Taxation of Partnerships

December 13, 2022 at 1pm ET

Questions?

All attendees can submit questions via the Q&A feature on the webinar interface

To Receive CLE Credit for this Program

- You must attend the entire program; partial credit is not available.
- Click on all attendance verification alerts.
- Click on the evaluation link at the end of the program.
- Wait for the online request for credit form.
- Enter the email address you want your CLE certificates sent to.
- Fill out the online request for credit form completely.
- Select a combination of MCLE jurisdictions you want CLE credit in.
- After submission, your CLE certificates will be emailed to you.

Taxation of Partnerships

ABA Section of Real Property, Trust & Estate Law

December 13, 2022

Charlotte P. Hopson

David H. Kirk

Agenda

- Contributions
- Basis
- Partnership Liabilities
- Distributions and Withdrawals
- Retirement or Death of a Partner
- Questions?

© 2022

Charlotte P. Hopson

Charlotte is an associate at Ivins, Phillips & Barker, Chtd. Her practice focuses on a range of federal income, estate and gift tax planning matters, and employee benefits issues. Prior to joining IPB, Charlotte practiced in the Financial Services group in the Washington, DC office of an AmLaw 100 Firm.

Charlotte earned her J.D., *cum laude*, from the Georgetown University Law Center and received a B.S.B.A., *cum laude*, from Georgetown University. During law school, she interned at the Securities and Exchange Commission and the Department of Justice, Tax Division.

Prior to law school, Charlotte worked as a CPA at a Big Four accounting firm. Her practice focused on partnerships and high-net-worth individuals.

© 2022

David H. Kirk

David is a Tax Partner and leader of the Private Tax group of Ernst & Young's National Tax Department in Washington, DC. Throughout his career, he has focused primarily on the taxation of individuals, trusts, S corporations, and partnerships and financial planning for high-net-worth family groups. He is the Firm's primary resource on charitable gifting for individuals, trusts & estates.

Prior to joining EY, he was an attorney in the Passthroughs and Special Industries division of the Office of Chief Counsel, Internal Revenue Service. He was a principal author of the income tax regulations under Section 1411 of the Internal Revenue Code (Net Investment Income Tax) and Revenue Procedure 2013-30 (Uniform Late S Corporation Election Relief). He is the author of the Bloomberg-BNA Tax Management Portfolio on the Section 1411 tax.

David earned a Bachelor of Science in Accounting from Syracuse University and a JD from the University of Pittsburgh. He also earned an LLM in Taxation from Georgetown University Law Center and has served as an adjunct professor in the same program since 2009.

© 2022

Agenda

Contributions

- The Basics
- Exceptions

Basis

Partnership Liabilities

Distributions and Withdrawals

Retirement or Death of a Partner

© 2022

The Basics

© 2022

The Basic Scheme

- Pursuant to section 721(a), neither the partner nor the partnership recognize gain or loss on the transfer of property to a partnership in exchange for a partnership interest.
- This provision applies to contributions of property by partners at the time of the formation of the partnership and subsequently. Reg § 1.721-1(a).
- Nonrecognition is not based on the contributor or contributors being in "control" of the partnership immediately after the transfer.

© 2022

Key Exceptions

1. The contribution cannot constitute "services," it must be "property."
2. Section 721(a) does not apply to contributions to a "partnership investment company."
3. Transfers of appreciated property to partnerships with related foreign partners may be taxable.
4. A contribution is taxable if it is part of a "disguised sale."
5. There may be a gain when a partner contributes property subject to a liability and the partnership assumes the partner's liability.
6. Section 721(a) does not apply to contributions which are, in substance, a lease or license.

© 2022

What Constitutes Property?

- The Code does not define "property."
- Case law interpreting "property" for section 351 purposes have held that the term is analogous for section 721 purposes. *See, e.g.*, *Stafford v. United States*, 611 F.2d 990, 995-997 (5th Cir. 1980).
- "Property" is generally interpreted broadly and may include:
  1. Money;
  2. Installment obligations;
  3. Contract rights to purchase property;
  4. Goodwill; and
  5. Accounts receivable.

© 2022

Exceptions

© 2022

Contribution of Services

- The exchange of services for a partnership interest constitutes a taxable transfer. Reg. § 1.721-1(b)(1).
- **BUT,** rights and assets created by a partner's personal efforts may qualify as property.
- A "profits" interest for services is generally nontaxable. Rev. Proc. 93-27.

© 2022

Capital Interest or Profits Interest?

- Key factors:
  1. Liquidation rights; and
  2. Capital accounts.
- Liquidation rights – a service provider has a capital interest if the provider has a right to a distribution if the interest were liquidated at fair market value.
- Capital accounts – a service provider has a capital interest if the provider's capital account has a positive balance immediately after receiving the partnership interest.
- A right to a portion of future partnerships profits alone would be a "profits interest."

© 2022

Partnership Investment Company

- Pursuant to section 721(b), a contribution of property to a partnership investment company is treated as a sale of the property to the partnership by the contributing partner.
- An entity is a partnership investment company if it would be an investment company under section 351(e)(1).

© 2022

Related Foreign Partners

- Section 721(a) does not apply to a contribution if:
  1. a related foreign person is a direct or indirect partner; and
  2. the U.S. person and related persons directly or indirectly own 80 percent or more of the interests in partnership capital, profits, deductions, or losses.

© 2022

Disguised Sales

- A partner may receive cash or other property (boot), as well as a partnership interest, in exchange for contributed property.
- Pursuant to section 707(a)(2)(B), the contributor must recognize gain or loss to the extent he is deemed to have "sold" property to the partnership for the boot.

© 2022

Liability Shifts

- If the partnership receives contributed property subject to a liability, the portion of the liability allocated to other partners under section 752 is treated as a cash distribution from the partnership to the contributor.
- If the contribution affects the profits and loss interests of any noncontributing partners, the affected partners' shares of partnership liabilities may also change under section 752.
- If the portion of the contributor's liabilities allocated to the other partners exceeds the contributor’s adjusted basis in the partnership interest, the contributor is taxed on the excess.
- If the reduction in a noncontributing partner's share of preexisting liabilities exceeds the adjusted basis of his partnership interest, the noncontributing partner is taxed on the excess.

