A Practical Guide to the Tax Consequences of Disposing of a Partnership (or LLC) Business

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I. Overview

A. **Passthrough Entity.** A partnership (or a limited liability company (LLC) which is taxable as a partnership)\(^1\) is a pass-through entity. This means, generally, that tax consequences of transactions are taxed to the partners instead of at the entity level.

B. **Sale of Assets vs. Sale of Partnership Interests.** Because a partnership is a pass-through entity, it would be logical to assume that a sale of interests in the entity would be taxable in the same manner if the entity sells its assets. This assumption is correct to a point, but there are a number of differences and special rules which must be noted.

1. **Types of Dispositions.** There are a variety of alternative forms for a disposition of a partner’s interest in a partnership or a sale of the partnership’s business:

   a. Sale of the interest.

   b. An exchange of the interest.

   c. Sale of assets.

   d. Gifts.

   e. Transfers by death.

   f. Retirement of a partner.

   g. "Disguised" sales.

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\(^1\) This outline will refer to partnerships and LLCs interchangeably. Thus, all references to a "partnership" refer to an LLC, and all references to the "partners" in a partnership refer to the members of an LLC.
C. **Character of Income.** Because a sale of a partnership interest would permit the unwarranted conversion of ordinary income into capital gains, attention must be paid to the recharacterization rules under Section 751, which treat as ordinary income a portion of the income from the sale of a partnership interest.

D. **Basis.** An important issues which may arise in connection with a transfer of the assets or interests in a partnership concerns the basis of the acquired assets (or the inside basis of the assets) of the partnership after the transaction. Particular attention needs to be paid to the basis adjustment rules under Sections 732, 734 and 743.²

E. **Liabilities.** Gain recognition upon the disposition of an interest in a partnership will often exceed the cash received because of the treatment of liabilities under Section 752. As a practical matter, the partners’ "negative capital accounts" are usually the key to determining the amount of gain which will be recognized upon a sale.

F. **Retirement of a Partner.** In planning for the retirement of a partner, Section 736 provides special rules under which payments could be ordinary income or capital gain to the retiring partner (and deductible or capital expenditures to the partnership).

G. **Disguised Sales.** Out of fear of various abuses, Congress has enacted legislation which addresses certain types of "disguised sales" of partnership interests or assets. These transactions can be traps for the unwary or planning opportunities.

H. **Transfers by Gift or at Death.** Special rules also apply when a partnership interest is transferred by gift or upon the death of a partner.

I. **Planning.** Planning for basis adjustments and allocation of deductions remains a critical part of the planning for a disposition of an interest in a partnership. In this regard, it is still possible for a partnership to deduct all or a portion of the payments made to a retiring partner, which is often a win-win situation for the buyer and the seller of interests in a partnership. Likewise, other planning opportunities exist, although consideration must be given to the impact, if any, of the partnership anti-abuse regulations.

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² All statutory references are to the Internal Revenue Code of 1986, as amended ("Code").
II. A Brief Overview of Partnership Taxation.

A. Income and Loss Recognition. Section 701 provides that a partnership shall not be subject to taxation. Instead, under Section 702, in determining his income tax, each partner is required to take into account separately his distributive share of the items of income of the partnership. Section 702(b) provides that the character of items of income, gain, loss, deduction or credit included in a partner's distributive share is determined as if such item were realized directly by the partner.

B. Contributions. In recognition of the pass-through nature of partnerships, a partner's contribution of assets to a partnership generally does not result in the recognition of gain or loss under Section 721. The basis of an interest in a partnership is equal to the partner's basis of any money or property contributed to the partnership; the partnership will generally have a "carryover" basis in the assets which are contributed to it, and the character of property (particularly inventory and unrealized receivables) will also be unchanged. Sections 722, 723 and 724, respectively. If any contributed assets are sold, the gain or loss which is inherent in the property at the time of contribution must be allocated to the contributing partner under Section 704(c).

1. Planning Alert. The potential application of Section 704(c), which can result in one partner having greater income or loss than another upon the sale of assets, is one of the important planning considerations in disposing of a partnership business.

C. Distributions. In general, Section 731 provides the rules for the recognition of gain or loss in the case of a distribution by a partnership to a partner.

1. Partnership Level. Under Section 731(b), no gain or loss is recognized to a partnership on a distribution to a partner of property, including money.

2. Gain Recognition by a Partner. Under Section 731(a)(1), gain is not recognized to a partner in the case of a distribution by a partnership to the partner except to the extent, if any, that any money distributed to the partner exceeds the partner's adjusted basis in his interest in the partnership immediately before the distribution. Any gain which is recognized is treated as gain from the sale or exchange of the partnership interest, i.e., capital gain.
a. **Effect of Liabilities.** As discussed in detail below, the reduction of a partner's share of the liabilities of a partnership can result in a deemed distribution of money to the partner under Section 752(b), which can result in the recognition of gain under Section 731(a)(1).

3. **Loss Recognition by a Partner.** Under Section 731(a)(2), loss is not recognized in the case of a distribution by a partnership to a partner, except that upon a distribution in liquidation of a partner's interest in a partnership, loss is recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of (A) any money distributed, and (B) the basis to the distributee of any unrealized receivables and inventory. Any loss which is recognized is treated as loss from the sale or exchange of the partnership interest, i.e., capital loss.

4. **Distribution of Marketable Securities.** Section 731(c) provides that for purposes of determining the amount of money distributed by partnership, the term "money" includes marketable securities.

a. **Marketable Securities.** In general a financial instrument is a marketable security if it is of a type that is, as of the date of distribution, actively traded under Section 1092(d)(1). Under this provision, actively traded personal property includes any personal property for which there is an established financial market. These markets include not only the stock and commodities exchanges, but also an interdealer market and a debt market. In addition, certain notional principal contracts (swaps) are treated as personal property of a type that is actively traded.

i. **Interest in an entity.** An interest in an entity is a marketable security if substantially all (90 percent or more) of the assets of the entity consist of marketable securities or money. If 20 percent or more but less than 90 percent of the assets of an entity consist of marketable securities, then that portion is treated as a distribution of a marketable security.
a. **Trap for the Unwary.** If an entity has significant cash reserves, a distribution of an interest in the entity could be taxable in part.

b. **Exceptions.** There are a number of important exceptions to the general rule.

i. **Contributed Securities.** A marketable security which is contributed to the partnership by the distributee is disregarded.

ii. **Certain Nonrecognition Exchange Securities.** Section 731(c) does not apply to the distribution of a marketable security to the extent that the security was acquired by the partnership in a nonrecognition transaction in exchange for property other than marketable securities or cash and (i) the security is actively traded as of the date of the distribution, and (ii) the security is distributed by the partnership within five years of either the date the security was acquired by the partnership or, if later, the date the security became actively traded.

iii. **Certain Acquired Securities.** Section 731(c) does not apply to the distribution of a marketable security if (i) the security was not actively traded on the date acquired by the partnership, and the entity to which the security related had no actively traded securities, (ii) the security is actively traded as of the date of the distribution, and (iii) the security was held by the partnership for at least six months before it became actively traded and the security was distributed by the partnership within five years of the date on which the security became actively traded.

c. **Special Rule for Inherent Gain.** The amount of marketable securities that is treated as money is reduced by the excess of (i) the partner’s share of the net gain in the partnership’s securities of the same class and issuer as the distributed securities immediately before the distribution, over (ii) the partner’s share of such gain immediately after the distribution. This provision allows the partner to withdraw the partner’s share appreciation in the partnership’s marketable securities without gain
recognition. For purposes of this provision, all of the marketable securities held by a partnership are treated as marketable securities of the same class and issuer.

d. **Basis.** The distributee partner's basis in distributed marketable securities with respect to which gain is recognized is the basis of the security under Section 722, increased by the amount of gain recognized.

e. **Investment Partnerships.** Section 731(c) does not apply to the distribution of marketable securities by an investment partnership. An investment partnership is any partnership which has never been engaged in a trade or business and substantially all of the assets of which have always consisted of money, stock in a corporation, debt instruments, notional principal contracts, foreign currencies or derivative financial instruments. For purposes of this provision, a partnership is not treated as engaged in a trade or business by reason of any activity undertaken as an investor, trader or dealer, including the receipt of commitment fees, break-up fees, director's fees, guarantee fees or similar fees. Likewise, reasonable and customary services provided by the partnership in assisting the formation, capitalization, expansion or offering of interests in a corporation or other entity in which the partnership holds or acquires a significant equity interest (including bridge loans, guarantees and the provision of advice or consulting services) is not treated as a trade or business if the compensation for the services does not represent a significant purpose of the partnership's investment and is incidental to the investment in the entity.

f. **Anti-Abuse Rule.** Like many recent regulations, the regulations under Section 731(c) contain an anti-abuse rule under which the rules and regulations must be applied in a manner consistent with the purpose of Section 731(c). Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of Section 731(c), the IRS can recast the transaction. The determination whether the result is inconsistent with the purpose of Section 731(c) is made on the basis of all of the facts and circumstances.
4. **Basis.** As discussed in more detail below, the basis of distributed property depends upon the nature of the distribution. In general, under Section 732(a), the basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner’s interest in the partnership is its adjusted basis to the partnership immediately before the distribution, but it cannot exceed the adjusted basis of such partner’s interest in the partnership reduced by the amount of money, if any, distributed in the same transaction. In contrast, under Section 732(b), the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner’s interest is equal to the adjusted basis of such partner’s interest in the partnership reduced by any money distributed in the same transaction.

a. **Liabilities.** For purposes of determining the amount of money distributed in a transaction, any reduction in the partner’s share of partnership liabilities is treated as a distribution of money under Section 752(b).

b. **Allocation.** As discussed below, if a distribution is in liquidation or the amount of the basis is limited to the partner’s basis in her partnership interest, the basis of distributed property is allocated first to any unrealized receivables and inventory, and then to any other distributed properties.

c. **Optional Adjustment to Basis of Undistributed Partnership Property.** As discussed below, Section 734 provides for a basis adjustment for undistributed property in the event a Section 754 election is made and the partnership distributes property to a partner and gain or loss is recognized to the distributee partner.

d. **Special Rule.** As discussed below, Section 732(d) provides a special rule under which the basis of distributed property is determined as if a Section 754 election were made, even if no election was made.

