Therefore, the basis adjustment equals $1,000.

**“B” is an incorrect response.** The total basis adjustment equals $4,000 ($12,000 outside basis less $8,000 (10% x $80,000) inside basis). $1,600 would be correct if the adjustment were allocated to the appreciated assets on the basis of relative fair market value ($40,000/$100,000 x $4,000 = $1,600).

**“C” is an incorrect response.** $2,000 is the basis adjustment allocated to the ordinary income assets ($1,000 to the A/R and $1,000 to the inventory).

14. **“C” is the correct response.** In order to revoke a Section 754 election, a business purpose is required. The regulations provide four examples that satisfy the business purpose requirement. The regulations also note that approval to revoke the election will not be granted to avoid reducing the bases of the partnership assets. Consequently, a decline in the value of the partnership assets is not considered a business purpose.

**“A” is an incorrect response.** This reason is the second example of a business purpose provided by the regulations.

**“B” is an incorrect response.** This reason is the third example of a business purpose provided by the regulations.
B.3 Other Implications Resulting from the Sale

Although the partnership’s taxable year is unaffected by a partner’s sale (unless a termination described in Section E.3 occurs), the taxable year closes with respect to the selling partner at the time of sale if the partner's **entire interest** is sold.\(^6\) Thus, the partner is required to report his distributive share of income in the year of sale. Depending on the partnership taxable year, this requirement could result in reporting up to 23 months of income in one year. The partner must report his share of income for the length of time the partnership interest was held during the year. Two methods are available. First, by agreement among the partners, the entire year's partnership income, deduction, gain or loss, according to how long each partner held a partnership interest during the year (pro rata method).\(^7\) Second, if the partners fail to agree on the pro rata method, an interim closing of the partnership books is required.

Example 36

Bob Jones is a 1/3 partner of the ABC partnership which reports its activities on a March 31 fiscal year. For the fiscal year ended (FYE) 3/31/11, the ABC’s partnership income is $90,000. On September 30, 2011, Bob sold his entire interest. The partners agree to use the pro rata method for allocating partnership income and treat each month as a 30 day-period (i.e., 360 days per year). For the FYE 3/31/12, ABC reports $120,000 of partnership income.

Because Bob sold his entire interest in 2011, his partnership taxable year beginning on April 1, 2011, closes on September 30, 2011. During 2011 he must report $50,000 of partnership income computed as follows:

\[
\begin{align*}
\text{FYE 3/31/11 - 1/3 x $90,000} & = 30,000 \\
\text{FYE 3/31/12 - 1/3 x $120,000 x 180/360} & = 20,000 \\
\text{Total} & = 50,000
\end{align*}
\]

Example 37

Refer to the facts of Example 36 except the partnership agreement requires the use of the interim closing method. For the six-month period ending 9/30/11 the partnership income is $30,000. As a result, Bob would only have to report $10,000 (1/3 x $30,000) of partnership income for the FYE 3/31/12.

Another implication of a sale may be the termination of the partnership if more than a 50% interest in the partnership is sold during a 12-month period. Partnership terminations are covered in Section E. 3 below.

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

15. On September 30, 2011, Jack Sanders sells one-half of his 40% interest in ABC partnership. The partnership reports on a fiscal year ending (FYE) June 30. For the FYE ending June 30,
2011, partnership income was $60,000. For the FYE ending June 30, 2012, partnership income was $120,000. Assuming that Jack reports on the calendar year, what is Jack's share of partnership income under the pro rata method for 2011 and 2012.

a. 2011 - $24,000; 2012 - $30,000.

b. 2011 - $30,000; 2012 - $24,000.

c. 2011 - $24,000; 2012 - $48,000.

Solutions

15. “A” is the correct response. Since Jack did not sell his entire interest, his taxable year did not close on September 30, 2011 so none of his share of income for the FYE June 30, 2012 is reported in 2011. In 2011, he reports $24,000 (40% x $60,000) of income for the FYE June 30, 2011. Under the pro rata method, he reports $30,000 of income in 2012 computed as follows: (1) for the first three months of the 2012 fiscal year he reports $12,000 ($120,000 x 3/12 x 40%); (2) for the remaining nine months of the 2012 fiscal year he reports $18,000 ($120,000 x 9/12 x 20%); (3) the combined amount equals $30,000 ($12,000 + $18,000).

“B” is an incorrect response. If the taxable year closed with respect to the 20% interest that was sold on September 30, $6,000 ($120,000 x 3/12 x 20%), of partnership income for FYE June 30, 2012 would be reported in 2011 making the total $30,000 for the year. However, the taxable year closes with respect to the selling partner only if the partner’s entire interest is sold.

“C is an incorrect response. $48,000 would be Jack’s share of income in 2012 if he had not sold 20% of his partnership interest.

C. PARTNERSHIP DISTRIBUTIONS

The first partnership taxation course explains the general tax consequences of nonliquidating distributions. This course provides a detailed analysis of distributions including, the basis allocation rules when multiple properties are distributed, the optional basis adjustment resulting from partnership distributions, the tax treatment of liquidating distributions, and the tax treatment of disproportionate distributions.

C.1 Nonliquidating Distributions

As covered in the first partnership taxation course, generally gain is recognized only if the amount of cash distributed exceeds the basis of the partner’s interest in the partnership (outside basis). The only exceptions to this rule are (1) certain property distributions which trigger built-in gain recognition (covered in Section A.13 above), disproportionate distributions (covered in Section C.3 below), and distributions of marketable securities (considered cash) which exceed the partner’s outside basis (covered in Section D.1 of the first partnership taxation course). Losses may be recognized only in the cases of liquidating distributions and disproportionate distributions.
For nonliquidating distributions, generally the basis of the property in the hands of the partner equal the basis of the property distributed. However, if the partner’s outside basis is less than the basis of the property distributed, the property’s basis is reduced to the partner’s outside basis immediately before the distribution. In the event multiple properties are distributed, the allocation of the partner's outside basis is made to the assets distributed in the following order:

1. Cash (including a reduction in the partner's share of partnership debt).
2. Unrealized receivables and inventory items in an amount equal to the basis to the partnership of the property distributed (category 1).
3. Other Property (category 2).

The amount of basis allocated to each category of assets as well as to individual assets within a category depend on whether the bases of the assets distributed are greater or less than the partner’s outside basis immediately before the distribution. We first cover the case when the partner's outside basis after any cash distribution is greater than the sum of the bases of the assets distributed. The bases of the property in the hands of the partner will be the same as they were when the assets were held by the partnership and the partner’s outside basis will be positive.

Example 38

Partner A has an outside basis of $50,000. Pursuant to a nonliquidating distribution, Partner A receives $20,000 (basis of $15,000) of inventory and $25,000 (basis of $20,000) of land held by the partnership for investment. Since his outside basis is greater than the sum of the bases of the assets distributed, his outside basis is reduced down to $15,000 by the sum of the bases of the assets distributed ($35,000) and the bases of the assets in the hands of the partner equal the bases of the assets inside the partnership ($15,000 for the inventory and $20,000 for the land).

We next cover the case when the partner's outside basis after any cash distribution is less than the sum of the bases of the assets distributed. The partner’s outside basis is first allocated to the category 1 assets up to the amount of the their basis. If there is insufficient outside basis to cover the category 1 assets, the basis of each asset in category 1 is reduced according to a formula explained in the next paragraph. If there is sufficient outside basis to cover the category 1 assets, any remaining basis is allocated to category 2 assets in a manner described in the next paragraph.

Example 39

Partner A has an outside basis of $45,000. Pursuant to a nonliquidating distribution, he receives $10,000 of cash, $22,000 (basis of $20,000) of inventory and $20,000 (basis of $24,000) of land held by the partnership for investment.

Partner A’s basis after the cash distribution is $35,000. Since this is less than the $44,000 in basis of the two other assets distributed, the ordering rules require that
the partner’s outside basis of $35,000 be allocated first to the inventory (category 1 asset) in an amount of its basis of $20,000. The remaining basis of $15,000 ($35,000 - $20,000) is allocated to the land (category 2 asset). Thus, the basis of the two properties after the distribution are $20,000 for the inventory and $15,000 for the land and Partner A’s outside basis has been reduced to zero.

Suppose the land in Example 39 was actually two parcels of land A and B, where land A is valued at $12,000 (basis of $13,000) and land B is valued at $8,000 (basis of $11,000). We know that in total, the bases of the two parcels will equal $15,000 which results in a basis reduction of $9,000 ($15,000 - $24,000). The basis allocation rules mandate how the reduction is allocated to the two assets in a two-step process. First, the basis of each asset is reduced by their unrealized depreciation (decline). In this case, the basis of Land A is reduced by $1,000 ($12,000 - $13,000) and the basis of Land B is reduced by $3,000 ($8,000 - $11,000). If the total basis reduction were less than the total unrealized depreciation ($4,000 in this case), the basis reduction would be allocated to the properties on the respective amounts of unrealized depreciation (see Example 40 below) and there would be no need for step 2. Second, the remaining $5,000 reduction is allocated in proportion to the property’s respective bases after the reduction in the first step. In this case, 60% ($12,000/($12,000 + $8,000)) of the $5,000 reduction or $3,000 is allocated to Land A and $2,000 of the reduction is allocated to Land B resulting in an adjusted basis of $9,000 for Land A and $6,000 for Land B summarized as follows:

<table>
<thead>
<tr>
<th>Original basis in the property</th>
<th>Land A</th>
<th>Land B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$13,000</td>
<td>$11,000</td>
<td>$24,000</td>
<td></td>
</tr>
<tr>
<td>Step 1 – unrealized depreciation</td>
<td>(- 1,000)</td>
<td>(- 3,000)</td>
<td>(- 4,000)</td>
</tr>
<tr>
<td>Net before Step 2</td>
<td>12,000</td>
<td>8,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Step 2 – remaining reduction</td>
<td>(- 3,000)</td>
<td>(- 2,000)</td>
<td>(- 5,000)</td>
</tr>
<tr>
<td>Basis after the distribution</td>
<td>$ 9,000</td>
<td>$ 6,000</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

Note that the final basis allocation of $15,000 to Land A and B has been made in proportion to the properties’ fair market values. In order for this to happen two conditions are required: (1) both steps are needed to make the bases reductions and (2) both properties have declined in value.

**Example 40**

Assume the same facts as Example 39 except the partner’s outside basis is $51,000. After the $10,000 cash reduction and $20,000 of basis allocated to the inventory, the partner’s remaining outside basis is $21,000 resulting in a total basis reduction in Land A and B of $3,000 ($21,000 - $24,000). Since the unrealized depreciation of $4,000 is greater than the $3,000 basis reduction, the $3,000 is allocated to Land A and B on the relative declines of $1,000 and $3,000 or 25% ($750) to Land A and 75% ($2,250) to Land B. As a result, the bases of Land A and Land B are $12,250 and $8,750 summarized as follows:
<table>
<thead>
<tr>
<th>Original basis in the property</th>
<th>Land A</th>
<th>Land B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$13,000</td>
<td>$11,000</td>
<td>$24,000</td>
<td></td>
</tr>
</tbody>
</table>

Step 1 – unrealized depreciation, limited to an overall reduction of $3,000

<table>
<thead>
<tr>
<th></th>
<th>Land A</th>
<th>Land B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>(750)</td>
<td>(2,250)</td>
<td>(3,000)</td>
<td></td>
</tr>
</tbody>
</table>

$12,250 $8,750 $21,000

Note that final allocations are no longer based on the properties relative fair market values since Step #2 was not necessary.