© 2022

Liability Shifts: Example

- A, who is not currently a partner, contributes a building to partnership X in exchange for a twenty percent interest in the partnership. The building has a fair market value of $500,000, an adjusted basis of $150,000, and is encumbered by a recourse mortgage of $200,000. The portion of the mortgage allocable to other partners is $160,000. This portion of A's liability, which is allocated to the other partners, is treated as a distribution of money by the partnership to A. The $10,000 excess of this hypothetical cash distribution over A’s $150,000 basis in his partnership interest immediately prior to such distribution is gain, so A would recognize a gain of $10,000.

© 2022

Lease or License

- If a contribution merely transfers the right to use property, and is a lease or license in substance, section 721(a) does not apply.
- The transaction is instead characterized as a transfer with a third party.
- **Example.** A contributes the right to use a building for ten years to partnership AB. Section 721(a) does not apply to the contribution. Instead, A must recognize rent on the transaction, as if she were a nonpartner.

© 2022

Agenda

- Contributions
- Basis
- Partnership Liabilities
- Distributions and Withdrawals
- Retirement or Death of a Partner

Ivins Phillips Barker
CHARTERED

© 2022

Relevancy of Partner Basis

- Pursuant to section 704(d), a partner's distributive share of partnership deduction or loss is deductible only to the extent of his basis at the end of the year
- Any disallowed losses are carried forward until there is sufficient basis, and the carryforward is prorated among the various items of loss for the year.
- **Example.** At the end of year 1, Partnership AB has a loss of $20,000. A's share of this loss is $10,000, and his adjusted basis at the end of year 1 is $6,000. A may only deduct $6,000 of the $10,000 of loss allocated to him. His basis is reduced to zero, and $4,000 of loss is carried forward to year 2.

© 2022

Contribution of Property

- As previously discussed, under section 721(a), when a partner contributes property, including money, to an LLC in exchange for an LLC interest, no gain or loss is recognized by either the partner or the LLC.
- By way of comparison, a transferor of property to a corporation in exchange for its stock will only receive nonrecognition treatment if the transferor – or a group of transferors – owns 80% or more of the corporation immediately after the transfer. This absence of a control requirement means that an entity that expects its owners to make ongoing contributions of property, or that expects to add new partners who will be required to contribute property, will benefit from choosing to operate as an LLC rather than a corporation.
- Section 721(b) provides that section 721(a) does not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated.

© 2022

Partner & Partnership Basis

- Partner. Under section 722, the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.
- Partnership. Under section 723, the basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

© 2022

Partner & Partnership Basis: Example

- Individuals A and B decide to form LLC AB. A contributes property X, which has an adjusted tax basis of $100 and a fair market value of $200, to LLC AB in exchange for a 50% interest, while B contributes cash of $80 and property Y, which has an adjusted tax basis of $110 and a fair market value of $120, in exchange for the remaining 50% interest.
  - Neither A nor B nor LLC AB will recognize any gain or loss on the contribution of properties X and Y to the LLC. In order to preserve A's unrecognized $100 of gain, A will take a basis in the LLC interest received of $100, so that if A were to sell the interest the next day for its value of $200, the $100 of gain that went unrecognized upon contribution would be triggered.
  - LLC AB will take a basis in property X of $100, so that if it sells the property the next day for its value of $200, the $100 of gain that went unrecognized upon contribution will be recognized. Similarly, B will take a basis in the LLC interest received of $190, comprised of the $80 of cash and property with an adjusted tax basis of $110. LLC AB will take a basis in property Y of $110. Thus, B's $10 of unrecognized gain upon contribution is preserved in both B's basis in the LLC interest and LLC AB's basis in property Y.

© 2022

Purchase, Gift, & Inheritance

- The basis of an interest acquired other than by contribution is either a cost basis if acquired via purchase, a carryover basis if acquired via gift, and a fair market value basis if acquired via inheritance.
- If via gift, then:
  - Any suspended passive losses, at-risk losses, and disallowed 163(j) business interest expense is added to basis immediately before the gift.
- Watch out for Reg. § 1.1001-2(c), Example 5 – Grantor recognizes gain to the extent he is relieved of partnership liabilities related to partnership interest owned by a grantor trust and grantor status is terminated. *See also* Rev. Rul. 77-402.
  - Same treatment also applies in gifts, but not charitable gifts. See Reg. § 1.1011-2.
- Under section 643(e), a distribution out of an estate/trust is carryover basis transaction (unless an election under section 643(e)(3) is made).

Ivins Phillips Barker
CHARTERED

© 2022

Mixing Bowl

- Under section 704(c)(1)(B), if a partner contributes property to a partnership and that property is distributed to another partner within seven years of the original contribution, the so-called “mixing bowl rules” require the contributing partner to accelerate recognition of the pre-contribution gain or loss.
  - The gain or loss to be recognized is capped at the amount that would have been allocated to the contributing partner had the partnership sold the property for its fair market value.
- **Example.** As an alternative to the previous example, assume that partnership AB distributes the property contributed by A – with a basis of $100 and a FMV of $200 -- to B a year after formation. At the time of the distribution, property X has a fair market value of $175. A must recognize the pre-contribution gain, limited to the excess of the fair market value of the property at the time of distribution over its tax basis. Thus, A must accelerate $75 of gain ($175 fair market value - $100 adjusted tax basis) upon the distribution.

© 2022

Mixing Bowl Example

- Individuals A and B decide to form LLC AB. A contributes property X, which has an adjusted tax basis of $100 and a fair market value of $200, to LLC AB in exchange for a 50% interest, while B contributes cash of $80 and property Y, which has an adjusted tax basis of $110 and a fair market value of $120, in exchange for the remaining 50% interest.
  - Neither A nor B nor LLC AB will recognize any gain or loss on the contribution of properties X and Y to the LLC. In order to preserve A's unrecognized $100 of gain, A will take a basis in the LLC interest received of $100, so that if A were to sell the interest the next day for its value of $200, the $100 of gain that went unrecognized upon contribution would be triggered.
  - LLC AB will take a basis in property X of $100, so that if it sells the property the next day for its value of $200, the $100 of gain that went unrecognized upon contribution will be recognized. Similarly, B will take a basis in the LLC interest received of $190, comprised of the $80 of cash and property with an adjusted tax basis of $110. LLC AB will take a basis in property Y of $110. Thus, B's $10 of unrecognized gain upon contribution is preserved in both B's basis in the LLC interest and LLC AB's basis in property Y.