### III. Sale of Assets vs. Sale of Partnership Interests

#### A. In General

When a taxpayer is considering a disposition of a business conducted through a partnership or LLC, one of the most important decisions will involve whether the taxpayer sells the assets of the
partnership or whether one or more of the partners in the partnership sell their partnership interests.

1. **Sale of Less Than All of a Business.** It is very difficult to sell an undivided interest in a business; for example, who wants to own an undivided interest in machinery, cars, etc. Furthermore, under Section 761, tenants in common will frequently be treated as partners unless the "business" is passive, such as a net lease of property. Thus, in situations in which a taxpayer wants to sell an undivided interest in a business, it usually is necessary to create a partnership. However, even in this situation it is possible to sell an undivided interest in assets and then have the two parties transfer their assets to a new partnership.

B. **Sale of Assets.** The tax consequences of a sale of assets by a partnership are very straightforward. The selling partnership recognizes (i) gain equal to the excess, if any of the amount of consideration received (including the amount of liabilities assumed) over the seller’s adjusted basis in the assets sold, and (ii) loss if the seller’s adjusted basis in the assets exceeds the consideration received; this gain "flows through" to the partners. The buyer has a basis equal to the cost of the assets. These basic rules determine the amount of gain or loss recognized by the partners in a partnership on the sale of its assets.

1. **Basis.** The partner’s basis in his partnership interest will be increased by any gain recognized upon the sale and decreased by any loss recognized on the sale. Thus, if cash received on the sale is distributed, there will be no additional gain or loss recognized if inside basis and outside basis are the same.

a. **Example a.** Brittany is a 50% partner in BCD, and she has an adjusted basis in her partnership interest of $20; BCD has assets with an inside basis of $40 and a fair market value of $100. If BCD sells its assets for cash equal to their fair market value, BCD will recognize gain of $60, $30 of which will flow through to (and be recognized as gain by) Brittany. The gain will increase Brittany’s basis in her partnership interest to $50. When the partnership distributes to Brittany her share of the cash proceeds, the distribution of $50 will reduce the basis of her partnership interest to $0. Thus, Brittany will recognize gain from the sale of the assets of BCD once (and only once).
b. **Example b.** If inside basis is less than outside basis, the tax results would be different. Assume that Anne is the other 50% partner in BCD, but Anne has a basis in her partnership interest of only $12 (perhaps Anne purchased her interest for that amount and BCD did not make a Section 754 election, as discussed below). In that event, Anne would recognize gain of $30 (same as Brittany), which would increase her basis in her partnership interest to $42. The distribution of $50 in cash would result in a distribution of $8 in excess of her basis, resulting in additional gain to Anne of $8 under Section 731(a).

c. **Example c.** What if Ann had purchased her interest in BCD for $29? In that event, she would also recognize gain of $30 on the sale, increasing her basis in her partnership interest to $59. The distribution of $50 would reduce her basis to $9. If the assets sold were the only assets of the partnership, so that the partnership liquidated, Anne would recognize an additional capital loss under Section 731(b) of $9.

2. **Effect of Liabilities.** The fact that property which is sold is encumbered by a liability results in two offsetting tax consequences. First, the amount of the liability assumed by the buyer results in additional gain to the seller, increasing the seller’s basis in the seller’s partnership interest. The elimination of the liability, however, results in a deemed distribution to the seller under Section 752(b). The net effect is that the basis increase and decrease offset each other, so that only the net gain is recognized.

a. **Example.** Jack is a 50% partner in JKL, which owns a building with an adjusted basis of $10, which is encumbered with a liability of $30 and has a fair market value of $50; Jack has an adjusted basis in his partnership interest of $5. JKL sells the building for $20 cash plus assumption of the debt. Jack’s share of the gain on the sale would be $20, resulting in a basis to Jack in his interest in JKL of $25. However, Jack’s share of the liabilities of JKL was reduced by $15 (1/2 of $30 of debt), resulting in a deemed distribution to Jack of $15, so that his adjusted basis in his interest in JKL was reduced to $10 as a result of that distribution. In addition, Jack will receive $10 of cash proceeds from the sale, reducing the adjusted basis in his partnership interest to zero.
3. **Character of Gain.** The character of the gain or loss to the selling partnership is determined by reference to the assets sold. Thus, any gain or loss would be capital or ordinary depending upon the nature of the assets and how the assets have been utilized. The "character" of this gain or loss will flow through to the partners in the selling partnership.

   a. **Impact on Partners.** If the assets sold are "ordinary" assets, such as inventory, so that gain or loss is ordinary income, a difference in inside and outside basis can have tax consequences to the partners.

      i. **Example.** Consider the example, above, in which Anne is a 50% partner in BCD and has a $12 basis in her interest; BCD has assets with an adjusted basis of $20 and a fair market value of $50. If the assets of BCD which were sold were inventory, Anne would recognize $30 of ordinary income on the sale and, pursuant to the cash distribution, $8 of capital gain. On the other hand, what if Anne’s basis in her interest in BCD were $29? In that event, Anne would still have $30 of ordinary income on the asset sale, and she would have a capital loss of $9 on the liquidation of the partnership. If Anne does not have capital gains, she could not use the capital loss to offset the ordinary income.

   b. **Section 469.** The assets sold will also determine whether the gain or loss will be active or passive for purposes of the passive loss rules of Section 469. Thus, the sale of a rental building could result in different tax consequences than the sale of a trade or business, depending upon the individual’s participation in the trade or business.

4. **Allocation of Gain.** In determining the tax consequences of an asset sale, it is necessary to consider the impact of Section 704(c)(1)(A). Under this provision, income, gain, loss and deduction with respect to property contributed to a partnership by a partner must be shared among the partners so as to take account of the various between the basis of the
property to the partnership and its fair market value at the time of contribution.³

a. **Example.** If Frank contributes Blackacre with an adjusted basis of $50 and a fair market value of $200 to partnership FG, and Gary contributes $200 of cash, when Blackacre is sold for $200, the gain of $150 must be allocated to Frank. Likewise, if Henry contributes Whiteacre which an adjusted basis of $70 and a fair market value of $40 to partnership HL, and Laura contributes $40 in cash, if Whiteacre is sold for $40, Henry must be allocated $30 of loss.

b. **Permissible Methods.** The regulations under Section 704(c)(1)(A) provide that a reasonable method of allocation must be utilized to satisfy the requirements of this provision. Three methods which are provided in the regulations include (i) the "traditional method," (ii) the "traditional method with curative allocations," and (iii) the "remedial method"; these methods are used primarily to make certain that deductions for depreciation and amortization comply with the requirements of Section 704(c)(1)(A). A detailed discussion of the allocation rules under Section 704(c)(1)(A) is beyond the scope of this outline.

5. **Section 1060.** When the assets of a partnership are sold, the purchase price must be allocated among the assets under Section 1060.

a. **General.** In general, section 1060 requires an allocation of the purchase price (i) first, to cash, (ii) second, to certain cash equivalents, (iii) third, to all assets other than goodwill and similar intangibles, and (iv) fourth, to goodwill, going concern value, etc. The details of Section 1060 are beyond the scope of these materials.

b. **Section 197.** As a result of the enactment of Section 197, virtually all of the purchased assets, including goodwill, are depreciable. This will often

³ In addition, depreciation and amortization must be allocated to the partners to take into account Section 704(c)(1)(A).
increase the amount that a prospective buyer is willing to pay for the assets of a business.

6. **Like-Kind Exchanges.** The recognition of gain or loss on the transfer of the assets of a partnership can be deferred in some situations under Section 1031. A detailed discussion of Section 1031 is beyond the scope of this outline.

7. **Non-Tax Considerations.** The most important reason why a purchaser will usually prefer a sale of assets to a sale of a partnership interest is a non-tax consideration, i.e., the purchaser will not want to assume all or certain of the liabilities of the partnership.

C. **Distribution Prior to Sale.** What happens if a partnership distributes its assets to its partners prior to a sale by the partners? In general, no gain or loss will be recognized to the distributees unless the amount of cash distributed to a partner exceeds such partner’s basis in his or her partnership interest. Furthermore, if the distribution is in liquidation of the partnership, the partners will have a basis in the distributed property equal to their basis in their partnership interests; if the distribution is not in liquidation, the partners will have a basis equal to the partnership’s basis in the distributed property.