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

16. Partner A has an outside basis of $200,000. Pursuant to a nonliquidating distribution, Partner A receives $120,000 (basis of $100,000) of inventory, land A worth $29,000 (basis of $33,000) and Land B worth $87,000 (basis of $91,000). Both land A and B were held by the partnership for investment. After the distribution, what is the basis of Land A in the hands of the partnership?

   a. $33,000.
   b. $29,000.
   c. $25,000.

Solutions

16. “C” is the correct response. According to the basis ordering rules, the basis of the inventory is considered to be distributed first thereby reducing A’s outside basis to $100,000 ($200,000 - $100,000). The remaining $100,000 is allocated as follows:

<table>
<thead>
<tr>
<th>Original basis in the property</th>
<th>Land A</th>
<th>Land B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$33,000</td>
<td>$91,000</td>
<td>$124,000</td>
<td></td>
</tr>
<tr>
<td>(4,000)</td>
<td>(4,000)</td>
<td>(8,000)</td>
<td></td>
</tr>
<tr>
<td>Net before Step 2</td>
<td>29,000</td>
<td>87,000</td>
<td>116,000</td>
</tr>
<tr>
<td>Step 2 – remaining reduction (by basis)</td>
<td>(4,000)</td>
<td>(12,000)</td>
<td>(16,000)</td>
</tr>
<tr>
<td>Basis after the distribution</td>
<td>$25,000</td>
<td>$75,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

“A” is an incorrect response. $33,000 is the original basis. When the partner’s outside basis is less than the basis of the properties distributed, the bases are reduced as explained above.

“B” is an incorrect response. $29,000 is the basis of Land A before step 2. It is further reduced in proportion to its relative basis after step 1 as shown above.

C.2 Liquidating Distributions

C.21 Basis of Property Distributed

When the partner’s outside basis after any cash distribution is less than the sum of bases of the assets distributed as in the case of Examples 39 and 40 above, the basis allocation rules for liquidating distributions are the same as the rules for nonliquidating distributions. However, the basis allocation rules for liquidating distributions are not the same when the partner's outside basis after any cash distribution is greater than the sum of bases of the assets distributed. In the
nonliquidating case, the partner continues to be a partner so he retains an outside basis. However, in the liquidating case, the partner’s outside basis is eliminated because he no longer is a partner.

Under no circumstances may the basis of category 1 assets (unrealized receivables and inventory) be greater (stepped up) than their bases inside the partnership. Therefore, any excess basis (outside basis less basis of assets distributed) is allocated to category 2 assets. Similar to basis reductions, the basis increases are allocated to the category 2 assets in a two-step process. First, the basis of each category 2 asset is increased by their unrealized appreciation. If the total basis increase is less than the total unrealized appreciation, the basis increase is allocated to the properties in proportion to their unrealized appreciation. Second, the remaining increase, if any, is allocated in proportion to the property’s respective fair market values.

Example 41

Partner A has an outside basis of $58,000. Pursuant to a liquidating distribution, Partner A receives $30,000 (basis of $25,000) of inventory, $20,000 (basis of $15,000) of land A and $10,000 of land B (basis of $7,000). Land A and B had been held for investment by the partnership. Assume the distribution is not considered to be a disproportionate distribution.

According to the ordering rules for distributions, the inventory is deemed to be distributed first. Since there is sufficient amount of outside basis, the basis of the inventory in the hands of the partner equals the basis inside the partnership, or $25,000 in this case. The remaining $33,000 ($58,000 - $25,000) is allocated to land A and B as follows:

<table>
<thead>
<tr>
<th>Original basis in the property</th>
<th>Land A</th>
<th>Land B</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 1 – unrealized appreciation</td>
<td>$15,000</td>
<td>$7,000</td>
<td>$22,000</td>
</tr>
<tr>
<td>Step 2 – remaining increase (relative FMVs)</td>
<td>$5,000</td>
<td>$3,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>Basis after the distribution</td>
<td>$22,000</td>
<td>$11,000</td>
<td>$33,000</td>
</tr>
</tbody>
</table>

Note that as in the case of Example 39 above, the final basis allocation of $33,000 to Land A and B has been made in proportion to the properties’ fair market values. In order for this to happen two conditions are required: (1) both steps are needed to make the bases increases and (2) both properties have increased in value.

C.22 Tax Treatment of Partnership Liquidations

As in the case of nonliquidating distributions, gain generally is recognized only to the extent that the cash distributed exceeds the basis of the partner's interest in the partnership. Loss is recognized only if the sum of (1) cash + (2) basis of unrealized receivables, + (3) basis of inventory items (or any combination of the three items) distributed to the partner is less than the partner's outside basis. No other property may be distributed if loss recognition is to be permitted. The loss is a capital loss.
Example 42

Billy and Bob are equal partners of the BB partnership. They have decided to liquidate the partnership. The fair market value and basis of assets of the partnership immediately before liquidation are as follows:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>50,000</td>
<td>42,000</td>
</tr>
<tr>
<td>Land (capital asset)</td>
<td>50,000</td>
<td>48,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$200,000</strong></td>
<td><strong>$190,000</strong></td>
</tr>
</tbody>
</table>

Assume that each partner has a basis of $95,000 in his partnership interest. All partnership debts have been paid prior to liquidation. It is decided that each partner will receive a pro rata distribution of each property.

As a result, neither partner will recognize gain (cash distributed does not exceed partner's basis in the partnership interest). In addition, no loss will be recognized since property (land) other than cash, unrealized receivables and inventory is distributed to each partner.

Example 43

Refer to the facts of Example 42 and assume that Billy will receive all of the cash and Bob will receive the inventory and land.

Billy must recognize $5,000 of gain since the cash distribution exceeds his basis by $5,000. Bob recognizes no gain or loss.

Example 44

Assume the same facts as in Example 42 except Billy receives $50,000 cash and all of the inventory. Bob receives $50,000 of cash and all of the land.

Billy recognizes a $3,000 loss since the basis of Billy's partnership interest ($95,000) exceeds the sum of the $50,000 cash and the basis of the inventory ($42,000) distributed by $3,000.

The results in Example 44 may seem irrational since the partner's realized gain is $5,000 ($100,000 amount realized less $95,000 basis). In addition, the inventory actually has appreciated. Recall from Section C.21 that under no circumstances may the basis of category 1 assets (inventory in this case) be greater than their bases inside the partnership. Without this rule, Billy’s $45,000 of basis remaining after the cash distribution would be allocated to the inventory stepping it up by $3,000. If he sold the inventory immediately after the distribution for $50,000, his gain would $5,000 instead of $8,000. The rule essentially prevents the conversion of ordinary income to capital gain or loss. The numbers are small in this case but if they were multiplied by 10, generally, $50,000 of ordinary income and no capital gain or loss is better tax wise than $80,000 of ordinary income and $30,000 of capital loss, particularly, if the taxpayer did not have any capital gain income (only $3,000 of capital loss is deductible).
C.23 Optional Basis Adjustment Resulting from Property Distributions

The rules governing the optional basis adjustment for property distributions generally are more cumbersome than for sales of a partnership interest. Two distinct events trigger a basis adjustment to the partnership assets resulting from partnership distributions – (1) gain or loss recognition by the partner and (2) an upward or downward adjustment to the basis of property distributed to the partner receiving the property.

If gain or loss is recognized from a cash or property distribution, the amount of the adjustment is the partner's gain or loss. The gain or loss may have occurred because of the appreciation of capital assets, trade or business assets or ordinary income assets. However, the Treasury regulations require that the adjustment be allocated only to capital assets or trade or business property.67

Example 45

Partner A owns a 1/3 interest in the ABC Partnership. Currently, the fair market value (FMV) of the assets owned by the partnership is $60,000 and the liabilities total $30,000. The basis of the partnership assets is $45,000. A breakdown of the fair market value and basis of the assets is as follows:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>19,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Land A (capital asset)</td>
<td>12,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Land B (capital asset)</td>
<td>9,000</td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$60,000</strong></td>
<td><strong>$45,000</strong></td>
</tr>
</tbody>
</table>

Partner A's outside basis equals $15,000. Assume that the partnership liquidates his partnership interest for $10,000 cash plus the discharge of his share of partnership liabilities ($10,000).

The deemed cash distribution equals $20,000 ($10,000 cash plus $10,000 discharge of liabilities). As a result, Partner A reports a $5,000 capital gain and the partnership is allowed to increase the basis of the partnership assets by $5,000.

Even though a portion of Partner A's gain was attributable to an increase in the value of the inventory, the partnership must allocate the $5,000 basis adjustment to the capital assets (land A and land B).

The method of allocating the gain to the basis of the partnership’s capital assets is similar to the method of allocating “excess basis” (partner’s outside basis less basis of category 2 assets) to category 2 assets received by a partner pursuant to a liquidating distribution (see Section C.21 above). The first step allocates the gain to the partnership’s capital assets in proportion to their respective amounts of unrealized appreciation, but only to the extent of each property’s unrealized
appreciation. If there is additional gain to be allocated, the second step allocates any remaining gain to capital assets in proportion to their relative fair market values.\(^{58}\)

**Example 46**

Refer to the facts of Example 45. Both land A and B have appreciated $6,000. Therefore, the $5,000 adjustment is allocated equally ($2,500 each). If the unrealized appreciation had been less than $5,000, the remaining gain would be allocated on the basis of relative fair market values (12/21 of the remaining gain to land A and 9/21 of the remaining gain to land B).

If the partner had recognized a loss from the liquidation of her interest, the loss also is allocated using a two step process – (1) the loss is allocated to the partnership’s capital assets in proportion to their respective amounts of unrealized depreciation, but only to the extent of each property’s unrealized depreciation; (2) any remaining decrease is allocated to the capital assets in proportion to their adjusted bases (as adjusted after step 1).\(^{69}\)

**Example 47**

Partner A owns a 1/3 interest in the ABC Partnership. Currently, the fair market value (FMV) of the assets owned by the partnership is $60,000 and the liabilities total $30,000. The basis of the partnership assets is $45,000. A breakdown of the fair market value and basis of the assets is as follows:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>16,000</td>
<td>19,000</td>
</tr>
<tr>
<td>Land A (capital asset)</td>
<td>6,000</td>
<td>12,000</td>
</tr>
<tr>
<td>Land B (capital asset)</td>
<td>3,000</td>
<td>9,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$45,000</strong></td>
<td><strong>$60,000</strong></td>
</tr>
</tbody>
</table>

There are no partnership liabilities and Partner A's outside basis equals $20,000. Assume that the partnership liquidates his partnership interest for $15,000 cash. Partner A recognizes $5,000 ($15,000 - $20,000) of loss from the liquidating distribution. The optional basis adjustment is a decrease of $5,000 allocated only to the capital assets. Both land A and B have declined $6,000. Therefore, the $5,000 downward adjustment is allocated equally (minus $2,500 each).