© 2022

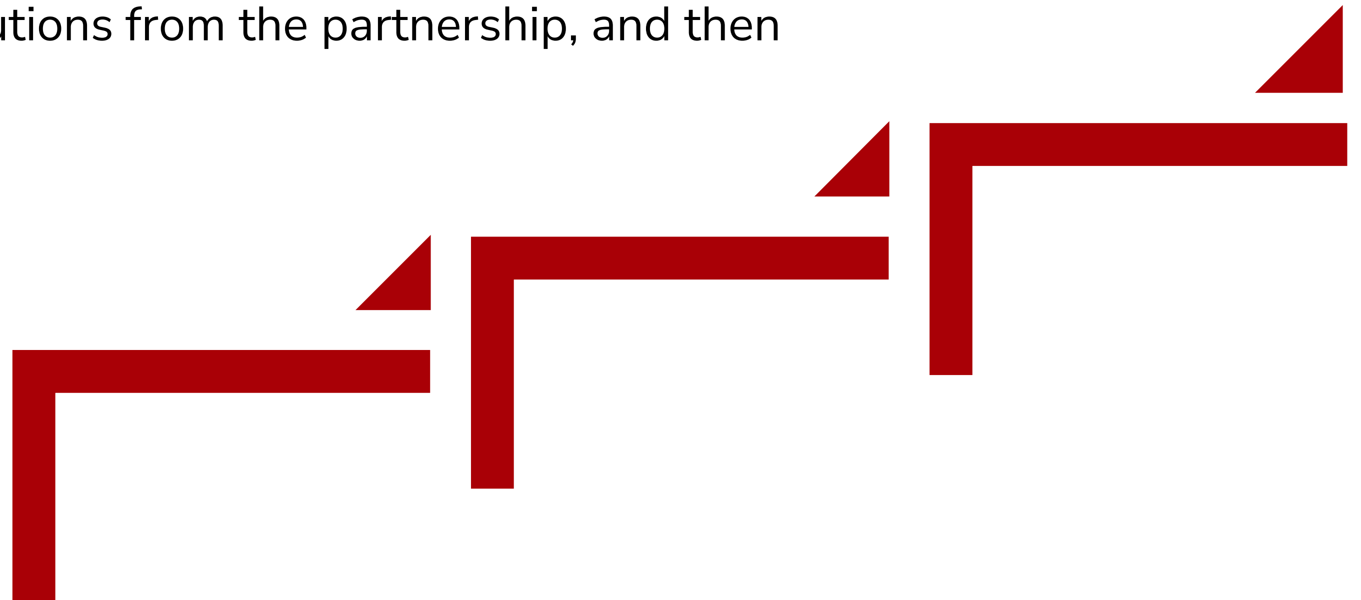
Basis & Liabilities

- Under section 752(a), an increase in a partner's share of liabilities is treated as a contribution of cash by the partner, while a decrease in a partner's share of liabilities is treated as a distribution of cash to the partner.
- Under section 752(b), any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.
  - When the same transaction results in both increases and decreases in a partner's share of liabilities, the increases and decreases are netted together. Reg. § 1.752-1(f).
  - As a result, when a partner contributes encumbered property to an LLC , the basis of the partner's interest is reduced by the portion of the debt assumed by the other partners, but is increased by the contributing partner's share of all of the LLC's liabilities.
- **Example.** A and B form LLC AB as equal partners. A contributes property X, which has an adjusted tax basis of $30, a fair market value of $100, and is encumbered by a liability of $20. B contributes property Y, which has an adjusted tax basis of $70, a fair market value of $130, and is encumbered by a liability of $50. A and B will share in the liabilities of LLC AB equally. A's basis in his LLC interest is $45. This is comprised of the $30 adjusted tax basis in property X, plus an increase in A's share of LLC liabilities of $35 (50% of $70), less a decrease in A's share of the liabilities contributed to the LLC of $20. B's basis in his LLC interest is $55. This is comprised of the $70 adjusted tax basis in property X, plus an increase in B's share of LLC liabilities of $35 (50% of $70), less a decrease in B's share of the liabilities contributed to the LLC of $50.

© 2022

Partner Basis: Ordering Rules

- Under section 705, each year a partner then adjusts his basis in the partnership interest as follows:
- It is first increased by the sum of his distributive share of partnership taxable income, tax-exempt income, additional capital contributions, and the excess of the deduction for depletion over the basis of the property subject to depletion, then
- Decreased, but not below zero, by distributions from the partnership, and then
- Decreased by the partner's distributive share of partnership losses, nondeductible expenses, separately stated items of deduction, and by the partner's deduction for depletion for any partnership oil and gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such partner.



© 2022

Basis & Liabilities Revisited

- Under section 752(a), an increase in a partner's share of liabilities is treated as a contribution of cash by the partner, while a decrease in a partner's share of liabilities is treated as a distribution of cash to the partner.
- Under section 752(b), any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.
  - When the same transaction results in both increases and decreases in a partner's share of liabilities, the increases and decreases are netted together. Reg. § 1.752-1(f).
  - As a result, when a partner contributes encumbered property to an LLC , the basis of the partner's interest is reduced by the portion of the debt assumed by the other partners, but is increased by the contributing partner's share of all of the LLC's liabilities.
- **Example.** A and B form LLC AB as equal partners. A contributes property X, which has an adjusted tax basis of $30, a fair market value of $100, and is encumbered by a liability of $20. B contributes property Y, which has an adjusted tax basis of $70, a fair market value of $130, and is encumbered by a liability of $50. A and B will share in the liabilities of LLC AB equally. A's basis in his LLC interest is $45. This is comprised of the $30 adjusted tax basis in property X, plus an increase in A's share of LLC liabilities of $35 (50% of $70), less a decrease in A's share of the liabilities contributed to the LLC of $20. B's basis in his LLC interest is $55. This is comprised of the $70 adjusted tax basis in property X, plus an increase in B's share of LLC liabilities of $35 (50% of $70), less a decrease in B's share of the liabilities contributed to the LLC of $50.