1. **Effect of Basis Rules.** The fact that the partners will have a "carryover" basis (either a direct carryover of the partnership’s basis or the basis of the partner’s interest) means that the amount of gain or loss recognized upon a subsequent sale could depend upon the manner in which the distribution is made if there is a difference between inside and outside basis.

   a. **Example a.** Assume that Jane is a 50% partner in GHI, which has assets with a fair market value of $50 and an adjusted basis of $30; Jane has a basis of $30 in her partnership interest. In that event, the tax consequences will be the same whether GHI sells the assets or, alternatively, distributes the assets (whether or not in liquidation of GHI) to Jane, who then sells the assets.

   b. **Example b.** If Jane has an outside basis in her interest in GHI of $26, then upon a liquidating distribution of GHI she will have a basis in the assets of $26. As a result, Jane would recognize $24 of gain on the sale of assets for $50. If she received, instead, a non-liquidating distribution of the assets prior to sale, she would recognize $20 of gain.
on the sale (subject to the potential application of Section 732(d), discussed below); the remaining $4 of gain would still be inherent in her partnership interest.

c. **Example c.** If Jane has an outside basis in her interest in GHI of $37, then upon a liquidating distribution of GHI she would have that basis in the distributed assets. On a subsequent sale of the assets for $50, Jane would recognize gain of $13. If she received, instead, a non-liquidating distribution of the asset prior to sale, she would recognize gain of $20 on the sale and have a basis in her partnership interest of $7.

2. **Character of Gain or Loss on Disposition of Distributed Property.** Section 735 provides special rules concerning the character of the gain or loss, if any, recognized in the event of a disposition of property distributed by a partnership to its partners.

   a. **Unrealized Receivables.** Under Section 735(a)(1), gain or loss on the disposition by a distributee partner of unrealized receivables (defined below in the discussion concerning Section 751) distributed by a partnership shall be considered as ordinary income or ordinary loss, as the case may be.

   b. **Inventory.** Gain or loss on the sale or exchange by a distributee partner of inventory items distributed by a partnership is treated as ordinary income or loss if the property is sold within 5 years from the date of the distribution.

   c. **Other Items.** The Code does not address the character of the gain or loss on the disposition of other items of property distributed by a partnership to its partners, whether in liquidation or otherwise. As a result, the use to which the assets are put will generally determine the character of gain or loss on sale.

3. **Holding Period.** For purposes of determining the period for which a partner has held property received in a distribution from a partnership, the partnership’s holding period of the assets is included.

4. **Special Rules.** There are several special rules concerning the disposition of distributed property.
a. **Inventory.** For purposes of defining what constitutes "inventory," the 1-year holding period of Section 1231(b) is disregarded.

b. **Substituted Basis Property.** If any unrealized receivables or inventory is disposed of in a nonrecognition transaction, the tax treatment which applies to such property also applies to any substituted basis property. This rule does not apply, however, to any stock in a C corporation received in an exchange described in Section 351.

D. **Sale of Partnership Interest.** The Code contains a number of special rules concerning the tax consequences of the sale of a partnership interest. These rules affect primarily (i) the character of the gain to the selling partner, and (ii) the purchaser's basis in his share of the assets of the partnership.

1. **Gain/Loss under Section 741.** In general, Section 741 provides that in the case of a sale or exchange of an interest in a partnership, gain or loss is recognized to the transferor partner. The resulting gain or loss is considered to be gain or loss from the sale or exchange of a capital asset, except as otherwise provided in Section 751 with respect to unrealized receivables and substantially appreciated receivables.

a. **Identity of Buyer.** Capital gains treatment under Section 741 applies whether the interest is sold to one or more members of the partnership or to other persons. Section 741 also applies even though the sale of the partnership interest results in a termination of the partnership under Section 708.

i. **Like Kind Exchanges.** Like kind exchanges of partnership interests cannot be made under Section 1031; an attempted exchange would be taxable. However, the conversion of a general partnership into a limited partnership, or vice versa, or the conversion of any partnership into an LLC, is not a taxable event.

b. **Practical Effect.** In other words, gain on the sale of an interest in a partnership is generally capital gain; a loss would also usually be a capital loss.
2. **Hot Assets.** Under Section 751(a), the amount of any money, or the fair market value of any property received by a partner in exchange for all or part of his partnership interest is treated as ordinary income to the extent that such consideration is attributable to unrealized receivables of the partnership or substantially appreciated inventory (so-called "Hot Assets").

a. **Unrealized Receivables.** The term "unrealized receivables," which is defined in Section 751(c), has a meaning far beyond its usual import. Specifically, the term includes, first, to the extent not previously includible in income, any rights (contractual or otherwise) to payment for (i) goods delivered, or to be delivered, to the extent that the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (ii) services rendered or to be rendered. In addition, the term "unrealized receivable" includes various types of recapture, including:

i. **Section 1245.** Personal property subject to depreciation recapture under Section 1245 is treated as an unrealized receivable to the extent of such recapture.

ii. **Section 1250.** Real property subject to depreciation recapture under Section 1250 is treated as an unrealized receivable to the extent of such recapture.

iii. **Other Items.** Other items which are treated as unrealized receivables include (a) gain from mining property, (b) gain from a stock in a DISC, (c) gain from stock in certain foreign corporations described in Section 1248, (d) certain farm recapture property, (e) gain from franchises, trademarks or trade names referred to in Section 1253(a), and (f) gain from certain natural resource recapture.

iv. **Determining Partner's Share.** If (a) a partnership holds any unrealized receivables, and (b) the distribution of the property would have resulted in a special basis adjustment under Section 732(d) (discussed below), then for purposes of determining the partner's share of such unrealized receivables, the determination is made in a manner that is
consistent with the manner in which the partner’s share of partnership property is determined.

a. **Example.** In determining the amount of gain that a partner would recognize under Section 1245 upon a sale of partnership property, items are allocated to the partner in the same manner as the partner’s share of partnership property is determined.

b. **Substantially Appreciated Inventory.** Partnership inventory items are deemed to be substantially appreciated if, at the time of the sale or distribution, the total fair market value of all the inventory items of the partnership exceeds 120 percent of basis. To prevent “stuffing” with unappreciated property, inventory does not include any property if a principal purpose of acquiring such property was to avoid the purpose of this provision.

i. **Inventory Defined.** Inventory means (a) property described in Section 1221(1), (b) any other property which upon sale would be consider property other than a capital asset and other than property described in Section 1231, and (c) gain on foreign investment company stock under Section 1246.

c. **Tiered Partnerships.** Under Section 751(f), in determining whether property of a partnership is a Hot Asset, such partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner.

d. **Certain Distributions Treated as Sales of Hot Assets.** Under Section 751(b), to the extent that a partner receives a distribution of Hot Assets in exchange for all or a part of his interest in other partnership property (including money), or other property (including money) in exchange for his interest in Hot Assets, the transaction is considered a sale. This rule applies whether or not the distribution is in liquidation of the partner’s interest in the partnership.

i. **Exchange Required.** Section 751(b) applies only in the event of a distribution which is in exchange for the partner’s interest in other partnership property. Thus, a distribution to each partner of his pro rata
share of partnership property does not trigger the application of Section 751(b). In determining whether a partner has received only his share of Hot Assets or other property, his interest in such property remaining in the partnership immediately after the distribution must be taken into account.

a. Example. Assume that the Hot Assets of ABC have a fair market value of $100,000, and A has a 30% interest in ABC. If A receives $20,000 of Hot Assets in a distribution, and continues to have a 30% interest in the remaining $80,000 of Hot Assets in the partnership after the distribution, then only $6,000 of the distribution would be his share of the Hot Assets distributed (A had $30,000 of Hot Assets in the partnership before the distribution and $24,000 after, so $6,000 were distributed to A); the remaining $14,000 of the distributed Hot Assets were in excess of his share.

ii. Effect. Under Reg. Sec. 1.751-1(b)(2), upon a distribution subject to Section 751(b), the partnership realizes ordinary income or loss on the sale or exchange of the Hot Assets. The amount of the income or loss to the partnership is measured by the difference between the adjusted basis to the partnership of the Hot Assets which are considered as sold or exchanged and the fair market value of the distributee partner’s interest in other partnership property which he relinquished in the exchange. The distributee partner realizes gain or loss measured by the difference between his adjusted basis for the property relinquished in the exchange and the fair market value of the Hot Assets received by him in the exchange. The inverse rule applies if a partner receives other property in exchange for his share of the Hot Assets of the Partnership.

iii. Exceptions. Section 751(b) does not apply to the distribution to a partner of property which the distributee partner contributed to the partnership. It also does not apply to payments made to a
retiring partner or to a decreased partner’s successor in interest to the extent that, under Section 736(a) (discussed below), such payments constitute a distributive share of partnership income or guaranteed payments.

iv. **Statement Required.** If a distribution is made which is subject to Section 751(b), a statement indicating the gain or loss recognized by the partnership and the partner must be submitted with their returns.

e. **Practical Effect.** The practical impact of Section 751 is that, upon the sale of a partnership interest, the selling partner will be required to recognize as ordinary income his share of the appreciation in the Hot Assets of the partnership, including depreciation recapture. This rule prevents a sale under Section 741 from resulting in the conversion of ordinary income into capital gain. Furthermore, Section 752(b) prevents disproportionate distributions being utilized so that selling partners recognize capital gain while the partnership retains its Hot Assets.

3. **Basis of Interest.** The basis of an interest in a partnership acquired other than by contribution is generally treated as its cost.