When property is distributed to a partner and its basis is adjusted in the manner described in Section C.21 above, the partnership makes an adjustment in the same amount but in the opposite direction to property of a similar character which it holds.\(^{70}\) Property is broken down into two categories, (1) capital assets and trade or business property, and (2) ordinary income property. Thus, if the partner made a downward basis adjustment in capital asset property, the partnership would make an upward basis adjustment to capital assets and trade or business property. If like property is not held by the partnership following the distribution or the basis of the property is already reduced to zero (in the case of a downward adjustment), the adjustment is suspended until the partnership
acquires property of a like character to which an adjustment can be made. The allocations of the basis adjustment to the assets within a class are made in the same manner as the allocations of gain (basis increase) or loss (basis decrease) which resulted from a partner liquidating distribution.

**Example 48**

Partner A is a one-third partner in the PRS partnership and is liquidating his interest in the partnership. The adjusted basis and fair market value of PRS's assets prior to A's liquidation are as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
<th>Basis</th>
<th>Appreciation or Decline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Gain Property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset 1</td>
<td>$ 75,000</td>
<td>$ 25,000</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Asset 2</td>
<td>117,500</td>
<td>100,000</td>
<td>17,500</td>
</tr>
<tr>
<td>Asset 3</td>
<td>60,000</td>
<td>50,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Ordinary Income Property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset 4</td>
<td>45,000</td>
<td>40,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Asset 5</td>
<td>60,000</td>
<td>50,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Asset 6</td>
<td>2,500</td>
<td>10,000</td>
<td>(7,500)</td>
</tr>
<tr>
<td>Total</td>
<td>$360,000</td>
<td>$275,000</td>
<td>$ 85,000</td>
</tr>
</tbody>
</table>

Assume that PRS distributes Assets 3 and 5 to Partner A in complete liquidation of A's interest in the partnership. Partner A's basis in the partnership interest was $75,000. The partnership's basis in Assets 3 and 5 was $50,000 each. A's $75,000 basis in its partnership interest is allocated to Assets 3 and 5 in a manner described in Section C.21. Partner A will, therefore, have a basis of $50,000 in Asset 5 (ordinary income or category 1 property) and a basis of $25,000 in Asset 3 (capital gain or category 2 property). The partnership has an election in effect under section 754. Because the distribution results in a $25,000 decrease in Asset 3, the partnership will have a $25,000 increase in the basis of capital gain property. There is no change in the basis of ordinary income property. The $25,000 is allocated to Assets 1 and 2 in proportion to their relative appreciation as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Total</th>
<th>Asset 1</th>
<th>Asset 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original basis</td>
<td>$125,000</td>
<td>$25,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Basis increase</td>
<td>25,000</td>
<td>18,519 (50k/75.5k x $25k)</td>
<td>6,481</td>
</tr>
<tr>
<td>Total</td>
<td>$150,000</td>
<td>43,519</td>
<td>$106,481</td>
</tr>
</tbody>
</table>

It should be reemphasized that the basis adjustment is required only if an IRC Section 754 election is in effect (see Section B.22 above). While these adjustments may restore equity and eliminate anomalies, they increase the recordkeeping burden for partnerships. Therefore, the costs and benefits of a Section 754 election should be evaluated before the election is made.

**REVIEW QUESTIONS AND SOLUTIONS**  (Based on Sections C.2 - C.23)

**Questions**

17. Which one of the following statements is true concerning the liquidation of a partnership interest assuming that the distribution is not disproportionate (Section 751(b) does not apply) and there is no built-in-gain property?
a. A partner liquidating a partnership interest may not recognize a loss at the time of liquidation.

b. A partner receiving only $20,000 cash in complete liquidation of his interest will recognize a $5,000 loss if his outside basis equals $15,000.

c. A partner liquidating a partnership interest will not recognize a gain at the time of liquidation if only property (not including cash or marketable securities) is distributed to the partner.

BASE YOUR ANSWERS TO QUESTIONS 18 AND 19 ON THE FACTS BELOW

John is a partner in a partnership which is in liquidation. All partnership debts have been paid. The fair market value and basis of partnership assets distributed to John pursuant to the liquidation are as follows:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>40,000</td>
<td>35,000</td>
</tr>
<tr>
<td>Land (capital asset)</td>
<td>60,000</td>
<td>35,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100,000</strong></td>
<td><strong>70,000</strong></td>
</tr>
</tbody>
</table>

John's outside basis immediately before the liquidation is $80,000.

18. What is the gain or loss recognized by John as a result of the liquidating distribution?

a. $20,000 Gain.
b. $10,000 Loss.
c. $  -0-.

19. The basis of the land to John after the liquidation equals:

a. $45,000.
b. $48,000.
c. $35,000.

20. With respect to the optional basis adjustment triggered by a partner's receiving a liquidating distribution, which one of the following statements is true?

a. If a partner recognizes gain, the partnership is allowed to increase all of its appreciated assets by a percentage of the gain.
b. If a partner is required to reduce the basis of the property distributed, the partnership increases the basis of appreciated assets of similar character.
c. The partnership is not allowed to make any basis adjustment if a partner recognizes a loss from the liquidating distribution.

Solutions

17. “C” is the correct response. Except for the conditions specified above, gain is recognized by the partnership only if cash is distributed and the cash distributed exceeds the partner’s outside basis.

“A” is an incorrect response. Losses are recognized at the time of liquidation when (1) capital assets and trade or business assets are not included in the distribution and (2) the sum of cash and the basis of the assets distributed (only unrealized receivables and inventory items) are less than the partner’s outside basis.
“B” is an incorrect response. Since the cash distributed exceeds the partner’s outside basis, gain is recognized. Loss would be recognized if the amount of the cash distribution were less than $15,000.

18. “C” is the correct response. The solutions to question #17 detail the circumstances when gain or loss is recognized by a partner as a result of a liquidating distribution. Since no cash was distributed, there can be no gain recognition and since a capital asset was distributed, there can be no loss recognition.

“A” is an incorrect response. No gain is recognized since cash was not distributed.

“B” is an incorrect response. Loss is not recognized because a capital asset was distributed.

19. “A” is the correct response. According to the basis ordering rules, the basis of the inventory is considered to be distributed first thereby reducing A’s outside basis to $45,000 ($80,000 - $35,000). The remaining $45,000 is allocated to the land.

“B” is an incorrect response. $48,000 would be correct if the partner’s outside basis of $80,000 were allocated on the basis of relative fair market values (60% of $80,000).

“C” is an incorrect response. $35,000 would be correct if the land were considered to be distributed before the inventory or the law provided for no basis step up (carryover basis).

20. “B” is the correct response. When a partner makes a basis adjustment to distributed property, the partnership makes an adjustment in the same amount but in the opposite direction to property of a similar character which it holds.

“A” is an incorrect response. When a partner recognizes gain from a partnership distribution, the partnership makes a positive adjustment only to capital assets and trade or business assets.

“C” is an incorrect response. When a partner recognizes loss from a partnership distribution, the partnership makes a negative adjustment only to capital assets and trade or business assets.

C.3 Disproportionate Distributions

From a technical viewpoint, disproportionate distributions increase the record-keeping requirements of partnerships and are somewhat difficult to explain to a partner who does not have an expertise in income taxation. However, from a conceptual viewpoint, the provisions governing disproportionate distributions are fairly simple. They attempt to prevent the shifting of the character of income or loss items from one partner to another.

A disproportionate distribution cannot occur unless the partnership contains either unrealized receivables or substantially appreciated inventory immediately before the distribution. Unrealized receivables and inventory items were defined in Section B.1 above. Substantially appreciated inventory is defined as inventory items, with respect to which the aggregate fair market value exceeds 120% of the aggregate basis of the inventory items. For presentation purposes, unrealized receivables and substantially appreciated inventory are termed
Section 751 assets. Other assets are termed Section 741 assets (trade or business assets and capital assets). The provisions governing disproportionate distributions do not apply to liquidating payments which represent guaranteed payments or a distributive share of partnership income (see Section D).

Example 49

Partner A owns a 1/3 interest in the ABC Partnership. Currently, the fair market value (FMV) of the assets owned by the partnership is $90,000 and the liabilities total $30,000. The basis of the partnership assets is $60,000. A breakdown of the fair market value and basis of the assets is as follows:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>A/R</td>
<td>9,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Inventory</td>
<td>24,000</td>
<td>21,000</td>
</tr>
<tr>
<td>Building</td>
<td>15,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Land (capital asset)</td>
<td>27,000</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$90,000</strong></td>
<td><strong>$60,000</strong></td>
</tr>
</tbody>
</table>

The building has been depreciated on the straight-line basis. Therefore, there is no depreciation recapture potential. Taking the word "inventory" literally, it would appear that the 120% test is failed since 120% of the $21,000 basis for inventory is $25,200 and the fair market value of the inventory is only $24,000. Thus, we can conclude that the partnership does not have substantially appreciated inventory. Or can we?

Recall that the definition of an inventory items includes property other than a capital asset or a trade or business asset. Thus, unrealized receivables are considered to be an inventory item. As shown below, the 120% test is met, so the partnership does in fact have substantially appreciated inventory.

<table>
<thead>
<tr>
<th></th>
<th>FMV of inventory items ($9,000 + $24,000)</th>
<th>$33,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis of inventory items (-0- + $21,000)</td>
<td>21,000</td>
<td></td>
</tr>
</tbody>
</table>

FMV/Basis % 157%

---

**TAX SAVER!!** Collecting unrealized receivables before selling the partnership interest may be beneficial if it results in reducing the appreciation of inventory items below 20 percent. Referring back to Example 49, if there were no unrealized receivables, the inventory would not be substantially appreciated.

---

When a distribution is made, it will not be considered disproportionate if the distribution of Section 751 assets and Section 741 assets are made in proportion to the total value of the two classes of assets. That is, each type of asset need not be distributed pro rata. Rather, the distributions of the two classes of assets need to be made on a pro rata basis.

Example 50

Partner B is liquidating his 20% partnership interest. The fair market value and basis of the assets of the partnership immediately before the liquidating distribution are as follows:
There are no liabilities and Partner B is to receive 20% of each property in liquidation of his interest.

The inventory is a Section 751 asset (greater than 20% appreciation). However, since Partner B receives a pro rata interest in each property, the disproportionate distribution rules do not apply so the general rules of partner liquidating distributions apply.

Example 51

Refer to the facts of Example 50. Assume that Partner B's $18,000 property liquidation consists of $6,600 of inventory and $11,400 of cash. Is this a disproportionate distribution?