© 2022

Contributions of BIG or BIL Property

- However, if a partner contributes property with a built-in gain (BIG) or built-in loss (BIL), special rules under section 704(c) (and corresponding Regulations) are to be taken into account to ensure there is no inappropriate shifting of pre-contribution gain or loss to other partners
- In summary, depending on which method is used, §704(c) and the Regs are designed to "catch-up" the partner's tax basis books to the actual economic reality of property transactions (and the partner's capital accounts or book basis)
- Property subject to §704(c) includes any property contributed to a partnership that has a book value that differs from it's adjusted tax basis. Reg. § 1.704-3(a)(2)
  - Book value is equal to the property's fair market value, and is generally the amount credited to the partner's capital account
  - The partner's tax basis in the partnership will be increased by only the property's adjusted tax basis
- Pre-contribution gain or loss is first allocated to the contributing partner, with any remaining gain or loss allocated using the generally reasonable:
  - Traditional Method
  - Traditional Method with Curative Allocations
  - Remedial Allocation Method

Ivins Phillips Barker CHARTERED

© 2022

Additional Loss Limitations

- When a partner is allocated a loss, the first hurdle in order for the partner to recognize the loss is their basis in the partnership under section 704(d)
- Next the “at risk limitation” under section 465
- Then “passive activity limitation” under section 469
- And finally, “excess business losses” under section 461(l)

Ivins Phillips Barker
CHARTERED

© 2022

Agenda

Contributions

Basis

Partnership Liabilities

- The Basics
- Mechanics

Distributions and Withdrawals

Retirement or Death of a Partner

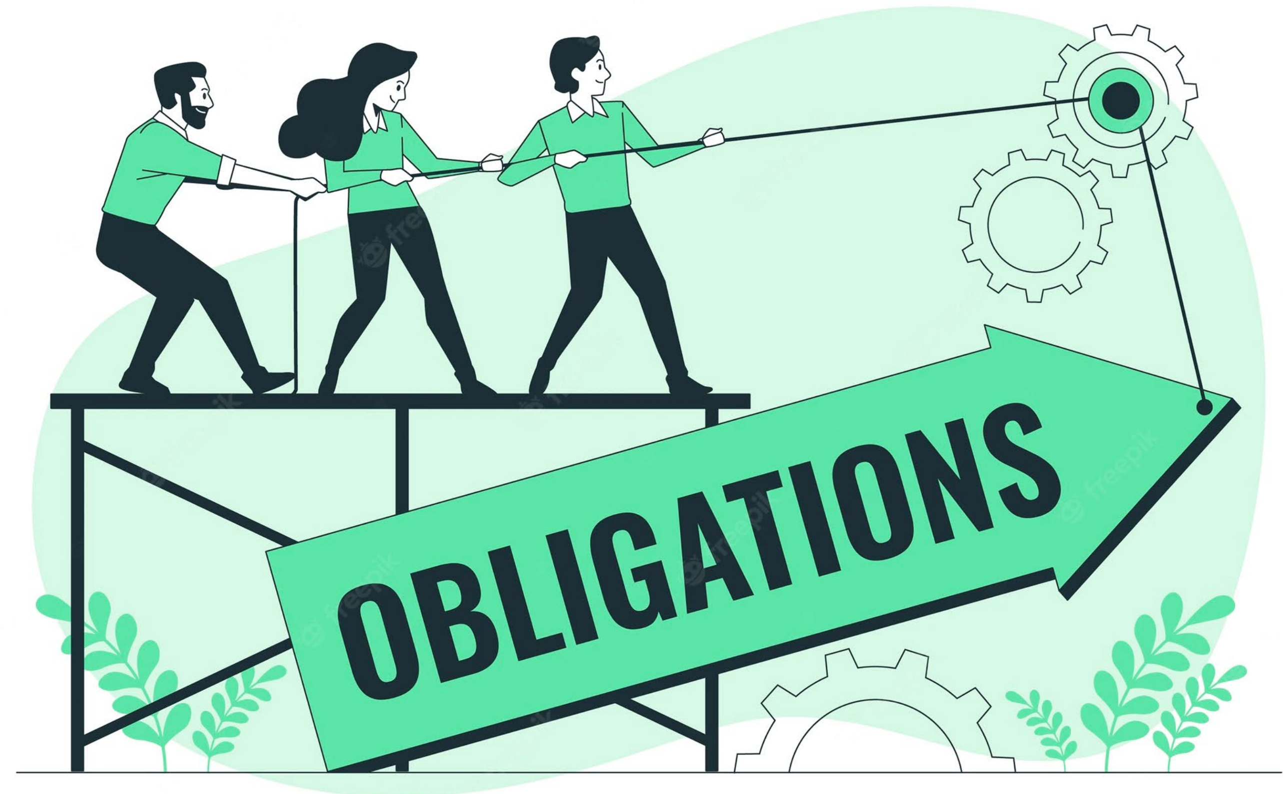
© 2022

The Basics

© 2022

Two Types of Liabilities

- Liabilities for purposes of:
  - Section 752 and Reg. § 1.752-1; and
  - Reg. § 1.752-7.
- The section 752 regulations define "liability" in reference to "[a]n obligation."



Ivins Phillips Barker
CHARTERED

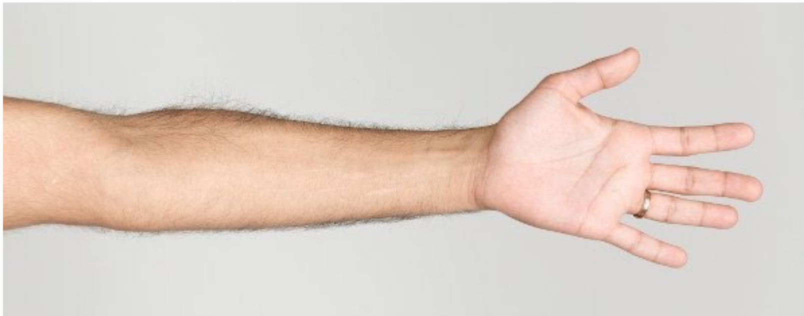
© 2022

Section 752 and Reg. § 1.752-1 Liabilities

- A liability is a section 752 liability if the obligation:
  - Creates or increases the basis of the obligor’s assets;
  - Creates an immediate deduction for the obligor; or
  - Creates an expense that is neither deductible in calculating the obligor’s taxable income or is chargeable to capital

© 2022

Reg. § 1.752-7 Liabilities



- An obligation:
  1. That is not a section 752 liability; or
  2. The amount of the obligation exceeds the amount taken into account in incurring the obligation. Reg. § 1.752-7(b)(3)(i).
- The amount of the obligation is based on an arms-length transaction:
  - The amount of cash that a willing assignor would pay to a willing assignee to assume the obligation. Reg. § 1.752-7(b)(3)(ii).
- When a partnership assumes a Reg. § 1.752-7 from a partner, the partner's basis is not immediately reduced.
  - Instead, the basis is reduced later if a triggering event occurs.