4. **Basis Adjustment.** The basis of partnership property is not adjusted as a result of a transfer of an interest in a partnership by sale or exchange (or on the death of a partner) unless the partnership has made a Section 754 election (discussed below) or, under current law, unless the partnership terminates as a result of the sale.

a. **Section 754 Adjustment.** Under Section 743(b), if a Section 754 election is in effect, the partnership is required to adjust the basis of its assets by (a) increasing the adjusted basis of the partnership property by the excess of the basis to the transferee of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, and (b) decreasing the adjusted basis of partnership property by the excess of the transferee partner’s proportionate share of the adjusted basis of partnership property over the basis of his interest in the partnership.
i. **Transferee Partner Only.** The basis adjustment under Section 743 applies only to the basis of partnership property with respect to the transferee partner. Thus, for purposes of determining depreciation, depletion, gain or loss, and distributions, the transferee partner will have a special basis for those partnership properties.

ii. **Recordkeeping Requirements.** Many partnerships decline to make a Section 754 election to avoid the recordkeeping which is required. Unfortunately, this will often result in adverse tax consequences to a transferee partner, particularly if the partnership has appreciated property which generates ordinary income.

   a. **Example.** Tricia acquires a 50% interest in TUV for $100; the assets of TUV consist of inventory with a basis of $150 and a fair market value of $200. When TUV sells its assets for $200, if there is no Section 754 election, Tricia will have $50 of ordinary income, which will increase her basis in her interest in TUV to $150. When she subsequently receives a distribution of $100 in liquidation of her interest, Tricia would have a capital loss of $50. If Tricia cannot use the capital loss, she will have paid tax on "phantom" income.

iii. **Share of Basis; Amount of Adjustment.** A partner’s share of the adjusted basis of partnership property is equal to the sum of his interest as a partner in partnership capital and surplus, plus his share of partnership properties. The amount of the adjustment is the difference between the transferee’s basis in his partnership interest and his share of the adjusted basis of partnership property.

iv. **Allocation of Basis.** One of the most important facets of the basis adjustment under Section 743(b) is the allocation of basis to assets under Section 755. These rules are discussed below.
b. **Termination of the Partnership.** Under current law, if 50 percent or more of the capital and profits of a partnership are transferred by sale or exchange within a 12-month period, the partnership is deemed to liquidate, its assets are deemed to be distributed to the partners, and the partnership is then deemed to have been re-formed. If this occurs, a transferee partner who has a stepped-up (or stepped-down) basis in her partnership interest will take a basis in the assets of the partnership equal to her basis in her partnership interest under Section 732(b), without regard to whether the partnership has made a Section 754 election. Thus, a step-up or step-down in the basis of partnership assets occurs automatically if the partnership terminates. The partner’s basis in her partnership interest is allocated to the assets pursuant to the rules in Section 732(c), discussed in detail below.

i. **Proposed Regulations.** The IRS has issued proposed regulations which would eliminate the deemed liquidation of a partnership; instead, the partnership is deemed to transfer its assets to a new partnership and then distribute in liquidation the interests in the new partnership to the former partners in the old partnership. The effect of this change is to eliminate the automatic step-up or step-down in the basis of the assets attributable to the acquiring partner.

5. **Section 754 Election.** The application of Section 743(b) depends upon whether or not a partnership has made an election under Section 754. An election under Section 754 is made by filing a written statement with the partnership return for the taxable year during which the distribution is made; the election must be filed with the original return for the taxable year and prior to the due date (including extensions) for that return. Thus, a Section 754 election cannot be made on an amended return.

a. **Prior Year Election.** If a valid election under Section 754 has been made for a prior taxable year and has not been revoked, the prior election remains in effect and a new election is not required.

b. **Revocation.** A partnership may revoke a Section 754 election only with approval of the IRS. The application to revoke the election must be filed with the district director
not later than 30 days after the close of the partnership taxable year with respect to which revocation is intended to take effect.

i. **Grounds.** An application for revocation of a Section 754 election must set forth the grounds for the request. Examples which may be considered sufficient grounds for revocation of a Section 754 election include (a) a change in the nature of the partnership business, (b) a substantial increase in the assets of the partnership, (c) a change in the character of partnership assets, or (d) an increased frequency of retirements of shifts of partnership interests, so that an increased administrative burden would result to the partnership from the election. No application shall be approved when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution.

6. **Rules for Basis Adjustment.** Section 755 sets forth the rules for the basis adjustment under Section 743(b), as well as the basis adjustment under Section 734(b) (discussed below), which is made to the assets of the partnership. These rules are a source of substantial tax planning opportunities.

a. **In General.** The amount of the increase or decrease in the adjusted basis of partnership property involves a two step process. First, the partnership's assets are divided into two classes: (i) capital assets and property described in Section 1231(b); and (ii) any other property of the partnership. The portion of the increase or decrease allocated to each class is then allocated to the bases of the properties within the class in a manner which will reduce the difference between the fair market value and the adjusted basis of partnership properties. In the alternative, permission to allocate the basis in a different manner may be obtained from the IRS.

i. **Treatment of Classes.** The allocation of the adjustment between the two classes of property is based on the extent that the basis adjustment is "attributable" to the value of the assets in each class. In other words, the value of the property in each class must be taken into account in order to
determine the amount of adjustment allocated to each class.

b. **Allocation of an Increase in Basis.** If there is an increase in basis to be allocated to partnership assets, such increase must be allocated only to assets whose values exceed their bases and in proportion to the difference between the value and basis of each. No increase shall be made to the basis of any asset the adjusted basis of which equals or exceeds its fair market value.

c. **Allocation of a Decrease in Basis.** If there is a decrease to be allocated to partnership assets, such decrease must be allocated to assets whose bases exceed their value and in proportion to the difference between the basis and value of each. No decrease shall be made to the basis of any asset the fair market value of which equals or is less than its adjusted basis.

d. **Treatment of Goodwill.** The foregoing rules require that a portion of the adjusted be allocated to partnership goodwill, to the extent that good will exists and is reflected in the value of the interest or property distributed.

e. **Example 1.** Assume that partnership ABC, which has assets worth $3,000, has three assets: land with an adjusted basis of $1,000 and a value of $1,500; depreciable property with an adjusted basis of $1,000 and a value of $900; and inventory with an adjusted basis of $700 and a value of $600. A 1/3 partner sells his interest for $1,000, and the buyer’s share of the adjusted basis of partnership assets would be $900, so that a basis adjustment of $100 under Section 755 would be needed if a Section 754 election were made. The buyer must allocate the basis adjustment solely to the land because that is the only adjustment which will have the effect of reducing the difference between the value and basis of the asset. No part of the basis adjustment could be allocated to the other assets because the result would be to increase the difference between the basis and value of each other asset.

f. **Example 2.** Assume the same facts as above, except that the depreciable property has a value of $1,100 and the inventory has a value of $400. In that event, the basis
adjusted must be shared between the land and the inventory. The adjustment is allocated to these assets in proportion to the difference between the value and basis of each. Therefore, if the basis adjustment is $100, it must be allocated solely to the land and the depreciable property in proportion to the difference between the value and basis of each asset.

g. Coordination with Section 1060. If there is a purchase to which Section 1060 applies, special rules are utilized for the basis adjustment. First, for purposes of determining the fair market value of each item of partnership property other than goodwill or going concern value, the determination shall be made on the basis of all of the facts and circumstances. Second, the fair market value of partnership property in the nature of goodwill or going concern value is deemed to equal the amount (not below zero) which if assigned to such property could result in a liquidating distribution to the transferee equal to such partner's basis for the transferred partnership interest immediately after the transfer if all partnership property were sold immediately after the transfer for an amount equal to the fair market value of such property.

7. Sale of Profits Interest. Section 741 applies to the sale of all partnership interests, including profits interests which lack a capital account. Thus, even though a partner may have no interest in partnership capital, the sale of a profits interest can result in capital gain under Section 741, notwithstanding that the future profits of the partnership would be treated as ordinary income to the selling partner.

a. Deemed Asset Sale. Presumably this result reflects the fact that if the partnership had sold all of its assets, including goodwill, the gain from the sale of goodwill would have been taxable to all partners, including partners who only have profits interests, as capital gain. On the other hand, the same result would apply even if the holder of the profits interest only had a right to receive "operating" income and did not share in any "capital" income of the partnership.

b. Service Partnerships. The utilization of Section 741 to achieve capital gain upon the transfer (or redemption) of interests in a service partnership (i.e., a partnership in
which capital is not a material income-producing factor) is a very useful planning technique from the seller’s point of view. On the other hand, as discussed below, as long as the differential between capital gains and ordinary income is not too great, both the seller and the buyer may benefit if deductible payments are created using Section 736.

8. Abandonment. Another way in which a partner could transfer his interest in a partnership is by abandonment.

a. Character of Loss. In general, the abandonment by a partner of his interest in the partnership will result in an ordinary loss unless the conditions of a sale or exchange have been satisfied. Rev. Rul. 93-80. In contrast, a capital loss will arise if the abandonment or worthlessness of the partnership interest is treated as a sale or exchange.

i. Liabilities. If the partner is allocated any liabilities by the partnership prior to the abandonment, the release of the partner from his share of such liabilities results in a sale or exchange. Thus, to get ordinary loss treatment, the partner must have $0 liabilities included in his basis.

b. Substantiation. The taxpayer must substantiate an abandonment by an affirmative act of abandonment. This requires a closed and completed transaction. Although written notification is not mandatory, it is highly desirable.