To answer this question, you need to calculate Partner B's share of Section 751 and 741 assets. His share of the inventory is $6,600 (20% x $33,000). His share of Section 741 assets is $11,400 ((20%) x ($15,000 + $15,000 + $27,000)). Although he did not receive his share of each asset, he did receive his share of Section 751 and Section 741 assets. Thus, a disproportionate distribution has not occurred and the general liquidation rules apply.

Example 52

Refer to the facts of Example 50. Assume that Partner B's $18,000 property liquidating distribution consists of $3,000 cash and the $15,000 building.

In this case, he received no Section 751 assets. Thus, a disproportionate distribution has occurred.

Example 53

Refer to the facts of Example 50. Assume that Partner B's $18,000 property liquidating distribution consists of $18,000 of inventory.

In this case, he received no Section 741 assets. Thus, a disproportionate distribution has occurred.

C.31 Tax Consequences to the Liquidating Partner and the Partnership

When there is a disproportionate distribution, the following transactions are deemed to take place in the order specified.

1. A pro rata distribution of each asset category.
2. A sale of a portion of the "distributed" assets to the partnership.

The amount of the deemed distribution depends on how much Section 751 or Section 741 assets were given up in exchange for the other class of assets. The partner's outside basis is first reduced by the basis of the assets deemed to be distributed to the partner. The basis of the remaining assets distributed are computed in the manner described in Section C.21 above.
The deemed sale of property depends on the actual distribution. If there is a distribution of “excess” (more than the partner’s share) **Section 751 property**, the following "sales" take place:

1. The partnership is deemed to have sold some or all of its Section 751 property to the partner. Thus, it realizes ordinary income from the sale.\(^\text{76}\)

2. The partner is deemed to have sold some or all of his share of Section 741 property to the partnership thereby realizing capital gain (or trade or business gain) from the sale.\(^\text{77}\)

If there is a distribution of “excess” (more than the partner’s share) **Section 741 property**, the following "sales" take place:

1. The partnership is deemed to have sold some or all of its Section 741 property to the partner. Thus, it realizes capital gain (or trade or business gain) from the sale.\(^\text{78}\)

2. The partner is deemed to have sold some or all of his share of Section 751 property to the partnership thereby realizing ordinary income from the sale.\(^\text{79}\)

Anytime there is a disproportionate distribution, four questions need to be answered:

1. What is the gain recognized by the partnership (if any)?
2. What is the gain recognized by the partner (if any)?
3. What are the bases of the assets distributed to the partner?
4. What are the bases of the assets retained by the partnership.

The next example answers these questions by taking you through the required calculations.

**Example 54**

Assume the partnership has the following assets:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>A/R</td>
<td>9,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Inventory</td>
<td>24,000</td>
<td>21,000</td>
</tr>
<tr>
<td>Land</td>
<td>48,000</td>
<td>30,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$90,000</strong></td>
<td><strong>$60,000</strong></td>
</tr>
</tbody>
</table>

Also assume that the partner's outside basis is $20,000 and there are no liabilities. The partner received $30,000 of land in complete liquidation of his one-third interest in the partnership. Since the partner gave up his right to his share of Section 751 assets (A/R and inventory), a disproportionate distribution has occurred.
Tax Consequences to the Partner

1. Determine the partner's distributive share of all assets:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>A/R</td>
<td>3,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Inventory</td>
<td>8,000</td>
<td>7,000</td>
</tr>
<tr>
<td>Land</td>
<td>16,000</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$30,000</strong></td>
<td><strong>$20,000</strong></td>
</tr>
</tbody>
</table>

2. Categorize his share of the FMV of the assets into Section 751 assets and Section 741 assets.

- **Section 741 assets** ($3,000 + $16,000) = $19,000
- **Section 751 assets** ($3,000 + $8,000) = $11,000

**Total** = $30,000

3. Determine how much Section 751 assets were "sold" for Section 741 assets.

- **Total interest** = $30,000
- **Less Section 741 assets** = -19,000

**Deemed Sale of Section 751 assets** = $11,000

Note, since the partner did not receive any actual Section 751 assets, the sales price also can be computed by adding his share of Section 751 assets ($3,000 + $8,000).

4. Determine the gain or loss from the sale. Absent any agreement, the assets are deemed to be sold pro rata.

- **Sales Price** = $11,000
- **Basis** (1/3 x $30,000) = -7,000

**Ordinary Income** = 4,000

5. Determine the basis of assets in the hands of the liquidating partner.

- **Basis of partner's interest** = $20,000
- **Less basis of property attributable to the "deemed sale"** (1/3 of the basis of A/R and inventory) = -7,000

**Remaining basis allocated to $19,000 of land which was distributed and not treated as a sale/purchase.** = $13,000

**Plus basis of land from the "purchase" of $11,000** = 11,000

**Total basis in the land** = $24,000

Note that the $24,000 basis is equal to the basis of the land that would have resulted from the land distribution ($20,000) plus the gain recognized by the partner ($4,000).
Tax Consequences to the Partnership

1. Determine the "deemed sale" of partnership assets to the liquidating partner.

   Partnership's interest in Section 741 assets (before liquidation) $38,000
   Less 741 assets remaining -27,000

   Deemed sale of 741 assets $11,000

   Notice that the $11,000 amount equals the partner's deemed sale of Section 751 assets.

2. Determine the gain or loss from the sale of the land by the partnership to the partner.

   Sales price $11,000
   Basis of land ($30,000 basis/$48,000 FMV) x ($11,000) -6,875

   Capital Gain $  4,125

3. Determine the basis of the assets remaining in the partnership.

   Cash $  9,000
   Inventory (2/3($21,000) + $11,000 "purchased") 25,000
   Land $30,000/$48,000 x ($18,000 FMV remaining) 11,250

   Total $45,250

   Generally, any gain or loss recognized by the partner or partnership should be reflected in a basis adjustment of the assets. In Example 54, a total gain of $8,125 was recognized ($4,000 by the partner and $4,125 by the partnership). To verify the above calculations, a reconciliation of the adjusted bases before and after the distribution follows:

   Reconciliation

   Partnership's basis in assets after the distribution $45,250
   Partner's basis in land 24,000

   Total $69,250

   Beginning Partnership Basis $60,000
   Gain Recognized by Partner 4,000
   Gain Recognized by Partnership 4,125

   Total $68,125

   Difference $  1,125

   The $1,125 difference eventually will be eliminated if the partnership has a Section 754 election in effect. Recall in Step #5 above for the partner's tax consequences, Partner A took a basis of $13,000 in land valued at $19,000. The basis of this land in the hands of the partnership was $11,875 ($19,000 x ($30,000 basis/$48,000 FMV). Thus, Partner A actually increased the land's
basis by $1,125 ($13,000 - $11,875). If the partnership had made a Section 754 election, it must decrease the basis of capital and trade or business assets by $1,125 in a manner described in Section C.23 above.

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

21. True or False. Prior to a liquidating distribution, a partnership has no unrealized receivables and the value of the partnership’s inventory exceeds its basis by 15.5%. As a result, the disproportionate distribution rules do not apply to the liquidating distribution.

** BASE YOUR ANSWERS TO QUESTIONS 22 AND 23 ON THE FACTS BELOW **

Assume the ABCD Partnership has the following assets and has no partnership liabilities:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>40,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Land (Business Asset)</td>
<td>20,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Total</td>
<td>$80,000</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

22. Partner D’s outside basis is $12,500. She receives $4,000 of inventory and $16,000 of land in complete liquidation of her 25% partnership interest. What is the amount and character of the gain recognized by the D?

a. $5,000 Ordinary Income.
b. $3,000 Ordinary Income.
c. $3,000 Capital Gain.

23. What is the basis of the $16,000 worth of land held by D after his liquidation?

a. $ 8,000.
b. $11,000.
c. $13,500.

Solutions

21. ** True is the correct response. ** One of the conditions for the application of the disproportionate distributions rules is that the partnership must have either unrealized receivables or substantially appreciated inventory. For the later, the inventory items must have appreciated by 20%. Since they have not and there are no unrealized receivables the disproportionate distribution rules do not apply.

** False is the incorrect response. ** A second condition for the application of the disproportionate distributions rules is that the classes of property (Sections 741 and 751) are not distributed on a pro rata basis. Both conditions must exist. Since the partnership does not have unrealized receivables or substantially appreciated inventory, the disproportionate distribution rules do not apply.

22. ** “B” is the correct response. ** Partner D’s share of the inventory (which has substantially appreciated) is $10,000 (25% x $40,000). Since she received only $4,000 of inventory, the distribution is considered a disproportionate distribution. The deemed transaction is a distribution of $10,000 of inventory and $10,000 of land followed by sale of $6,000 of inventory in exchange for $6,000 of land. The basis of the inventory distributed (deemed and actual) is $5,000 ($20,000/$40,000 x $10,000) and the basis of the inventory sold is $3,000 ($6,000/$10,000 x $5,000). Therefore, Partner D recognizes $3,000 of ordinary income.
“A” is an incorrect response. $5,000 of ordinary income would be correct if the none of the inventory was actually distributed.

“C” is an incorrect response. Since the deemed sale of property is inventory, the character of the gain is ordinary rather than capital.

23. “C” is the correct response. The basis of the land is comprised of two “deemed” events: (1) the distribution portion and the (2) purchase portion. Recall from solution #22 that the deemed transaction is a distribution of $10,000 of inventory and $10,000 of land followed by sale of $6,000 of inventory in exchange for $6,000 of land. Under the basis rules, the inventory comes out first leaving a basis of $7,500 ($12,500 - $5,000) to be allocated to the $10,000 of land deemed to be distributed. The basis of the remaining $6,000 ($16,000 actual less $10,000 deemed) of land is its “purchase price” of $6,000. Thus, the total basis of the land equals $13,500 ($7,500 + $6,000).

“A” is an incorrect response. $8,000 is the original basis of the $16,000 of land that was distributed. Note that the basis originally equaled 50% of the land’s fair market value (FMV). It has increased $5,500 due to two basis adjustments – $2,500 for allocating $7,500 of basis to $10,000 of land that had an original basis of $5,000 and $3,000 for “purchasing” $6,000 of land that had an original basis of $3,000 (50% of the FMV).

“B” is an incorrect response. $11,000 does not include the $2,500 basis step up (from $5,000 to $7,500) from the deemed land distribution (FMV of $10,000).

D. PARTNERSHIP REDEMPTIONS OR RETIREMENTS

Existing partners of a partnership may agree to buy out a partner's interest in the partnership. The tax treatment is exactly the same as a sale of a partnership interest to an unrelated third party. This treatment was covered in Section B above. On the other hand, if the partnership agreement provides for retirement payments or the partnership buys out the partner's interest, the rules are different. These rules are covered in this section.