© 2022

Assumption of Liabilities

- A person assumes a liability if:
  1. The assuming person is personally obligated to pay the liability; and
  2. In the case of a partner or related person assuming a partnership liability, the obligee must know of the assumption, be able to directly enforce the obligation, and no other person or partner can bear the economic risk of loss immediately after the assumption. Reg. § 1.752-1(d).

© 2022

Recourse or Nonrecourse Liability?

- A partnership liability is a recourse liability if any partner or related person bears the economic risk of loss for the liability. Reg. § 1.752-1(a)(1).
- A liability is nonrecourse if no partner or related person bears the economic risk for the liability.

© 2022

Related Person

- A person is a related person if the person and the partner bear a relationship to each other that is specified in sections 267(b) or 707(b)(1), except:
  - "80 percent or more" is substituted for "more than 50 percent" each place it appears;
  - Family excludes brothers and sisters; and
  - Sections 267(e)(1) and 267(f)(1)(A) are disregarded. Reg. § 1.752-4(b).

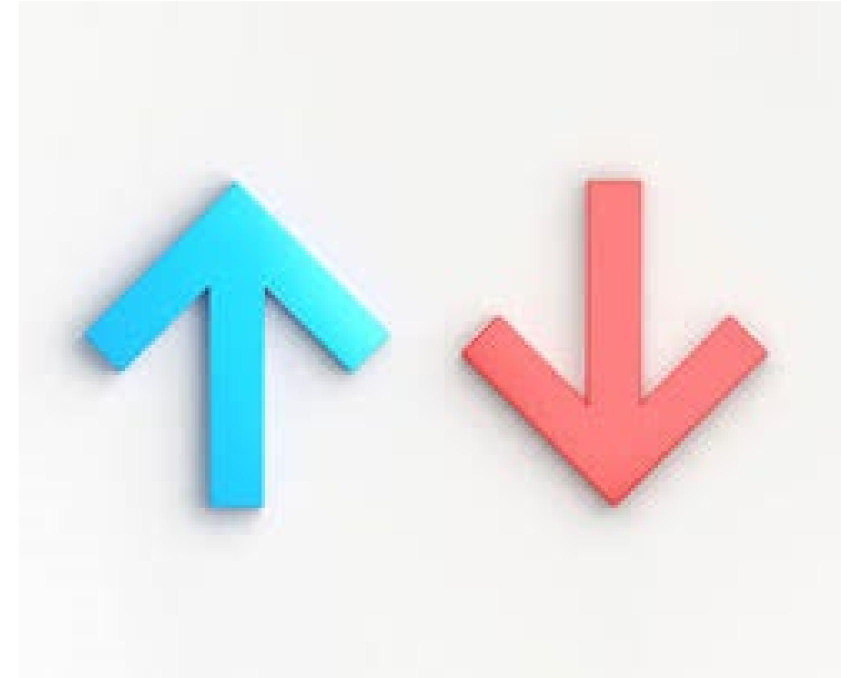
© 2022

Mechanics

© 2022

Partner's Share of Partnership Liabilities Revisited

- Under section 752(a), an increase in a partner's share of partnership liabilities, or an increase in a partner's individual liabilities from assuming partnership liabilities, is treated as a contribution of money by the partner to the partnership. *See also* Reg. § 1.752-1(b).
- Under section 752(b), a decrease in a partner's share of partnership liabilities, or a decrease in a partner's individual liabilities from assuming partnership liabilities, is treated as a distribution of money by the partnership to the partner. *See also* Reg. § 1.752-1(c).



© 2022

Distribution of Encumbered Property

- The distribution results in three adjustments to the partner's adjusted basis in the partnership interest:
  1. The basis increases by the amount of the liabilities;
  2. The basis decreases by the partner's share in the reduction of partnership liabilities; and
  3. The basis decreases by the partner's basis in the distributed property.

© 2022

Distribution of Encumbered Property: An Example

- A owns a 50% interest in partnership X and has an adjusted basis in the interest of $10,000. A receives a distribution of property with a FMV to the partnership immediately before the distribution of $50,000, an adjusted basis of $20,000, and subject to a liability of $30,000. A's basis in the partnership interest after the distribution is $5,000 ($10,000 + $30,000 – (.5*$30,000) - $20,000.

© 2022

Negative Capital Accounts

- A negative capital account may arise if:
  1. A partnership allocates tax deductions or losses to a partner in excess of the partner's tax basis; or
  2. A partner contributes property subject to a liability in excess of the property's adjusted tax basis.
- These transactions may result in a taxable event.

© 2022

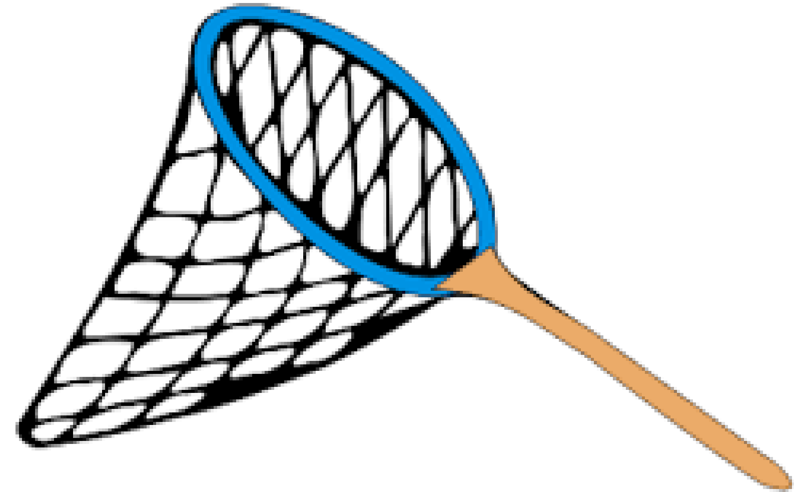
Deficit Restoration Agreement

- If a partner has a negative capital account, that partner is legally obligated to restore the deficit, also known as a deficit restoration obligation (DRO).
- A DRO is a promise by a partner to restore the negative capital account in the future either by a contribution to the partnership or by a later allocation of company income designed to bring the partner's capital account balance back to zero or positive.