9. Allocation Between Selling Partner and Transferee. Whenever a partner transfers her interest in a partnership, it is necessary to determine the allocation of items in that taxable year between the selling partner and her transferee.

a. In General. Upon any change in a partner’s interest in the partnership during any taxable year, each partner’s distributive share of any item of income, gain, loss, deduction or credit of the partnership for the taxable year is determined by taking into account the varying interests of the partners in the partnership during the taxable year.

b. Closing Books. The partnership’s taxable year closes with respect to a partner upon the sale or exchange of his entire interest in a partnership. The selling partner will include in his taxable income for his taxable year within or
with which his membership in the partnership ends his distributive share of income, gain, loss deduction or credits under Section 702, and any guaranteed payments under Section 707(c), for his partnership taxable year which ends on the date of sale.

i. **Allocation.** The transferor and transferee may allocate tax items using the methods set forth in the regulations: (a) estimation based on pro rata part of each item; (b) portion of the taxable year that has elapsed; or (c) any other reasonable method.

ii. **Cash Basis Items.** Cash basis items are required to be allocated pro rata over the period they accrue in order to avoid an allocation of deductions for accrued but unpaid items. These items include interest, taxes, payment for service or for the use of property, and other items specified by regulation.

c. **Retroactive Allocations.** Retroactive allocations are prohibited.

IV. **Other Basis Adjustments**

A. **Special Basis Rules.** The previous discussion focused on the special basis adjustment which can be made under Section 754 in the event of a purchase of a partnership interest. The other special basis adjustment rules relate to distributions of property by a partnership.

B. **In General.** As discussed briefly above, the basis of distributed property depends upon the nature of the distribution.

1. **Non-Liquidating Distribution.** Under Section 732(a), the basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner’s interest in the partnership is its adjusted basis to the partnership immediately before the distribution, but it cannot exceed the adjusted basis of such partner’s interest in the partnership reduced by the amount of money, if any distributed in the same transaction.

   a. **Liabilities.** For purposes of determining the amount of money distributed in a transaction, any reduction in the partner’s share of partnership liabilities is treated as a distribution of money under Section 752(b).
2. **Liquidating Distribution.** Under Section 732(b), the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is equal to the adjusted bases of such partner's interest in the partnership reduced by any money distributed in the same transaction.

   a. **Liabilities.** For purposes of determining the amount of money distributed in a transaction, any reduction in the partner's share of partnership liabilities is treated as a distribution of money under Section 752(b).

3. **Allocation of Basis.** If a distribution is in liquidation or the amount of the basis is limited to the partner’s basis in her partnership interest, the basis of distributed property is allocated first to any unrealized receivables and inventory, and then to any other distributed properties.

   a. **Limitation on Allocation.** The unrealized receivables and inventory of the partnership may not take a higher basis in the hands of the partner than their common adjusted basis to the partnership immediately before the distribution, unless such distribution is treated as a sale or exchange under Section 751(b) or unless the distributee partner has a special basis adjustment under Section 732(d), discussed below.

      i. **Proration.** If the adjusted basis to the partnership of unrealized receivables and inventory items exceeds the partner’s adjusted basis of his interest (reduced by the amount of money distributed to him in the same transaction), the basis is allocated in proportion to the adjusted bases of such properties in the hands of the partnership.

      ii. **Excess.** If the basis of the partner’s interest to be allocated is in excess of the adjusted basis to the partnership of unrealized receivables and inventory items to be distributed, and if the partnership distributes no other property, then the distributee partner sustains a capital loss to that extent.

      a. **Conversion of Ordinary Loss into Capital Loss.** The effect of treating any excess basis as a capital loss is to convert a potential ordinary loss (if the partnership sold its
unrealized receivables and inventory) into a capital loss. Obviously, this is a step which usually should be avoided.

b. **Allocation to Other Properties.** Any basis not allocated to unrealized receivable or inventory items is allocated to any other properties distributed to the partner in the same transaction, in proportion to the basis of such other properties in the hands of the partnership before the distribution.

i. **Impact.** If other property does not have any basis in the hands of the partnership immediately prior to the distribution, no portion of the partner's basis in her partnership interest can be allocated to these assets as a result of the distribution.

ii. **Example.** Subject to Section 732(d), discussed below, assume that John has a basis in his recently-acquired 10% partnership interest in ABC of $100. ABC has no Hot Assets but owns a building worth $1,000 and with an adjusted basis of $0 and a chair with a fair market value and adjusted basis of $50. ABC makes a liquidating distribution to John of an undivided 10% interest in the chair and the building. Because ABC does not have any unrealized receivables or inventory items, and assuming that ABC has not made a Section 754 election, John must allocate the basis in his interest ($100) to the assets received in proportion to their bases in the hands of the partnership immediately prior to the distribution. Because the building has no basis, John has to allocate the entire basis in his interest to his 10% undivided interest in the chair, even though his interest in the chair is worth only 1/20 of that amount.

4. **Special Rule.** Section 732(d) provides a special rule under which the basis of distributed property is determined in certain situations. These provisions apply only if a Section 754 election was not in effect at the time of the distribution.

a. **Elective Application of Section 732(d).** If a transferee partner receivables a distribution of property (other than money) from a partnership within 2 years after he acquired
his interest or part thereof in the partnership by a transfer
with respect to which there was no Section 754 election
in effect, the partner may elect to treat as the adjusted
basis of such property the adjusted basis such property
would have if a Section 754 election had been made. If
this election is made, the amount of the adjustment with
respect to the transferee partner is not diminished by any
depletion or depreciation on that portion of the basis
which results from the Section 754 election.

i. **Like Property.** If property is distributed to a
transferee partner who elects under Section 732(d),
and if such property is not the same property which
would have had a special basis adjustment, then
such special basis adjustment shall apply to any like
property received in the distribution, provided that
the transferee has relinquished his interest in the
property which respect to which he would have had
a special basis adjustment.

ii. **How to Elect.** The election under Section 732(d) is
made with the tax return (i) for the year of the
distribution, if the distribution includes any property
subject to depreciation, depletion or amortization, or
(ii) for the first taxable year for which such
adjustment is pertinent if the distribution does not
include any such property.

b. **Mandatory Election under Section 732(d).** A partner who
acquired any part of his partnership interest in a transfer
not subject to a Section 754 election, the special basis
adjustment under Section 732(d) is mandatory with
respect to any distribution to such partner, whether or not
made within 2 years after the transfer, if at the time of his
acquisition of the transferred interest: (i) the fair market
value of all partnership property (other than money)
exceeded 110% of its adjusted basis to the partnership;
(ii) an allocation of basis under the general rules upon a
liquidation of the interest would have resulted in a shifting
of basis from property not subject to an allowance for
depreciation, depletion or amortization to property subject
to such an allowance; and (iii) a special basis adjustment
under Section 743(b) would change the basis to the
transferee partner of the property actually distributed.
i. **Less Than 110%.** If the fair market value of all of the partnership’s property does not exceed its adjusted basis by 110%, then Section 732(d) cannot be mandatorily applied. This provides a planning opportunity if a partnership has both "winners" and "losers" among its assets.

ii. **Effect of Section 197.** The regulations under Section 732(d) were drafted at a time when goodwill and going concern value were not amortizable. As a result of the enactment of Section 197, virtually every asset has become depreciable, including goodwill and going concern value. Until the regulations are changed, however, there may be situations in which Section 732(d) cannot be mandatorily applied by the IRS because all of the partnership’s assets are depreciable or amortizable.

5. **Section 751 Exception.** When a partnership distributes Hot Assets in exchange for any part of a partner’s interest in other partnership assets, the tax consequences of the distribution are determined under Section 751 and not under Section 732.

6. **Optional Adjustment to Basis of Undistributed Partnership Property.** The foregoing rules address the basis of distributed property. In some situations, it is appropriate to adjust the basis of undistributed property. Section 734 provides for such a basis adjustment if the partnership has made an election under Section 754.

   a. **Basis Increase.** Under Section 734(b)(1), the partnership will increase the adjusted basis of partnership property by the sum of (A) the amount of any gain recognized to the distributee partner under Section 731(a)(1) [relating to the amount of cash distributed in excess of the partner’s basis in his partnership interest] and (B) in the case of property distributed in complete liquidation of the partner’s interest in the partnership, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted under Section 732(d)) over the basis of the distributed property to the distributee. The basis allocation among the partnership’s properties is made pursuant to Section 755.
i. **Example.** Partner A has a basis of $10,000 for his 1/3 interest in partnership ABC. The partnership has no liabilities and has assets consisting of cash of $11,000 and property with a partnership basis of $19,000 and a value of $22,000. A receives $11,000 in cash in liquidation of his entire interest in ABC, resulting in a gain of $1,000 under Section 731(a)(1). If the partnership has made a Section 754 election, the partnership’s basis for its property is increased to $20,000.

ii. **Example.** Partner D has a $10,000 basis in his interest in partnership DEF. In liquidation of his interest, D receives partnership property with an "inside" basis of $11,000. If DEF has made a Section 754 election, the partner’s basis in its property is increased by $1,000, which is the partnership’s basis for its property before the distribution to D less his interest in the property after the distribution.