D.1 General Concepts

Section 736 governs payments made to a retiring partner or to a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership.80 The payments are made by the partnership, not the partner, in redemption of the partner’s interest. For example, a sale by partner A to partner B of his entire one-fourth interest in partnership ABCD would not come within the scope of Section 736. This section classifies redemption payments as one of three payments:

1. Distributive share of partnership income (Section 736(a)(1)).
2. Guaranteed payments (Section 736(a)(2)).
3. Partner's interest in partnership property (Section 736(b)).

Because of the adverse interests of the retiring partner and the remaining partners, there is considerable latitude in classifying the character of the payments. For example, Section 736(b)
payments qualify for capital gain or loss treatment by the retiring partner and are not deductible by the partnership. The calculation of gain or loss by the retiring partner receiving Section 736(b) payments, as well as the determination of the basis of the property distributed to the retiring partner, are made in the same manner as in the case of the complete liquidation of the partnership (Section C.2 above).

Section 736(a)(1) and (a)(2) payments are taxable as ordinary income to the retiring partner and reduce the amount of taxable income which is allocated to the remaining partners. If the retiring partner has no capital losses, and is in a relatively low marginal tax rate, it could be advantageous for the partnership to increase the overall retirement payment if the retiring partner agrees to shift a portion of 736(b) payments (within the legal requirements of Section 736) to either of the 736(a) payments assuming the shift would not result in extra self-employment tax. The immediate reduction of taxable income to the remaining partners resulting from Section 736(a)(1) and (a)(2) payments is clearly better for the remaining partners than nondeductible Section 736(b) payments.

Before the retiring partner consents to a shift to Section 736(a)(1) or (a)(2) payments, the effect of self-employment tax should be considered. Net earnings from self-employment generally include income payments from a trade or business carried on by the partnership. Both Section 736(a)(1) and (a)(2) payments are considered distributive shares of income for purposes of the self-employment tax and therefore, would be subject to the tax. There is, however, one important exception. The payments will be excluded from self-employment income if the payments (1) are received pursuant to a written plan of the partnership, (2) are on account of retirement, (3) are made on a periodic basis generally to partners or a class of partners, (4) continue until the partner's death, and (5) are not received on account of the retiring partner's rendering any services during the year. In addition, (6) no other obligation may exist from the other partners, and (7) the capital of the partnership must have been paid to the retiring partner in full by the close of the taxable year.

Section 736 applies only to payments made by the partnership to a retiring partner and not to nonliquidating distributions or transactions between the partners. The payments may be made in cash or partnership property, in lump-sum or multiple payments, and may be fixed or contingent. The effects of the various payment options are discussed next.
** REVIEW QUESTIONS AND SOLUTIONS **

Questions

24. True or False. Concerning complete redemptions of a partner’s interest in a partnership, the partnership would rather classify payments as Section 736 (b) payments rather than Section 736(a) payments.

Solutions

24. **False is the correct response.** Section 736(b) payments are not deductible whereas 736(a) payments reduce the amount of income allocated to the remaining partners. As a result, the partnership would rather have payments classified as 736(a) payments.

**True is the incorrect response.** Section 736(a)(1) payments (distributive share of income) allocate income to the retiring partner and Section 736(a)(2) payments (guaranteed payments) generally are deductible in arriving at taxable income making Section 736(a) payments more attractive to the partnership.

D.2 Lump-sum Cash Payments

If a one-time cash distribution is made in liquidation of the partner's entire interest, the first step in determining the tax treatment of the distribution is to compute the amount of the distribution that is treated as a Section 736(b) payment. Gain is recognized to the extent the Section 736(b) cash distribution exceeds the partner's outside basis. A reduction in liabilities is considered a cash distribution. In determining whether a payment is for the partner's interest in partnership property (Section 736(b) payment), Section 736(b)(2) provides that payments in exchange for a partner's interest in partnership property do not include payments for (1) a partner's interest in unrealized receivables, or (2) goodwill that is not specifically provided for in the partnership agreement.

Payments for these items are taxed as ordinary income to the partner.

Example 55

Partner A owns a 1/3 interest in the ABC Partnership. Assume that the partnership is a professional service partnership (i.e., capital is not a material income-producing factor) and that the partnership agreement provides for no specific payment for goodwill. Currently, the fair market value (FMV) of the assets owned by the partnership is $90,000 and the liabilities total $30,000. Partner A bears the economic risk of loss for $10,000 of the debt. The basis of the partnership assets is $60,000. A breakdown of the fair market value and basis of the assets is as follows:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>A/R</td>
<td>9,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Building</td>
<td>39,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Land</td>
<td>27,000</td>
<td>15,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$90,000</strong></td>
<td><strong>$60,000</strong></td>
</tr>
</tbody>
</table>

The building has been depreciated on the straight-line basis. Therefore, there is no depreciation recapture potential (not an unrealized receivable). Assume that the
The partnership completely redeems Partner A's interest by distributing $25,000 cash. Since the partner is relieved of $10,000 of partnership liabilities, the amount realized is $35,000 ($25,000 cash + $10,000). Absent, Section 736, (as well as the disproportionate distribution rules discussed in Section C.3), Partner A would realize capital gain of $15,000 ($35,000 - $20,000 outside basis). Partner A's share of the partnership's tangible assets is $30,000 (1/3 of $90,000). Arguably, the remaining $5,000 ($35,000 - $30,000) represents a payment for unrecorded goodwill. However, as discussed above, the $3,000 payment for his share of accounts receivable does not represent a Section 736 payment since it is an unrealized receivable. In addition, the $5,000 payment in excess of his share of assets does not constitute a Section 736 payment because payments for goodwill are not specifically provided for in the partnership agreement. As a result, only $27,000 ($35,000 - $3,000 - $5,000) is classified as a Section 736(b) payment resulting in the recognition of capital gain income of $7,000 ($27,000 - $20,000). Since the remaining $8,000 of payments are not determined with respect to income, they are treated as a guaranteed payment and taxed as ordinary income.

---

**TAX SAVER!!** Payments for a partner's interest in goodwill will result in capital gain for the partner and nondeductible payments to the partnership. To avoid misunderstandings and to comply with Section 736(b)(2)(B), any payments for goodwill should be provided for in the partnership agreement.

---

To make matters more complicated, the property payment exclusion rule for unstated goodwill and unrealized receivables applies only if capital is not a material income-producing factor for the partnership and the retiring partner or deceased partner was a general partner. That is, partnership payments are not deductible by partnerships for either a general partner's interest in goodwill (whether specified or not in the partnership agreement) or unrealized receivables where capital is a material income-producing factor. Unfortunately, the regulations do not provide any guidance on how to characterize a payment in excess of the partner’s share of tangible assets. While the excess payment may indeed constitute goodwill, it also may represent a guaranteed payment (perhaps as payment for prior services, future services, or even an incentive payment to induce the partner to retire).

Capital is not considered to be material where substantially all of the partnership's gross income consists of fees, commissions, or other compensation for personal services performed by an individual. Thus, partnerships engaged in medicine, law, accounting, or architecture will not be treated as a trade or business in which capital is a material income-producing factor even if the practitioner may have a substantial capital investment in professional equipment or in an office building, providing that the capital is incidental to the professional practice.
Example 56

Refer to the facts of Example 55 except that capital is a material income producing factor. As a result, the $3,000 for his share of unrealized receivables is considered a Section 736(b) payment. With respect to the remaining $5,000, the tax treatment is somewhat uncertain. If the facts indicate that it was intended to pay Partner A for goodwill, even though it is not provided for in the partnership agreement, then it will also be classified as a Section 736(b) payment. Conversely, if the facts indicate that the payment is intended to pay Partner A for past or future services or it is a payment to induce retirement, it should be classified as a guaranteed payment.

After reading Example 56, it appears that retiring partners in a partnership where capital is a material income producing factor have a tax advantage over service partnerships. This is somewhat true but proper planning by the service partnership could overcome this difference. Although unrealized receivables are treated as a Section 736(b) payment for capital intensive partnerships, if the Section 736(b) payment is considered to be a disproportionate distribution, then the partner will recognize ordinary income to the extent of the cash received for the partner’s share of unrealized receivables. With respect to the tax treatment of goodwill, if a service partnership would like to treat retirement payments for goodwill as a Section 736(b) payment, they can as long as the partnership agreement provides for these payments.

** REVIEW QUESTIONS AND SOLUTIONS **

Questions

25. Concerning the retirement of a partner’s interest, which one of the following statements is true?
   a. Guaranteed payments under Section 736(a)(2) are not deductible by the partnership.
   b. The buyout of a partner by the remaining partners is treated differently than a redemption of a partner’s interest by the partnership.
   c. A partner’s share of substantially appreciated inventory is considered a Section 736(b) payment (interest in partnership property) only if capital is a material income producing factor.

26. Rhonda owns a 20% interest in the ABC Partnership. She is retiring this year. A schedule of assets including an estimate for goodwill is provided below.

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>A/R</td>
<td>20,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Inventory</td>
<td>50,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Land (Capital Asset)</td>
<td>60,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>50,000</td>
<td>-0-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$200,000</strong></td>
<td><strong>$100,000</strong></td>
</tr>
</tbody>
</table>
Pursuant to her retirement, she is to receive a lump-sum payment of $40,000. The partnership provision does not specifically provide for the payment of goodwill. Assuming that capital is a material income-producing factor for the partnership, how much of the payment is considered to be for her interest in partnership property?

a. $40,000.
b. $36,000.
c. $26,000.

27. Refer to the facts of Question #26 except capital is not a material income-producing factor for the partnership. How much of the payment is considered to be for her interest in partnership property?

a. $40,000.
b. $36,000.
c. $26,000.

Solutions

25. **“B” is the correct response.** A buyout of partner by the remaining partners is treated as a sale, which is covered in Section B above. A redemption is treated as a liquidation with respect to Section 736(b) payments and ordinary income with respect to Section 736(a) payments. While the results may be similar if the partnership does not have unrealized receivables, some differences may occur dealing with character of the income and basis adjustments to the partnership property.

**“A” is an incorrect response.** To the contrary, if a retirement payment is classified as a guaranteed payment, it is deductible by the partnership in arriving at taxable income.

**“C” is an incorrect response.** Payments for inventory always are considered a Section 736(b) payment. Only the tax treatment of unrealized receivables and goodwill not provided in the partnership agreement depends on whether capital is a material income producing factor.

26. **“A” is the correct response.** When capital is a material income-producing factor, unrealized receivables and goodwill are included in Section 736(b) payments. Thus, the total payment of $40,000 (20% x $200,000) is considered her interest in partnership property.

**“B” is an incorrect response.** $36,000 would be correct if her interest in partnership property did not include unrealized receivables.

**“C” is an incorrect response.** $26,000 would be correct if her interest in partnership property did not include unrealized receivables and goodwill.

27. **“C” is the correct response.** When capital is not a material income-producing factor, unrealized receivables and goodwill not specified in the partnership agreement are not included in Section 736(b) payments. Therefore, her Section 736(b) payment equals $26,000 ($40,000 - $4,000 - $10,000).