© 2022

Netting Increases and Decreases

- A partner can net increases and decreases in liabilities that result from the same transaction. Reg. § 1.752-1(f).
- Only a net increase is treated as a contribution of money to the partnership and only a net decrease is treated as a distribution of money from the partnership.



© 2022

Sale or Exchange

- If a partnership interest is sold or exchanged, the reduction in the transferor partner's share of partnership liabilities is treated as an amount realized under section 1001 and the regulations thereunder.
- **Example.** If a partner sells an interest in a partnership for $750 cash and transfers to the purchaser the partner's share of partnership liabilities in the amount of $250, the seller realizes $1,000 on the transaction.

© 2022

Bifurcation of Partnership Liabilities

- If one or more partners bears the economic risk of loss as to part, but not all, of a partnership liability represented by a single contractual obligation, that liability is treated as two or more separate liabilities for purposes of section 752. Reg. § 1.752-1(i).
- The portion of the liability as to which one or more partners bear the economic risk of loss is a recourse liability and the remainder is a nonrecourse liability. Reg. § 1.752-1(i).
- If a related person bears the economic risk with respect to part of a partnership liability, the partner to whom the person is related is treated as bearing the economic risk of the liability. Reg. § 1.752-2(b).

© 2022

Contingent Liabilities

- If an obligation is subject to contingencies that make it unlikely to ever be discharged, the obligation is disregarded for purposes of the partner sharing rules. Reg. § 1.752-2(b)(4).
- This is based on "all the facts and circumstances." Reg. § 1.752-2(b)(4).
- If a partner is obligated to make a payment upon the happening of a future event, and the timing of that event is not determinable with reasonable certainty, the obligation is disregarded until the event occurs. Reg. § 1.752-2(b)(4).

© 2022

Agenda

Contributions

Basis

Partnership Liabilities

Distributions and Withdrawals

- Current Distributions
- Liquidating Distributions

Retirement or Death of a Partner

© 2022

Current Distributions

© 2022

Section 731

- A distribution from a partnership can be either a current distribution or a liquidating distribution.
  - Current distributions include distributions which are not in liquidation of a partner's entire interest in the partnership. Current distributions encompass not only draws against a partner's distributive share of partnership income, however, but also any distribution in partial liquidation of a partner's interest. Reg. § 1.731-1(a)(1).
  - A liquidating distribution is a distribution or a series of distributions to a partner which terminates a partner's entire interest in a partnership . IRC § 761(d).

© 2022

Current Distributions: Introduction

- A current distribution that represents a partner's distributive share of partnership income is taken into account on the last day of the tax year, regardless of when the distribution occurred. Reg. § 1.731-1(a)(1)(ii).
- A current distribution that represents a partial liquidation of a partner's interest, however, is taken into account on the date of distribution.
- Unless the "hot asset" rules of section 751 apply, the partnership recognizes no gain or loss on a current distribution.
- The ability of a partnership to distribute appreciated property without the recognition of gain is the primary reason most real estate is held in a partnership form rather than in corporate form. If a corporation – whether C or S – distributed appreciated property, section 311(b) requires the corporation to recognize gain as if it sold the property for its fair market value.

Recognition of Gain

- Gain is recognized to the distribute partner on a current distribution only to the extent the money distributed exceeds the partner's adjusted basis in his partnership interest. Reg. § 1.731-1(a)(1)
- **Example.** A has a $10,000 basis in his partnership interest. A receives a current distribution of cash of $8,000 and property with a fair market value of $3,000. A recognizes no gain on the distribution, because the cash received does not exceed his basis in the partnership interest.
- Recall that, under section 752(b), a reduction in a partner's share of the partnership's liabilities is treated as a constructive distribution of money to that partner.
- Any distribution of money, whether actual or constructive, will trigger gain if the distribution exceeds the partner's basis in his interest.
- From a practical perspective, because a partner's share of the debts of the partnership is included in his basis under section 752, the relief of such a liability is generally not a taxable event.
  - This rule of thumb only applies to the extent that losses have not be taken in excess of the basis of contributed capital.

© 2022

Hot Asset Rules

- The gain recognized on a current distribution is generally capital gain, unless the “hot asset” rules of section 731 apply. Reg. § 1.731-1(a)(3).
- No loss is ever recognized by the distribute partner on a current distribution. Reg. § 1.731-1(a)(2).
- A partner’s basis in property distributed in a current distribution is the lesser of:
  - The partnership’s basis in the property, or
  - The partner’s basis in his partnership interest, reduced by any money (or debt relief) received in the same distribution.
- **Example.** A has an adjusted basis of $15,000 in his partnership interest. A receives a current distribution of property with a basis of $10,000 and $2,000 cash. A recognizes no gain on the distribution, because the cash received does not exceed A’s basis in his interest. A takes a basis in the property received of $10,000, the lesser of the LLC’s basis in the property ($10,000), or A’s basis in his interest reduced by the cash received as part of the distribution ($13,000). If instead, the LLC’s basis in the property had been $14,000, A’s basis in the property would be limited to $13,000, A’s remaining basis in his interest after reduction for the cash received.