b. **Basis Decrease.** Under Section 734(b)(2), the adjusted basis of partnership property is decreased by (A) the amount of any loss recognized to the distributee partner under Section 731(a)(2), plus (B) in the case of a distribution in liquidation of a partner’s interest, the excess of the basis of the distributed property to the distributee over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted under Section 732(d)). The basis allocation among the partnership’s properties is made under Section 755.

i. **Example.** G has a basis of $11,000 in his 1/3 interest in GHI. In complete liquidation of his interest, G receives $10,000 in cash, resulting in a loss of $1,000. If GHI has made a Section 754 election, the partnership’s basis for its property would be reduced by $1,000.

ii. **Example.** J has a basis of $11,000 for his interest in JKL; J receives property with a partnership basis of $10,000 in liquidation of his interest. If JKL has made a Section 754 election, the basis of other property in JKL would be decreased by $1,000.
c. **Adjustment after Distribution to Transferee Partner.** If a partner has obtained all or a part of his partnership interest by transfer, the basis adjustments required under Section 743(b) and 732(d) must be taken into account in applying Section 734(b). If a transferee partner, in liquidation of his entire partnership interest, receives a distribution of property (including money) with respect to which he has no special basis adjustment, in exchange for his interest in property with respect to which he has a special basis adjustment, and does not utilize his entire special basis adjustment in determining the basis of the distributed property, the unused special adjustment of the distributee shall be applied as an adjustment to the basis of the property retained by the partnership.

i. **Example.** Upon the death of his father, partner S acquires by inheritance a 1/2 interest in ABC. Partners A and C each have a 1/4 interest in ABC; ABC’s assets consist of $10,000 cash and land used in farming worth $10,000 with a basis of $1,000 to the partnership. Since the partnership had made an election under Section 754 at the time of the transfer, S has a special basis adjustment of $4,500 under Section 743(b) with respect to his 1/2 interest in the real estate. The basis of S’s interest is $10,000. If S retires from the partnership and receives $10,000 in cash in exchange for his interest, S would receive no benefit from the special basis adjustment to the real estate. As a result, the partnership’s basis in the real estate would be increased by the amount of the unused basis adjustment, i.e., by $4,500 (to $5,500).

V. **Treatment of Liabilities**

A. **In General.** A partner’s basis in his partnership interest includes the partner’s share of the liabilities of the partnership (as determined under Section 752). When the partner disposes of his interest in the partnership, the resulting increase or decrease in the partner’s liabilities can result in tax to the partner.

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4 A complete description of the rules for allocating liabilities under Section 752 is beyond the scope of this outline.
1. **Increase in Partner’s Liabilities.** Under Section 752(a), any increase in a partner’s share of the liabilities of a partnership, or any increased in a partner’s individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

   a. **Practical Effect.** If a partner’s interest in a partnership is liquidated in exchange for a distribution of property subject to a liability and, in the course of such transaction, the partner assumes the liability, the resulting basis increase from the deemed contribution of money to the partnership will make it less likely that the partner will recognize gain under Section 731(a)(1). This is because of the "netting" which will occur as the partner’s share of partnership liabilities decreases, while the partner’s own liabilities increase.

   i. **Example.** Jack is a 25% partner in partnership JKL, which owns property with a fair market value of $200 subject to a liability of $80; Jack’s basis in his partnership interest is equal to his share of partnership liabilities ($20). Jack’s interest in the partnership is redeemed in exchange for $50 of property subject to a liability of $20. Although Jack will receive a deemed distribution of $20 as a result of the decrease in his share of partnership liabilities, Jack will also be deemed to have made a contribution to the partnership of $20 as a result of his assumption of liabilities. As a result, Jack will recognize no gain or loss and will have a basis of $20 in the distributed property.

   b. **Assumption.** A person is considered to assume a liability only to the extent that the assuming person is personally obligated to pay the liability and, if a partner or related person assumes a partnership liability, the person to whom the liability is owed knows of the assumption and can directly enforce the liability.

2. **Decrease in Partner’s Liabilities.** Any decrease in a partner’s share of partnership liabilities, or any decrease in a partner’s individual liabilities by reason of the partner’s assumption of the individual liabilities of the partner, is treated as a distribution of money by the partnership to that partner.
a. **Practical Effect.** This provision often results in tax consequences to partners upon the liquidation of their partnership interests. When a partner’s interest is liquidated, the partner is deemed to receive a cash distribution equal to the amount of her share of the partnership’s liabilities. If this deemed distribution, together with the cash actually distributed to the partner, exceeds her basis in her partnership interest, she will recognize gain to that extent.

i. **Example.** Returning to the preceding example involving Jack, assume that Jack received a distribution of property worth $50 but did not assume any share of the partnership’s liabilities. In that event, the deemed distribution equal to Jack’s share of the liabilities of the partnership ($20) would reduce Jack’s basis to $0. As a result, Jack would have a $0 basis in the distributed property.

a. **Negative Capital Account.** If Jack had a "negative capital account," so that his share of partnership liabilities exceeded his basis in his partnership interest, Jack would recognize gain equal to the amount of his negative capital account. Thus, for example, if Jack’s "outside" basis in his partnership interest in JKL was $5, Jack would recognize $15 of gain ($20 share of liabilities minus $5 basis) upon the liquidation of his interest in JKL.

ii. **Example.** Assume that Linda is a 10% partner in LMN and she has a basis of $10 in her interest. LMN’s assets consist of $100 of cash and property worth $300 and subject to a liability of $100. Linda receives a cash distribution of $30 in liquidation of her interest in LMN. For purposes of determining the amount of gain recognized by Linda, her distribution must be increased by $10, which is her share of the liabilities of LMN. As a result, Linda will have gain of $30 on the liquidation of her interest.

3. **Property Subject to a Liability.** If property is contributed by a partner to the partnership or distributed by the partnership to a partner and the property is subject to a liability of the transferor,
the transferee is treated as having assumed the liability to the extent that the amount of the liability does not exceed the fair market value of the property at the time of the contribution or distribution.

a. **Excess Liability.** What happens to the excess liability which is not treated as having been assumed by the transferee? There is no clear law addressing this area.

4. **Netting of Increases and Decreases.** If, as a result of a single transaction, a partner incurs both an increase in the partner’s share of liabilities and a decrease in the partner’s share of liabilities, only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership. Generally, the contribution to or distribution from a partnership of property subject to a liability will be netted to determine if a partner will be deemed to have made a contribution or received a distribution as a result of the transaction.

5. **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.

a. **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.

VI. **Payments to a Retiring Partner**

A. **In General.** Section 736 provides rules governing the treatment of payments to a retiring partner or a deceased partner’s successor in interest. These rules provide a partnership with some flexibility, within limits, to characterize payments to the retiring partner as a payment for property or a distributive share of partnership profits.

1. **Nature of Decision.** The regulations under Section 736 recognize that when a partner retires from a partnership, the payments made to the retiring partner may represent several things. In part, they may represent the fair market value at the time of his death or retirement of the withdrawing partner’s interest in all of the assets of the partnership, including inventory, unreduced by partnership liabilities. Also, part of such payments may be attributable to the partner’s interest in unrealized receivables and
part to an arrangement among the partners in the nature of mutual insurance. When a partnership makes such payments to retire the withdrawing partner’s entire interest in the partnership, the payments must be allocated between (a) payments for the value of his interest in assets, except under certain circumstance good will and unrealized receivables, and (b) other payments.

B. **Section 736(a) Payments.** Under Section 736(a), except to the extent provided in Section 736(b), payments made in liquidation of the interest of a retiring partner or a deceased partner are treat as (1) a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or (2) a guaranteed payment described in Section 707(c) if the amount thereof is determined without regard to the income of the partnership.

1. **Complete Liquidation Required.** Section 736(a) applies only to payments which are in complete liquidation of a partner’s interest in a partnership.

2. **When Partner Status Terminates.** A partner retires when he ceases to be a partner under local law. However, for purposes of subchapter K of the Code, a retired partner or a deceased partner’s successor will be treated as a partner until his interest in the partnership has been completely liquidated.
   
   a. **Effect of Continued Partner Status.** The effect of the continuation of partner status for a retiring partner is that retiring partner will continue to receive K-1s and other information returns from the partnership until the partner’s interest is completely liquidated. This also means that a 2-person partnership will not terminate until the interest of the retiring partner is completely liquidated.

3. **Tax Treatment of Section 736(a) Payments.** Payments, to the extent considered as a distributive share of partnership income under Section 736(a)(1), are taken into account under Section 702 in the income of the withdrawing partner and thus reduce the amount of the distributive shares of income of the remaining partners. Likewise, payments treated as guaranteed payments under Section 736(a)(2) are deductible under Section 162(a) and are treated as ordinary income to the recipient.
   
   a. **When Included.** Any payments under Section 736(a) are included in the income of the recipient for his taxable year.
with or within which ends the partnership taxable year for which the payment is a distributive share or in which the partnership is entitled to deduct such amount as a guaranteed payment.

4. **Impact.** The impact of payments described in Section 736(a) is that such payments are effectively deductible by the partnership and ordinary income to the recipient partner (or capital gain if representing a distributive share of the partnership’s capital gain). Thus, the payments are made with "before tax" dollars. This is a planning opportunity when these payments are compared with the nondeductible payments under Section 736(b).