**“A” is an incorrect response.** $40,000 would be correct if unrealized receivables and goodwill were included in Section 736(b) payments when capital is not a material income-producing factor.

**“B” is an incorrect response.** $36,000 would be correct if the payment for goodwill was specified in the partnership agreement. That is, only unrealized receivables would be excluded as Section 736(b) payments when capital is not a material income-producing factor.
D.3 Multiple Payments - Fixed or Contingent

When Section 736 payments are made in installments, the payment must be allocated to each of the three types of payment unless the partners agree to a prescribed allocation.\textsuperscript{88} The Treasury regulations provide rules which allocate the payments into two categories -- Section 736(b), and Section 736(a)(1) and/or (a)(2) payments. Although the tax consequences of Section 736(a)(1) and/or (a)(2) payments are the same (ordinary income), the reporting requirements are different. If the payment is determined \textit{without} regard to partnership income, it is considered a guaranteed payment.\textsuperscript{89} Payments determined with regard to income (which are not considered payments for partnership property) are considered a retiring partner's distributive share of income (Section 736(a)(1) payment).

Two steps are required. In Step 1, determine the amount of the Section 736(b) payment. The portion of each payment deemed to be a Section 736(b) payment is based on the following formula\textsuperscript{90}:

\[
\frac{\text{Expected Total Section 736(b) Payments}}{\text{Expected Total Payments}} \times \text{Installment} = \text{Section 736(b) Payment}
\]

In Step 2, the Section 736(b) payment is subtracted from the actual installment payment to arrive at the amount of Section 736(a)(1) and/or (a)(2) payments. If the actual installment payment is less than the agreed payment, the amount received could be less than the Section 736(b) payment calculated by the above formula. If this occurs, the entire amount is a Section 736(b) payment and any unapplied portion of the Section 736(b) payment is added to the portion of the Section 736(b) payment for the following year.\textsuperscript{91} In other words, before any amounts are allocated to Section 736(a)(1) and (a)(2) payments in later years, any Section 736(b) payment deficiency is made up first.

Example 57

In 2010, Sid George retired from Tower Enterprises, a general partnership. The retirement agreement provided for $60,000 for his interest in partnership property and $40,000 as a guaranteed payment. The $100,000 is to be paid out evenly over 10 years. In 2012, Sid received $10,000 from the partnership.

Applying the above steps in 2012, $6,000 is considered a Section 736(b) payment and $4,000 is considered a guaranteed payment, computed as follows:

\[
\text{Step 1} - \frac{\$60,000}{\$100,000} \times \$10,000 = \$6,000
\]

\[
\text{Step 2} - \$10,000 - \$6,000 = \$4,000.
\]
**Example 58**

The facts are the same as in Example 57 except the partnership was short of cash in 2012 and only $5,000 was paid to Síd. Assume the partnership made up the balance by paying Síd $15,000 plus interest in 2013.

In 2012, all $5,000 is considered a Section 736(b) payment. In 2013, the first $7,000 ($6,000 + $1,000 unpaid from the prior year) is considered a Section 736(b) payment. The remaining $8,000 is considered a guaranteed payment.

If the retiring partner receives payments which are not fixed in amount, all of the payments first are considered to be Section 736(b) payments. When the retiring partner is paid for his entire interest in partnership property, all subsequent payments are Section 736(a)(1) or (a)(2) payments.

**Example 59**

Assume that Sid's interest in partnership property is valued at $60,000, but the terms of the retirement agreement provided that Sid would be paid 10% of income for the next 10 years. In years 1 - 5, partnership income averaged $100,000 per year. Accordingly, Sid was paid $50,000 ($100,000 x 10% x 5 years). In Year 6, the partnership income was $150,000 and Sid was paid $15,000.

In years 1 - 5, the $50,000 paid to Sid is classified as a Section 736(b) payment. In year 6, $10,000 is treated as a Section 736(b) payment. Since the payment is determined with respect to partnership income, the remaining $5,000 in year 6 as well as any payments in the future will be considered a distributive share of partnership income (Section 736(a)(1) payment).

**REVIEW QUESTIONS AND SOLUTIONS**

**Questions**

28. Assume in complete redemption of a partner’s partnership interest, the partner agrees to receive $16,000 of Section 736(b) payments and $4,000 of Section 736(a) payments for 10 years. In year 6, assume he only receives $15,000 of total payments. How much of the $15,000 payment is a Section 736(b) payment?
   a. $15,000.
   b. $12,000,
   c. $11,000.

**Solutions**

28. **“A” is the correct response.** If the actual payment is less than the agreed payment, Section 736(b) payments are considered to have been paid first. Thus, all $15,000 of the payment is a Section 736(b) payment.

   **“B” is an incorrect response.** If the rules provided for a proration of the payment to Section 736(b) and 736(a) payments, $12,000 ($16,000/$20,000 x $15,000) would be allocated to Section 736(b) payments.

   **“C” is an incorrect response.** $11,000 would be correct if Section 736(a) payments were considered to have been paid first. Then the amount in excess of the Section 736(a) payment $15,000 - $4,000) would be a Section 736(b) payment.
E. OTHER CHANGES IN PARTNERSHIP INTERESTS

E.1 Death of a Partner

When a partner dies, the income tax implications of the partnership interest are dictated by the partnership agreement. The partnership agreement may provide for (1) the purchase of the partnership interest by the existing partners (treated as a sale and discussed in Section B above), (2) the liquidation of the partnership interest (discussed in Section C.2 above), or (3) the continuation of the partnership interest owned by the estate or other successor in interest. If the partnership agreement makes no provision for the death of the partner, situation (3) generally is the end result. The basic tax implications of the three cases are presented in this section. Irrespective of the above, the tax year of the partnership with respect to the deceased partner closes on the date of death. Unless the partnership elects to use the pro rata method, the allocation of the income to the partners, including the decedent partner, is determined under the interim closing method.

Example 60

On September 30, 2011, Partner A of the ABCD partnership dies. Partner A held a 25% interest in the partnership. ABCD partnership reports its income on the calendar year. Income through September 30, 2011 was $100,000. Therefore, A’s share of income is $25,000 (25% x $100,000).

Assume instead that the partnership agreement specified that the pro rata method is to be used when the varying interest rule applies. For the year ended December 31, 2011, ABCD’s income is $120,000. Under the pro rata method, A’s share of income equals $22,500 ($120,000 x 25% x 9/12).

If, under the terms of an agreement existing at the date of death of a partner, a sale or exchange of the decedent's interest in the partnership occurs at the date of death, the tax implications are generally the same as the sale of a partnership interest to a third party (see Section B generally). The major difference is that the basis of the partner's interest in the partnership is generally stepped up to fair market value. If a Section 754 election is in effect, the partnership would be allowed to increase the basis of the partnership property as provided in Section B.2 above. A step-up in basis does not apply to partnership property which constitutes a right to receive an item of income in respect of a decedent. This includes items which the decedent had a right to receive at the time of death but was not included under the taxpayer's method of accounting. Unrealized receivables are a good example of income in respect of a decedent, which would not be allowed a basis step up.
The tax effects pertaining to a liquidation or a redemption of a decedent’s interest are covered in Sections C.2 and D. Again, the major tax implication of a liquidation of a decedent's partnership interest is the step-up in the basis of the partnership interest and a corresponding increase in the basis of the assets distributed under the liquidation rules.

If there are no buyout or liquidation provisions effective at the death of a partner, the partner’s interest is transferred to his estate or successor-in-interest. Because this transfer is not considered a sale or exchange, gain cannot be triggered as a result of liabilities relieved in excess of basis. In the year of the death, the decedent partner’s successor-in-interest will share in the partnership profits or losses under the varying interest rule described above. The successor-in-interest will continue to share in the partnership income and losses until the successor sells or liquidates the entire interest.94

E.2 Gift of Partnership Interest

Generally, no gain or loss is recognized by the donor as a result of a gift of a partnership interest. The donee essentially "steps into the shoes" of the donor. Assuming that the fair market value of the partnership interest exceeds the donor's basis in the interest at the time of gift, the donee's outside basis equals the donor's inside basis.

Recall that a relief of liabilities is considered a cash distribution. In the case of Estate of Levine,95 the donor was required to recognize gain to the extent that the sum of the (1) nonrecourse debt relieved, and (2) recourse debt assumed by the donee exceeded the donor's basis of the property. In this case, the transfer by gift was treated as a sale or exchange of property to the extent of the liabilities in excess of basis. The remaining portion was treated as a nontaxable gift.

Example 61

Mother owned a 20% interest in a partnership. The fair market value and basis of her partnership interest were $10,000 and $4,000, respectively. Her share of partnership liabilities was $6,000. She made a gift of the partnership interest to her son.

Since the liabilities relieved exceed the basis of her partnership interest, the gift is partitioned into a gift and sale. The sale portion is $2,000 ($6,000 liabilities less $4,000 basis) and Mother must recognize $2,000 of gain from the deemed sale.

E.3 Partnership Terminations

There are two types of termination. One is more or less a voluntary termination and the other is a "constructive termination." The first type of termination generally is evident -- the business no
longer is carried on by the partnership. Thus, the focus is on the entity. The second type of termination occurs when the change in ownership is fifty percent or more within a 12-month period. Thus, the focus is on the selling activity of the partners rather than on the level of activity of the partnership. This section clarifies the definition of both terminations and discusses the tax implications of partnership terminations.

E.31 Ceasing to Conduct Business by the Partnership

The first type of termination occurs if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of the partners in a partnership. This definition has been applied literally by the courts and Treasury regulations. For example, the regulations indicate that the partners may agree to dissolve the partnership, but the winding down period of the partnership is not considered a termination, and termination does not occur until the remaining assets are distributed to the partners.

It appears that nearly any activity by the partnership will keep it alive. For example, in Foxman, the partnership in 1958, transferred all of its assets to a corporation for 50% of the corporate stock and 3 promissory notes due in installments, with the last one due on June 15, 1959. The IRS argued that the partnership terminated at the time of transfer. However, the partnership still held 2 of the 3 notes. Although these were minor items, the court concluded that the partnership affairs were not completed and thus, the partnership had not terminated.

Of course, in order to have a partnership, you must have partners. Thus, if A & B of ABC partnership sell their interest to C, the business no longer is carried on in partnership form (only one owner). Similarly, upon the death of one partner in a two-partner partnership, the partnership is terminated unless the estate or successor continues to share in the profits or losses of the partnership business. In addition, a retiring partner or a deceased partner's successor in interest receiving payments under Section 736 is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated.

If a partner or partners intend to dissolve the partnership, it is very important to document this intention and legally dissolve the partnership. Otherwise, a "partner" who believed he had terminated his partnership interest may nevertheless be treated as a partner for income tax purposes. For example, in Fuchs, the taxpayer gave notice in 1969 that he was terminating his interest in the partnership. In 1971, the medical building was condemned and the taxpayer received his share of
proceeds. He elected to exclude gain under the involuntary conversion rules of Section 1033. However, the partnership never made a Section 1033 election. The taxpayer was treated as a partner on the tax return and continued to receive receipts until 1975.