© 2022

Basis Reduction

- If the pre-distribution bases of the distributed properties (other than money) exceed the partner's remaining outside basis after reduction for money received, the bases of the properties must be reduced, and this reduction must be allocated among the distributed properties. The basis reduction for each distributed property is calculated by initially assigning each property its pre-distribution basis and then reducing the basis of each property by its share of the total basis reduction.
- If the distribution does not include any inventory items or unrealized receivables ("hot assets"), the basis reduction is first allocated among all of the distributed properties to the extent of their unrealized depreciation. If the basis reduction exceeds the properties' unrealized depreciation, the remaining basis reduction is allocated according to their relative bases (taking into account the reduction allocated to unrealized depreciation). Reg. § 1.732-1(c)(1)(ii).
- **Example.** A is a partner in a partnership . A has an outside basis of $150. A receives a current distribution of $50 in cash as well as properties X and Y which are not hot assets. X has a basis of $85 and a FMV of $75. Y has a basis and FMV of $75. The total basis of the distributed property is $160 ($85 + $75), A's remaining outside basis after reduction for money received is $100 ($150-$50), and so the required basis reduction is $60 ($160 -$100). The first $10 of the basis reduction is allocated to X to the extent of its unrealized depreciation. This reduces X's basis to $65 and reduces the basis reduction to $30. The remaining basis reduction is allocated $25 each to X and Y because they have the same remaining basis. After the distribution, X and Y each have a $50 basis.

© 2022

Exceeding the Basis of Hot Assets

- Under Reg. § 1.732-1(c)(1)(i), if the distribution includes both hot assets and other property, and the partner's outside basis after reduction for money received exceeds the basis of the hot assets then:
  1. the partner's basis in hot assets equals their pre-distribution bases, and
  2. the basis reduction is allocated among the other property distributed as discussed above.
- **Example.** The facts are the same as previous example, except that in addition to X and Y, the LLC distributes $50 of cash and an inventory item that has a pre-distribution basis of $20. The total basis of the distributed property is $180 ($85+$75+$20), the partner's remaining basis after reduction for money received is $100 ($150-$50), and the required basis reduction is $80 ($160 -$100). Because A's outside basis after reduction for money received is $100, which exceeds the basis of the hot assets of $20, the first $20 of basis is allocated to the inventory. Of the $60 basis reduction, the first $10 is allocated to X to match its unrealized depreciation. This reduces X's basis to $75 and reduces the basis reduction to $50. The remaining basis reduction is allocated $25 each to X and Y because they have the same remaining basis. After the distribution X and Y each has a $50 basis.

Ivins Phillips Barker
CHARTERED

© 2022

Allocation to Hot Assets

- If the distribution includes hot assets and the partner's outside basis after reduction for money is less than the basis of the hot assets, then all of the required basis reduction will be allocated to the hot assets, and the other property distributed (if any) will take a basis of zero. The basis reduction is first allocated among the hot assets to the extent of their unrealized depreciation. If the basis reduction exceeds the hot assets' unrealized depreciation, the remaining basis reduction is allocated according to their relative bases (taking into account the reduction allocated to unrealized depreciation). Reg. §1.732-1(c)(1)(i).
- **Example.** A is a partner in a partnership . A has an outside basis of $90. A receives a current distribution of $80 in cash as well as inventory of $40 and properties X and Y which are not hot assets. X has a basis of $85 and a FMV of $75. Y has a basis and FMV of $75. The basis of the hot assets is $40, but A's outside basis after reduction for money received is only $10 ($90-$80). Thus, A takes a basis in the hot assets of $10 and a basis in X and Y of $0.

© 2022

Outside Basis

- A current distribution reduces a partner's outside basis by the amount of money distributed to him and the basis that the partner takes in any distributed property. In no event, however, may a partner's outside basis be reduced below zero. Cash distributions reduce the partner's basis before the property distributions are taken into account. Reg. § 1.731-1(a)(1).
- **Example.** A is a partner in a partnership . A receives a current distribution of $6,000 of cash and property X, which has an adjusted basis of $4,000 and a fair market value of $15,000. Prior to the distribution, A's basis in his partnership interest was $11,000. After the distribution, A's basis is $1,000 (his $11,000 starting basis, less $6,000 of cash, less the $4,000 basis of property X as determined under section 732).

Ivins Phillips Barker
CHARTERED

© 2022

Liquidating Distributions

© 2022

Liquidating Distributions: Introduction

- No gain or loss is recognized to a partnership that makes a liquidating distribution. Reg. § 1.731-1(b).
- A partner who receives a liquidating distribution will recognize gain only to the extent that the money – or debt relief -- he receives in the distribution exceeds his basis in his partnership interest immediately before the distribution. Reg. § 1.731-1(a)(1).
- Any gain recognized is considered capital gain. Reg. § 1.731-1(b)(3).
- **Example.** A is a partner in a partnership . A has a basis in his interest of $20,000. The partnership makes a liquidating distribution to A of cash of $12,000 and property with a FMV of $15,000. A recognizes no gain on the distribution because the cash received ($12,000) does not exceed A's basis in his partnership interest ($20,000). If the LLC distributed cash of $25,000 to A in addition to the property with a FMV of $15,000, A would recognize gain of $5,000 ($25,000 - $20,000).

© 2022

Basis in Distributed Property

- The partner takes a basis in any distributed property equal to the partner's basis in his LLC interest reduced by any money distributed. Reg. § 1.732-1(b).
- If the pre-distribution bases of the distributed properties (other than money) exceed the partner's outside basis after reduction for money received, their bases must be reduced to match the target basis (a reduced basis distribution) and this reduction must be allocated among the distributed properties under the rules discussed above for current distributions.
- **Example.** A is a partner in a partnership . A's outside basis in his LLC interest is $200. P distributes properties X and Y to A in liquidation of his partnership interest. X has a pre-distribution basis and FMV of $100. Y has a pre-distribution basis of $200 and a FMV of $100. The basis of the property distributed is $300 ($100+$200), A's outside basis after reduction for money received is $200, and the required basis reduction is $200. Y has $100 of unrealized depreciation so the first $100 of basis reduction is allocated to Y. A takes a basis of $100 in X and $100 in Y.

© 2022

Allocation of Basis Increase

- The partner takes a basis in any distributed property equal to the partner's basis in his LLC interest reduced by any money distributed. Reg. § 1.732-1(b).
- If the pre-distribution bases of the distributed properties (other than money) exceed the partner's outside basis after reduction for money received, their bases must be reduced to match the target basis (a reduced basis distribution) and this reduction must be allocated among the distributed properties under the rules discussed above for current distributions.
- **Example.** A is a partner in a partnership . A's outside basis in his LLC interest is $200. P distributes properties X and Y to A in liquidation of his partnership interest. X has a pre-distribution basis and FMV of $100. Y has a pre-distribution basis of $200 and a FMV of $100. The basis of the property distributed is $300 ($100+$200), A's outside basis after reduction for money received is $200, and the required basis reduction is $200. Y has $100 of unrealized depreciation so the first $100 of basis reduction is allocated to Y. A takes a basis of $100 in X and $100 in Y.