C. **Section 736(b)(1) Payments.** Under Section 736(b)(1), payments made in liquidation of the interest of a retiring partner or a decreased partner are, to the extent such payments are under regulations determined to be made in exchange for the interest of such partner in partnership property, considered as a distribution by the partnership and not as a distributive share or guaranteed payment under Section 736(a).

1. **Exceptions for Goodwill and Unrealized Receivables.** As discussed below, pursuant to Section 736(b)(2), Section 736(b)(1) does not apply to payments to a retiring partner for the goodwill or unrealized receivables of the partnership if capital is not a material income-producing factor for the partnership.

2. **Inventory.** Payments made to a retiring partner or to a successor in interest of a deceased partner for his interest in inventory are considered as made in exchange for such partner’s interest in partnership property.

   a. **Substantially Appreciated Inventory.** Payments for an interest in substantially appreciated inventory are subject to the rules provided in Section 751.

3. **Valuation of Property.** Generally, the valuation placed by the partners upon a partner’s interest in partnership property in an arm’s length agreement will be regarded as correct. If such valuation reflects only the partner’s net interest in the property (total assets less liabilities), it must be adjusted so that both the value of the partner’s interest in property and the basis for his interest take into account the partner’s share of partnership liabilities.
4. **Impact.** Payments which are described in Section 736(b)(1) are effectively treated as a payment for the partner's interest in property, i.e., capital gain or loss. As a result, the amount of any gain or loss with respect to the payment is generally determined under Section 731. Furthermore, the payment is not deductible to the partnership or the remaining partners. Thus, the payment is made with "after tax" dollars.

   a. **Election.** Where the total of the Section 736(b) payments is a fixed sum, a retiring partner or a deceased partner's successor in interest may elect (in his tax return for the first taxable year for which he receives such payments) to report and to measure the amount of any gain or loss by the difference between (i) the amount treated as a distribution under Section 736(b) in that year, and (ii) the portion of the adjusted basis of the partner for his partnership interest attributable to such distribution (i.e., the amount which bears the same proportion to the partner's total adjusted basis for his partnership interest as the amount distributed under Section 736(b) bears to the total amount to be distributed under Section 736(b).

D. **Section 736(b)(2) Payments.** Under Section 736(b)(2), payments for an interest in partnership property do not include amounts paid for (A) unrealized receivables of the partnership, and (B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to goodwill.

1. **Effect.** The effect of payments being described in Section 736(b)(2) is that such payments are treated as Section 736(a) payments. As a result, such payments are (i) ordinary income to the recipient, and (ii) deductible by the partnership.

   a. **Practical Impact.** If a payment is made under Section 736(b)(2) for a retiring partner's interest in the partnership, the partnership effectively is permitted to deduct the cost of goodwill. This results in a significant planning opportunity for the partnership.

2. **Limitation.** Under Section 736(b)(3), Section 736(b)(2) applies only if (A) capital is not a material income-producing factor for the partnership, and (B) the retiring or deceased partner was a general partner in the partnership.
a. **Effect.** This rule provides a significant limitation on the ability of a partnership to deduct the cost of a retiring partner’s share of the goodwill of the partnership. In effect, only service partnerships in which the interest of a general partner is being redeemed appear to qualify for the deduction of goodwill.

b. **Permitted Allocations.** An example of a partnership which would be able to deduct the value of its goodwill would be a law firm or an accounting firm. Arguably, capital is not a material income producing factor in either business, and the partners are frequently general partners. In that event, in lieu of paying a departing partner for her share of partnership assets, the partnership could allocate income to such partner under Section 736(a) which is equal to the value of the goodwill of the partnership.

c. **Other Situations.** There is some uncertainty whether Section 736(a) payments can be made to a withdrawing partner of a partnership in which capital is a material income-producing factor. For example, assume that Jill is a 10% partner in HIJ, and Jill is willing to leave the partnership if she is allocated 5% of the income of HIJ for the next 7 years. Although an argument could be made that such an allocation is not described in Section 736(a) because it must reflect the value of Jill’s interest in partnership property (including goodwill), there does not appear to be any authority which would prevent Jill from treating the payments as ordinary income under Section 736(a). In addition, the partners are permitted to allocate between payments for property and other payments, which implies that the partners have some flexibility in determining the portion of a payment to a withdrawing partner that is in exchange for his interest in partnership property.

E. **Segregation of Payments.** Where payments made under Section 736 are received during the taxable year, the recipient (and the partnership) must segregate the payments into payments described in Section 736(a), including particularly the partner’s distributive share of partnership income and guaranteed payments, and payments described in Section 736(b). The allocation is made as follows:

1. **Fixed Amount.** If a fixed amount (whether or not supplemented by any additional amounts) is to be received over a fixed number
of years, the portion of each payment to be treated as a distribution under Section 736(b) for the taxable year shall bear the same ratio to the total fixed agreed payments for such year as the total fixed agreed payments under Section 736(b) bear to the total fixed agreed payments under Sections 736(a) and (b). The balance of the amount received in the taxable year shall be treated as a payment under Section 736(a).

a. **Carryover Rule.** If the total amount received in any one year is less than the amount considered as a distribution under Section 736(b) for that year, the excess shall be added to the portion of the payments for the following year or years which are treated as a distribution under Section 736(b).

i. **Example.** Retiring partner W is entitled to an annual payment under Section 736(b) of $6,000 for 10 years for his interest in partnership property. In 1955, W receives $3,500, and in 1956 he receives $10,000. Of the payment in 1956, $8,500 ($6,000 for 1956 plus $2,500 carryover) is treated as a distribution under Section 736(b); the balance ($1,500) is treated as a distribution under Section 736(a).

2. **No Fixed Payments.** If the retiring partner or deceased partner’s successor in interest receives payments which are not fixed in amount, such payments shall be treated as payments in exchange for his interest in partnership property under Section 736(b) to the extent of the value of such interest and, thereafter, as payments under Section 736(a).

3. **Allocation per Agreement.** In lieu of the preceding rules, the allocation of each annual payment between Section 736(a) and Section 736(b) may be made in any manner to which all the remaining partners and withdrawing partners (or successors in interest) agree, provided that the total amount allocated to property under Section 736(b) does not exceed the fair market value of such property at the date of death or retirement.

F. **Practical Considerations.** The most important aspect of Section 736 is its practical side. As long as the capital gains rate is 28% and the tax rate on ordinary income is 39.6%, both the departing partner and the remaining partners may be better off if payments are subject to Section 736(a).
1. **Example.** Jack will retire from partnership JKL, provided that Jack receives an after-tax payment of $72; JKL is willing to pay Jack up to $100 in cash on an after-tax basis. In order to pay Jack $72 in cash on after-tax basis under Section 736(b), JKL’s cost is a full $100. If, instead, the payment could be subject to Section 736(a), Jack would need to receive $119.20. However, because the payment by JKL would be deductible, the cost to JKL of the payment would only be $72. Thus, Jack receives the same amount and JKL pays less on a net, after-tax basis. Obviously, the tax savings could be shared so that both parties are better off on an after-tax basis.

2. **Effect.** Section 736(a) is one of the few places in the Code where a payment made in exchange for a property right (a partnership interest) can be deductible to the payor. This is a planning possibility which needs to be considered every time that a partner withdraws from a partnership.

G. **Summary of Tax Consequences.** A brief summary makes the foregoing jumble of rules somewhat more coherent.

1. **Unrealized Receivables.** Payment made to a retiring partner for his interest in unrealized receivables (accounts receivable and unbilled work-in process) are treated as distributions made in exchange for each partner’s interest in the receivables. Such payments will generally be treated as ordinary income.

2. **Goodwill.** Payments made to a retiring partner for goodwill are generally treated as distributions in exchange for property, except in the case of a general partner in a service partnership, in which such payments can be made subject to Section 736(a).

3. **Substantially Appreciated Inventory.** Payments made to a retiring partner for substantially appreciated inventory are made in exchange for property under Section 736(b) but are subject to ordinary income treatment under Section 751.

4. **Other Partnership Property.** Payments made to the retiring partner in exchange for other partnership properties are taxed as distributions under Section 731 and will result in capital gain or loss.

5. **Basis Adjustment.** If a Section 754 election is in effect, the partnership will make an inside basis adjustment under
Section 734(b) for the partnership's retained assets as a result of the recognition of gain or loss by the withdrawing partner.

6. **Other Payments.** Other payments could be considered as a distributive share of partnership income, which means that such payments could be ordinary income (or capital gain) to the withdrawing partner under Section 702. Guaranteed payments are ordinary income to the withdrawing partner and deductible by the partnership.

7. **Holding Period.** The holding period to the withdrawing partner of distributed property includes the holding period of the partnership under Section 735(b).

VII. **Disguised Sales**

A. **Overview.** There are three major provisions in the Code that address the issue of "disguised sales": (1) Section 707(a)(2)(B); (2) Section 704(c)(1)(B); and (3) Section 737. These provisions constitute "traps for the unwary" in that in certain situations the distribution of cash or property by a partnership to a partner can result in tax consequences to that partner or another partner. However, in certain situations these provisions provide planning opportunities to persons who want to make certain that transactions are treated as taxable sales instead of nontaxable contributions and distributions to a partnership.

B. **Section 707(a)(2)(B).** Section 707(a)(2)(B) provides rules under which a transfer of property to a partnership, and the related transfer of money or other property to the transferor, is treated as a disguised sale.