The court concluded that the partnership never had terminated for tax purposes since the taxpayer continued to receive payments under Section 736. Thus, the taxpayer was not allowed to defer gain under Section 1033(a) since the partnership had not made the election.

In Fensel, the taxpayer ceased conducting business with his other partner in 1977. However, the business was continued by the other partner. The Third Circuit stated that even though the partner withdrew and ceased to be associated with the business, no official partnership or partner termination had occurred. As a result, as long as any of the business of the partnership was carried on by any of its partners, a termination had not occurred. Thus, he was required to report his distributive share of income even though he never received any income distributions.

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TAX SAVER!! As indicated by the above cases, any partner who decides to terminate an interest in a partnership should formally notify the partnership of such intent in writing.

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E.32 Constructive Partnership Terminations

A partnership terminates for tax purposes if, within a 12-month period, there is a sale or exchange of 50% or more of the total interests in partnership capital and profits. For this purpose, sales include sales to another member of the partnership. However, sales do not include a disposition of a partnership interest by (1) gift, (2) bequest, (3) inheritance or (4) liquidation of a partnership interest. In addition, a conversion of a general partnership interest to a limited partnership interest is not considered a sale or exchange. The 50% change means that at least 50% of the partnership's capital and profits of the original partner must change.

**Example 62**

A sells his one-third interest in the ABC partnership to D, and D sells his interest to E a short time later. Only a 33 1/3% change is considered to have taken place. As long as the original partners (B & C) retain their 66 2/3% (or at least 50.1%) interest for a year following Partner D's sale to E, the partnership will not terminate under this provision.

**Example 63**

The ABC Partnership is owned 20% by A, 20% by B, and 60% by C. Partner C would like to dispose of her interest. If A and B as partners each buy one-half of C's interest within one year, the partnership will terminate. However, if the ABC
partnership redeems Partner C's entire interest, the partnership will not terminate because sales do not include a liquidation of a partner's interest in the partnership.

**TAX SAVER!!** With proper planning constructive partnership terminations should be avoided. Sales agreements could be arranged whereby slightly less than 50% is sold within a 12-month period and the balance is sold after this period. Revenue rulings have allowed an ownership change of 49.9% in 12 months followed by a .1% change one day after 12 months without causing the partnership to terminate even though the sales were prearranged.\(^\text{104}\)

In Letter Ruling 9407030, the IRS ruled that a conversion of a partnership to a limited liability company did not terminate the partnership. The IRS indicated that the conversion was similar to the conversion of a general partnership into a limited partnership. Since the partnership's business continued and the partners' interests in capital, profits, and losses remained the same, the IRS ruled that the partnership did not terminate under Section 708(b).

In Revenue Ruling 95-55,\(^\text{105}\) the IRS considered the ramifications of a general partnership under New York state law which converted to a registered limited liability partnership (LLP) under New York state law, and how the LLP is classified for federal income tax purposes. Each partner's total percentage interest in the partnership's profits, losses, and capital was the same before and after formation as a LLP. The partnership's business continued to be carried on as a LLP. The IRS stated that since the LLP was formed under a state statute not similar to the Uniform Partnership Act, the LLP had to be classified using the Treasury regulations under Section 7701 of the Internal Revenue Code. The IRS treated the conversion as a partnership-to-partnership conversion. Therefore, the general partnership did not terminate, and the LLP is required to use the same methods of accounting used by the general partnership.

**E.33 Tax Consequence of Terminations**

For terminations involving the cessation of business at the partnership level, the normal liquidation rules described in Section A.3 above apply. For constructive terminations, the following is deemed to occur:

1. The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and immediately thereafter,

2. The terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership.\(^\text{106}\)
Although no gain or loss is recognized by the partners or partnership, there are some negative consequences as follows:

1. The taxable year is closed under Section 706(c). Thus, income from two different partnership fiscal years may have to be reported in one year by the continuing partners (potentially up to 23 months of income). This implication is not really an issue for the selling partners since their taxable year closes when their interest is sold.

2. Since the entity is considered a new partnership, the partnership's fiscal year election and other elections are lost.

Example 64

On July 1, 2012, the first day of the fiscal year, C purchases A's 60% interest in the AB partnership for $36,000. Because at least a 50% change in ownership occurred within 12 months, the partnership is terminated. The partnership's June 30 fiscal year is lost. Unless the new partnership is granted IRS approval, a calendar year is required. Thus, Partner B will have 18 months of partnership income to report in 2012 (12 months for the FYE 6/30/12 and 6 months for the year ended 12/31/12).

** REVIEW QUESTIONS AND SOLUTIONS ** (Based on Sections E.3 - E.33),

Questions

29. True or False. A partnership is owned 20% by A, 40% by B, and 40% by C. On 1/1/12, B sells his entire interest to D. D sells his interest to A on 7/1/12. The partnership is deemed to have terminated on 7/1/12.

30. True or False. If a partnership reporting on a fiscal year terminates under the constructive termination rules (more than a 50% ownership change within one year), the taxable year is closed on the date of termination.

Solutions

29. **False is the correct response.** Because the interest that was sold on 7/1/12 was the same interest that was sold on 1/1/12, it is not double counted in determining whether a constructive termination has occurred. That is, only a 40% interest has been sold within one year.

**True is the incorrect response.** Note that two of the original partners (A and C) have at least retained their combined 60% (20% plus 40%) interest since the first sale.

30. **True is the correct response.** One of the tax consequences of constructive terminations is that the taxable year closes. It is as if one partnership ended and a new one began on the date of the terminating event.

**False is the incorrect response.** With the closing of the partnership taxable year, the partners may have to report more than 12 months of income in one calendar year if the partnership had reported on a fiscal year. See Example 64.
F. CONCLUDING REMARKS

This course has discussed the special topics involving partnership operations and the tax implications of sales of partnership interests, partnership distributions, redemptions of a partner’s interest as well as other changes in partnership interests. The material reflects legislative changes made through the "Middle Class Tax Relief and Job Creation Act of 2012," signed by President Obama on February 22, 2012. Tax planning strategies have been illustrated throughout the course.

QUIZ QUESTIONS

Place your answers to the following 7 True-False Questions and 23 Multiple Choice Questions on the enclosed answer sheet.

TRUE FALSE QUESTIONS

1. A cash basis partner who contributes $20,000 of accounts receivable and $8,000 of accounts payable to a cash basis partnership has a $12,000 net built-in gain at the time of the contribution.

2. Angie, who is an attorney and a partner in a florist shop, periodically provides legal services to the partnership and bills the partnership at her normal rate. The partnership should treat payments for these services as guaranteed payments.

3. If John, an owner in a corner grocery store, works 650 hours in the store this year, his share of income or loss from the store is not considered to be from a passive activity.

4. In order for a partnership to make optional basis adjustments to its assets following a sale of a partnership interest, the partnership must have made a Section 754 election by the last day of its first taxable year.

5. Assuming the rules pertaining to built-in gain or loss property and disproportionate distributions do not apply, a partner may not recognize loss from a nonliquidating property distribution.

6. If a payment in redemption of a partner’s interest is considered to be a guaranteed payment, the payment is deductible by the partnership in computing partnership income.

7. A partnership is owned 20% by A, 40% by B, and 40% by C. On 1/1/12, A sells her entire interest to D. B agrees to sell his entire interest to E in two installments where one half of her interest is legally transferred to E on 7/1/12 and the other half is legally transferred to E on 2/1/13. The partnership is deemed to have terminated on 7/1/12.

MULTIPLE CHOICE QUESTIONS

8. Jim, a 30% partner in the ABCD Partnership, contributes depreciable business property to the partnership. Its fair market value and basis at the time of the contribution are $75,000 and $60,000, respectively. It has five years remaining of depreciation expense under the straight-line method (annual book depreciation of $15,000 and annual tax depreciation of $12,000 per year). What is Jim's share of depreciation for the first year assuming that the partnership uses the traditional method of allocation (without curative allocations)?

   a. $4,500.
   b. $3,600.
   c. $1,500.

9. Lindsey, a 20% partner in the ABC Partnership contributes depreciable business property to the partnership. Its fair market value and basis at the time of the contribution are $40,000 and $30,000, respectively. It has five years remaining of depreciation expense under the straight-line method (annual book depreciation of $8,000 and annual tax depreciation of $6,000 per year). Assuming that the partnership uses the traditional method of allocation with curative allocations, what would be the amount of the annual “cure” (such as additional income to Lindsey or less depreciation from another property), to overcome the limitations imposed by the ceiling rule under the traditional method of allocation (without curative allocations)?

   a. $ -0-.
   b. $ 400.
   c. $2,000.
10. Vanessa contributes land to the XYZ Partnership in exchange for a 20% interest. At the time of
the contribution, the fair market value and basis of the land are $100,000 and $80,000,
respectively. Three years later, the land is distributed to a partner in XYZ Partnership at a
time when the fair market value and basis of the land are $130,000 and $80,000, respectively.
As a result of the distribution, how much gain must be allocated to Vanessa for income tax
purposes?

a. $10,000.
b. $20,000.
c. $26,000.

11. Scott, a 20% partner in the LMN Partnership, manages the partnership. For the fiscal-year ended (FYE) September 30, 2011, LMN paid him $48,000 ($4,000 per month). For the FYE September 30, 2012, LMN increased the payments to $5,000 per month beginning on October 1, 2011. How much of the guaranteed payments are reported by Scott on his 2011 calendar-year tax return?

a. $63,000.
b. $51,000.
c. $48,000.

12. Jason, a 60% partner in the JJ partnership, sells land to the JJ partnership for $200,000. Jason’s basis in the land is $240,000. How much of the loss is deductible by Jason?

a. $ -0-.
b. $16,000.
c. $40,000.

13. With respect to the at-risk rules, which one of the following statements is false?

a. Suspended losses can be carried forward for five years.
b. One way to increase the amount at-risk would be to realize capital gain income from the sale of a partnership capital asset.
c. A partner’s at-risk amount is increased by the basis of the property contributed by the partner.

14. Which one of the following items is not considered to be an inventory item for purposes of calculating gain or loss on the sale of a partnership interest?

a. Marketable securities owned by the partnership.
b. Accounts receivable owned by an accrual-basis partnership.
c. Depreciation recapture attributable to depreciation on equipment owned by the partnership.
15. On May 1, 2012, Partner A of the ABCD Partnership sells her 25% partnership interest to E for $15,000. At the time of sale, the FMV and basis of the assets are as follows:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$4,000</td>
<td>$4,000</td>
</tr>
<tr>
<td>A/R</td>
<td>6,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Inventory #1</td>
<td>8,000</td>
<td>4,400</td>
</tr>
<tr>
<td>Inventory #2</td>
<td>2,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Land (capital asset)</td>
<td>40,000</td>
<td>43,600</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$60,000</strong></td>
<td><strong>$56,000</strong></td>
</tr>
</tbody>
</table>

Assuming there are no partnership debts and Partner A’s basis in the partnership interest is $16,000, what is the amount and character of gain or loss on the sale of A’s interests?

a. $2,400 Ordinary Income, $3,400 Capital Loss.
b. $1,900 Ordinary Income, $2,900 Capital Loss.
c. $1,000 Capital Loss.