Ivins Phillips Barker
CHARTERED

© 2022

Unrealized Appreciation

- The basis increase is first allocated among the other property up to the amount of their unrealized appreciation. If the basis increase exceeds the other properties' unrealized appreciation, the remaining basis increase is allocated according to their relative fair market values. Reg. §1.731-1(c)(2)(ii).
- **Example.** A is a partner in a partnership . A's basis in his partnership interest is $650. The LLC distributes inventory items and properties X and Y to A in liquidation of his partnership interest. The inventory items have a pre-distribution basis of $100 and a FMV of $200. X is a not a hot asset and has a pre-distribution basis of $50 and a FMV of $400. Y is a not a hot asset and has a pre-distribution basis and FMV of $100. The basis of the distributed assets are $250 ($100+$50+100), A's basis after reduction for money received is $650, and the required increase is $400. The inventory takes a basis of $100 to match its pre-distribution basis. X has $350 of unrealized appreciation so $350 of the basis increase is allocated to X. The last $50 of basis increase is allocated $40 to X and $10 to Y according to their relative FMVs. Thus, the basis of X is $440 and the basis of Y is $110.

© 2022

Loss

- If a distribution consists only of money and/or hot assets and the sum of (i) the amount of money distributed plus (ii) the partner's basis in the distributed hot assets is less than the partner's outside basis, the distributee partner will recognize a loss equal to the excess of the partner's outside basis over the sum of the amount of money distributed and the basis that the partner takes in the hot assets distributed. Reg. § 1.731-1(a)(2)
- **Loss is not recognized if any property is distributed in addition to cash and hot assets.**
- **Example.** Partner A has a basis in his LLC interest of $20,000. He retires from the LLC and receives, as a distribution in liquidation of his entire interest, $8,000 cash and inventory with a basis to him, as determined by section 732, of $6,000. A realizes a capital loss of $6,000. Assume instead that the LLC also distributes property with a basis and fair market value of $1,000. A may not recognize a loss because he received property other than cash and hot assets.

© 2022

Holding Periods

- Section 735(b) provides that, except for unrealized receivables and inventory, the partner's holding period for property distributed in either a current or liquidating distribution includes the holding period of the partnership for the property.
  - Section 735(a)(1) provides that gain or loss on the disposition by a distributee partner of unrealized receivables (as defined in section 751(c)) distributed by a partnership, shall be considered as ordinary income or as ordinary loss, as the case may be.
  - Section 735(a)(2) provides that gain or loss on the sale or exchange by a distributee partner of inventory items (as defined in section 751(d)) distributed by a partnership shall, if sold or exchanged within 5 years from the date of the distribution, be considered as ordinary income or as ordinary loss, as the case may be.

Ivins Phillips Barker
CHARTERED

© 2022

Agenda

Contributions

Basis

Partnership Liabilities

Distributions and Withdrawals

Death of a Partner

- Section 736
- Mechanics

© 2022

Section 736

© 2022

Section 736

- Pursuant to section 736, payments made upon the retirement or death of a partner are subject to special rules.
- Section 736 divides such payments between liquidating distributions and any other withdrawal payments. The latter are further classified as either:
  - Distributive share payments; or
  - Guaranteed payments.

© 2022

When Is a Partner Retired?

- A partner is not considered a retired partner until he ceases to be a partner under local law. Reg. § 1.736-1(a)(1)(ii).
- A distribution to a partner that reduces his interest in anticipation of his *eventual* retirement does not fall under section 736.
- A partner continues to be a partner until the liquidation process is complete.

© 2022

Two Partners

- Section 736 may apply to the liquidation of the interest of one partner of a two-person partnership. Reg. § 1.736-1(a)(6).
- Substantively, there is no difference between this transaction and a sale of the partnership interest to the other partner.
- **NOTE**, The partnership may terminate for other reasons (e.g., the remaining partner discontinues the business).

© 2022

Death of a Partner

- Upon a partner’s death, a partnership does not terminate for tax purposes. Reg. § 1.736-1(a)(1)(ii).
- The decedent's successor in interest is recognized as a continuing partner until the decedent's interest is sold or liquidated.
- If the partner's interest is liquidated as a result of his death, his successor is treated as a retired partner.
- Under section 706(c), the partnership’s tax year does not close as the result of the death of a partner, but the partner’s tax year does.

© 2022

Mechanics

© 2022

Classification of Payments

- The primary purpose of section 736 is to classify withdrawal payments.
- Other provisions govern the treatment of the payments:
  1. Liquidating distributions are determined under sections 731 and 751.
  2. A partner's distributive share is determined under section 702.
  3. Guaranteed payments are determined under section 707.

© 2022

Section 736(b)

- Payments made to a retiring or deceased partner for the partner's share of the value of partnership assets.
- Most distributions made in exchange for a retiring or deceased partner's interest fall under section 736(b).
- **Except**, section 736(b) does not apply to payments made to a general partner in a service partnership for the partner's share of unrealized receivables or goodwill.
- General principles applicable to liquidating distributions apply to these payments.

© 2022

Section 736(a)

- Payments:
  1. In excess of the retiring or deceased partner's share of partnership assets; or
  2. Made to a general partner in a service partnership in exchange for unrealized receivables or goodwill.
- Guaranteed payments - payments determined without regard to partnership income.
- Distributive shares – payments that are determined with regard to partnership income.

© 2022

Payments with Regard to Partnership Income

- The payments are included in the retiring or deceased partner's income under section 702.
- The remaining partners distributive shares are reduced accordingly.

© 2022

Payments without Regard to Partnership Income

- The payments are treated as ordinary income to the retiring partner or successor to a deceased partner under section 707.
- The payments are deductible for the partnership.

© 2022

AMERICAN BAR ASSOCIATION

Real Property, Trust and Estate Law Section

Taxation of Partnerships

December 13, 2022 | 1:00 PM Eastern

Sponsored By: The ABA Section of Real Property, Trust & Estate Law and Whittier Trust

Speakers

Charlotte P. Hopson
Ivins, Phillips & Barker, Chartered
Washington, DC

David H. Kirk
EY
Washington, DC