16. Tiffany purchases a 40% interest in the AZ Partnership for $80,000. Currently, the fair market value (FMV) of the assets owned by the partnership is $200,000 and there are no liabilities. The basis of the partnership assets is $125,000. A breakdown of the FMV and basis of the assets are as follows:

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$25,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>A/R</td>
<td>10,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Inventory #1</td>
<td>45,000</td>
<td>35,000</td>
</tr>
<tr>
<td>Inventory #2</td>
<td>5,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Land (Capital Asset)</td>
<td>115,000</td>
<td>55,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$200,000</strong></td>
<td><strong>$125,000</strong></td>
</tr>
</tbody>
</table>

Assuming a Section 754 election is in effect, what is the total basis adjustment to the partnership assets?

a. $75,000.
b. $32,000.
c. $30,000.

17. Refer to the facts of Question #16. What is the amount of the adjustment to Inventory #2.

a. Decrease of $5,000.
b. Decrease of $2,000.
c. No adjustment – the overall adjustment is made only to appreciated assets.
18. Assuming that a partner sells part or all of his interest during the year, which one of the following statements is true?
   
a. If his entire interest is sold, the taxable year closes with respect to the selling partner.

   b. The partnership must use the pro rata method to determine the selling partner’s share of partnership income.

   c. The partnership must file two tax returns (for the periods before and after the sale).

19. John is a partner of a partnership which is in liquidation. All partnership debts have been paid and the assets are distributed on a pro rata basis. The fair market value and basis of partnership assets which are distributed to John pursuant to the liquidation are as follows:

<table>
<thead>
<tr>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>50,000</td>
</tr>
<tr>
<td>Land # 1 (capital asset)</td>
<td>15,000</td>
</tr>
<tr>
<td>Land # 2 (capital asset)</td>
<td>15,000</td>
</tr>
<tr>
<td>Total</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

   Assume John's outside basis is $94,000. What is the basis of Land #1 to John after the liquidation?

   a. $ 5,000.
   b. $15,000.
   c. $17,000.

20. Erin and Christine are equal partners of the EC Partnership. They have decided to liquidate the partnership. The fair market value and basis of assets of the partnership immediately before liquidation are as follows:

<table>
<thead>
<tr>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$50,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>15,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>15,000</td>
</tr>
<tr>
<td>Land</td>
<td>20,000</td>
</tr>
<tr>
<td>Total</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

   Each partner has an outside basis of $47,000 in her partnership interest. All partnership debts have been paid prior to liquidation. The disproportionate distribution rules do not apply. Assume that Erin receives $15,000 of inventory and $35,000 cash. What is Erin’s gain or loss, if any, resulting from the liquidation?

   a. $3,000 gain.
   b. $1,000 loss.
   c. No gain or loss.
21. Refer to the facts of Question #20. Christine receives the remaining property ($15,000 cash, $15,000 of Accounts Receivable, and $20,000 of land). What is Christine’s gain or loss, if any, resulting from the liquidation?

a. $3,000 gain.
b. $1,000 gain.
c. No gain or loss.

22. Assuming a Section 754 election is in effect, which one of the following statements is false, concerning the optional basis rules resulting from a partner receiving a liquidating distribution?

a. If a partner recognizes a loss from the liquidating distribution, the basis adjustment to the partnership will be negative.
b. If the basis of the property distributed to the partner is reduced, the basis adjustment to the partnership will be positive.
c. If a partnership distribution results in gain recognized by the partner, the Section 734(b) adjustment is allocated to ordinary income assets and capital/trade or business assets according to their relative appreciation.

23. Assume the fair market value of the assets of LMN Partnership are as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$30,000</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>30,000</td>
<td></td>
</tr>
<tr>
<td>Land (Capital Asset)</td>
<td>40,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$100,000</td>
<td></td>
</tr>
</tbody>
</table>

There are no partnership liabilities. Pursuant to a liquidating distribution, Partner L, a 20% partner, receives $20,000 of cash in complete liquidation of her interest. What is the minimum amount the basis of the inventory can be to prevent the application of the disproportionate distribution rules?

a. $20,000.
b. $25,000.
c. $30,000.

24. Assume the ABC Partnership has the following assets and has no partnership liabilities:

<table>
<thead>
<tr>
<th>Description</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$30,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>30,000</td>
<td>24,000</td>
</tr>
<tr>
<td>Land (Capital Asset)</td>
<td>30,000</td>
<td>27,000</td>
</tr>
<tr>
<td>Total</td>
<td>$90,000</td>
<td>$81,000</td>
</tr>
</tbody>
</table>

Partner C’s outside basis is $27,000. She receives all of the Land in complete liquidation of her one-third partnership interest. What is the amount and character of the gain recognized by Partner C?

a. $2,000 Ordinary Income.
b. $2,000 Ordinary Income and $1,000 of Capital Gain.
c. No gain or loss.
25. Refer to the facts of Question #24. What is the basis of the Land after the liquidation of Partner C’s interest?

a. $27,000.
b. $29,000.
c. $30,000.

26. Which one of the following payments are always considered a Section 736(b) payment.

a. Payments for inventory.
b. Payments for goodwill.
c. Payments for accounts receivable.

27. Sally owns a 10% interest in the ABC Partnership. She is retiring this year. A schedule of assets including an estimate for goodwill is provided below.

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>A/R</td>
<td>30,000</td>
<td>-0-</td>
</tr>
<tr>
<td>Inventory</td>
<td>80,000</td>
<td>70,000</td>
</tr>
<tr>
<td>Land (Capital Asset)</td>
<td>80,000</td>
<td>60,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>40,000</td>
<td>-0-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$250,000</strong></td>
<td><strong>$150,000</strong></td>
</tr>
</tbody>
</table>

Pursuant to her retirement, she is to receive a lump-sum payment of $25,000. The partnership provision does not specifically provide for the payment of goodwill. Assuming that **capital is a material income-producing factor** for the partnership, how much of the payment is considered to be for her interest in partnership property?

a. $18,000.
b. $22,000.
c. $25,000.

28. Refer to the facts of Question #28 except capital is **not** a material income-producing factor for the partnership. How much of the payment is considered to be for her interest in partnership property?

a. $18,000.
b. $22,000.
c. $25,000.

29. How are redemption payments (Section 736(a) and Section 736(b) payments) to a partner first classified when the payment terms are **not fixed** in amount?

a. First as a Section 736(a) payment until it is recovered, second as a Section 736(b) payment.
b. First as a Section 736(b) payment until it is recovered, second as a Section 736(a) payment.
c. A proportionate amount of Section 736(a) and Section 736(b) payments until the Section 736(b) payment is recovered.
30. Concerning the termination of a partnership, which one of the following statements is true?

a. The courts have been very aggressive in terminating a partnership for tax purposes when extensive business activities are not ongoing.

b. If a 60% partner of a three-person partnership completely liquidates his interest, the partnership will terminate under the constructive termination rules.

c. A conversion of a general partnership interest to a limited partnership interest is not considered a sale or exchange.
1. IRC Sec. 704(c)(1)(A).
5. Reg. Sec. 1.704-3(b)(1).
7. Reg. Sec. 1.704-3(c)(1).
8. IRC Sec. 704(c)(1)(B)(i).
9. IRC Sec. 704(c)(1)(B)(iii).
10. IRC Secs. 704(c)(1)(B) and 704(c)(2).
11. IRC Sec. 737(a).
15. IRC Sec. 707(c).
16. IRC Secs. 267(a)(2) and 267(e).
17. IRC Sec. 267(e)(1)(B)(i).
19. IRC Sec. 707(b)(1).
20. IRC Sec. 707(b)(2).
21. IRC Sec. 707(b)(1)(A).
22. IRC Sec. 707(b)(1)(B).
23. IRC Secs. 267(d) and 707(b)(1).
24. IRC Sec. 267(c)(4).
25. Reg. Secs. 1.707-1(b)(3) and 1.267(b)-1(b).
27. IRC Sec. 704(d).
28. IRC Sec. 704(d).
29. IRC Secs. 465(b)(1) and (b)(2) and Proposed Reg. Sec. 1.465-22(c).
30. IRC Sec. 465(b)(2)(B).
31. IRC Sec. 465(a)(2).
32. IRC Sec. 465(b)(6).
33. IRC Sec. 469(a)(1).
34. IRC Sec. 469(b).
35. IRC Secs. 469(c)(1) and (c)(2).
36. IRC Section 469(c)(7)(B).
37. IRC Section 469(c)(7)(A).
38. IRC Sec. 469(g)(1)(A).
39. IRC Secs. 469(i)(1) and (i)(2).
40. IRC Sec. 469(i)(3)(A).
41. Treasury Regulation (Reg. Sec.) 1001-2(a).
42. Internal Revenue Code Section (Sec.) 741.
43. Sec. 751(a).
44. Sec. 751(c).
45. Reg. Sec. 1.751-1(c)(4)(i).
46. Sec. 751(d)(2).
47. Sec. 743(b).
48. Sec. 743(b)(1).
49. Sec. 704(c).
50. Sec. 743(b)(2).
52. Sec. 743(b)(2).
54. Reg. Sec. 1.754-1(b).
55. Reg. Sec. 1.754-1(c).
56. Sec. 706(c)(2).
57. Reg. Sec. 1.706-1(c)(2)(ii).
58. Sec. 732(a)(2).
60. Sec. 732(c)(3)(A).
61. Sec. 732(c)(3)(A).
62. Sec. 732(c)(3)(B).
63. Sec. 732(c)(2)(A).
64. Sec. 732(c)(2)(B).
65. Sec. 731(a)(1).
66. Sec. 731(a)(2).
73. Reg. Sec. 1.755-1(c)(6), Example (i).
74. Sec. 751(d)(1).
75. Treasury Regulation (Reg. Sec.) 1001-2(a).
81. Sec. 1402(c).
82. Reg. Sec. 1.707-1(c).
83. Sec. 1402(a)(10).
85. Sec. 736(b)(2)(A).
86. Sec. 736(b)(2)(B).
87. Section 736(b)(3).
89. Sec. 707(c).
90. Reg. Sec. 1.736-1(5)(i).
93. Sec. 1014(c).
94. Reg. Secs. 1.706-1(c)(3)(i) and (ii).
95. Levine, 80-2 USTC 9549 (2nd Cir. 1980) aff'g 72 TC 780 (1979).
96. Sec. 708(b)(1)(A).
100. Reg. Sec. 1.736-1(a)(6).
102. Fensel, 85-2 USTC 9627 (3rd Cir. 1986).
103. Sec. 708(b)(1)(B).
104. For example, see Private Letter Rulings 7952057, 8217028, 8252023, and 8517022.