1. **Statutory Provision.** Section 707(a)(1) provides that if a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership, such transaction will be considered as occurring between the partnership and one who is not a partner. Under Section 707(a)(2)(B), if (i) there is a direct or indirect transfer of money or other property by a partner to a partnership, (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and (iii) the transfers are properly characterized as a sale or exchange of property, such transaction will be treated as a transaction described in Section 707(a)(1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.
a. **Impact.** If a transaction is subject to Section 707(a)(2)(B), it will be treated as a taxable sale of property, in whole or in part, to the partnership instead of as nontaxable contributions and distributions.

b. **Effect on Other Code Provisions.** A transaction that is treated as a sale under Section 707(a)(2)(B) is treated as a sale for all tax purposes, including the installment sale rules and original issue discount provisions.

c. **Timing of Sale.** The sale is considered to take place on the date that, under general principles of Federal tax law, the partnership is considered the owner of the property, i.e., when the benefits and burdens of the ownership of the property is transferred.

d. **Partnership/Partner Status.** If a person purports to transfer property to a partnership in a capacity as a partner, the rules of Section 707(a)(2)(B) are applied to determine whether the transfer is in the person’s capacity as a partner or is a disguised sale. Thus, it is possible that the transferor might not be treated as a partner in the partnership.

2. **Transfers Treated As Sales.** A transfer of property (excluding money or an obligation to contribute money) by a partner to a partnership and a transfer of money or other consideration (including the assumption of or taking subject to a liability) by the partnership to the partner constitute a sale of property, in whole or in part, by the partner to the partnership only if, based on all of the facts and circumstances, (i) the transfer of money or other consideration would not have been made but for the transfer of property, and (ii) in cases in which the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

3. **Relevant Facts and Circumstances.** The application of Section 707(a)(2)(B) depends upon all of the facts and circumstances. The regulations list the following 10 facts and circumstances that may tend to prove the existence of a sale:5

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5 The regulations contain examples which address the application of these factors; a discussion of these examples is beyond the scope of this outline.
a. **Reasonable Certainty.** The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer.

b. **Legally Enforceable Right.** The transferor has a legally enforceable right to the subsequent transfer.

c. **Security.** The partner’s right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured.

d. **Contributions.** Any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration.

e. **Loans.** Any person has loaned or has agreed to loan the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations.

f. **Partnership Debt.** The partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt).

g. **Liquid Assets.** The partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets).

h. **Allocations, Distributions and Control.** Partnership distributions, allocations or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property.

i. **Proportionality.** The transfer of money or other consideration by the partnership to the partner is
disproportionately large in relationship to the partner's general and continuing interest in partnership profits.

j. **Obligation to Repay.** The partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.

4. **Presumptions.** The regulations contain two presumptions which are critical to the application of Section 707(a)(2)(B).⁶

a. **Transfers Made Within Two Years Presumed to Be a Sale.** If within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.

i. **Disclosure.** Disclosure to the IRS is required if (i) a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner within a two-year period (without regard to the order of the transfers), (ii) the partner treats the transfers other than as a sale, and (iii) none of the exceptions set forth below is applicable.

b. **Transfers Made More than Two Years Apart Presumed Not to Be a Sale.** If a transfer of money or other consideration to a partner by a partnership and the transfer of property to that partnership by that partner are more than two years apart, the transfers are presumed not to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers constitute a sale.

⁶ The regulations contain examples which address the application of these presumptions; a discussion of these examples is beyond the scope of this outline.
5. **Exceptions.** The regulations contain four major exceptions to the presumption of disguised sale treatment for certain types of transfers which otherwise would be subject to the two-year rule.

a. **Reasonable Guaranteed Payments.** A reasonable guaranteed payment for capital is not treated as part of a sale of property. A "guaranteed payment for capital" means any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner's capital.\(^7\)

i. **Reasonableness Requirement.** A transfer of money to a partner that is characterized as a guaranteed payment for capital is reasonable only to the extent that the transfer is made to the partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and only to the extent that the payment is made for the use of capital after the date on which that provision is added to the partnership agreement.

(a) **Calculation of Reasonable Return.** A transfer is reasonable in amount if the sum of any guaranteed payments for capital and preferred returns does not exceed the amount determined by multiplying either the partner's unreturned capital at the beginning of the year or, at the partner's option, the partner's weighted average capital balances for the year by the safe harbor interest rate for that year. The safe harbor interest rate for a partnership's taxable year equals 150 percent of the highest applicable Federal rate (i.e., the AFR under Section 1274), at the appropriate compounding period or periods, in effect at any time from the time that the right to the preferred return or guaranteed payment for

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\(^7\) Payments are not made for the use of partner's capital if the payments are designed to liquidate all or a part of the partner's interest in property contributed to the partnership rather than to provide the partner with a return on an investment in the partnership.
capital is first established pursuant to a written agreement.

(b) **Unreturned Capital.** A partner’s unreturned capital equals the excess of the aggregate amount of money and the fair market value of other consideration (net of liabilities) contributed by the partner to the partnership over the aggregate amount of money and the fair market value of other consideration (net of liabilities) distributed by the partnership to the partner other than payments which are treated as guaranteed payments, preferred returns or operating cash flow distributions (discussed below).

(c) **Accumulation.** Any reasonable guaranteed payment may be accumulated and paid in a subsequent year.

b. **Reasonable Preferred Returns.** A reasonable preferred return is not treated as part of a sale of property. A "preferred return" means a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain.

i. **Reasonableness Requirement.** A transfer or money to a partner that is characterized as a preferred return is reasonable only to the extent that the transfer is made to the partner pursuant to a written provision of a partnership agreement that provides for payment for the use of capital in a reasonable amount, and only to the extent that the payment is made for the use of capital after the date on which that provision is added to the partnership agreement.

(a) **Calculation of Reasonable Return.** A transfer is reasonable in amount if the sum of any guaranteed payments for capital and preferred returns does not exceed the amount determined by multiplying either the partner’s unreturned capital at the beginning of the
year or, at the partner's option, the partner's weighted average capital balances for the year by the safe harbor interest rate for that year. The safe harbor interest rate for a partnership's taxable year equals 150 percent of the highest applicable Federal rate (i.e., the AFR under Section 1274), at the appropriate compounding period or periods, in effect at any time from the time that the right to the preferred return or guaranteed payment for capital is first established pursuant to a written agreement.

(b) **Unreturned Capital.** A partner's unreturned capital equals the excess of the aggregate amount of money and the fair market value of other consideration (net of liabilities) contributed by the partner to the partnership over the aggregate amount of money and the fair market value of other consideration (net of liabilities) distributed by the partnership to the partner other than payments which are treated as guaranteed payments, preferred returns or operating cash flow distributions (discussed below).

(c) **Accumulation.** Any reasonable preferred return may be accumulated and paid in a subsequent taxable year.

c. **Operating Cash Flow Distributions.** The two-year presumption does not apply to operating cash flow distributions unless the facts and circumstances clearly establish that the transfer is part of a sale. "Operating cash flow distributions" are defined as one or more transfers of money by the partnership to a partner during a taxable year to the extent that such transfers (i) are not reasonable guaranteed payments or reasonable preferred returns for the use of capital, (ii) are not otherwise characterized as subject to Section 707(a)(1), and (iii) do not exceed the partner's share of the net cash flow of the partnership.

i. **Net Cash Flow Defined.** Net cash flow of a partnership from operations for a taxable year is an
amount equal to the taxable income or loss of the partnership arising in the ordinary course of the partnership’s business and investment activities, increased by tax-exempt interest, depreciation, amortization, cost recovery allowances and other noncash charges deducted in determining such taxable income and decreased by principal payments on indebtedness, property replacement or contingencies, capital expenditures other than from reserves or borrowings, and other cash expenditures (including preferred returns) not deducted in determining such taxable income or loss.

ii. **Partner’s Share.** The partner’s share of a partnership’s net cash flow is not defined in the regulations. However, under a safe harbor, in determining a partner’s operating cash flow distributions for the year, the partner may use the partner’s smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with such taxable year.

iii. **Tiered Partnerships.** In the case of tiered partnerships, the upper-tier partnership must take into account its share of the net cash flow from operations of the lower-tier partnership so that the amount of the upper-tier partner’s operating cash flow is neither overstated nor understated.

iv. **Accumulation.** Any unpaid operating cash flow distribution may be accumulated and paid in subsequent taxable years.

d. **Preformation Expenditures.** A transfer of money or other consideration by the partnership to a partner is not treated as part of a disguised sale to the extent that the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed, the amount of capital expenditures that (i) are incurred during the two-year period preceding the transfer by the partner to the partnership, and (ii) are incurred by the partner with respect to partnership organization and syndication costs.
6. Liabilities. In general, for purposes of determining whether or not a disguised sale has occurred, the assumption of, or taking property subject to, liabilities is treated as a transfer of consideration to the partner to the extent that the amount of the liability assumed or taken subject to exceeds the partner's share of that liability. (As discussed below, special rules are provided for the assumption of or taking property subject to so-called "qualified liabilities").

a. Practical Effect. If a 20% partner is the sole owner of property subject to a liability (other than a qualified liability), and the partner transfers the property to a partnership, the partner would be deemed to receive cash consideration equal to the amount by which the liability assumed exceeds his post-contribution share of the liability (20%).

b. Partner's Share of the Liability. The determination of the partner's share of a liability depends upon whether the liability is a recourse liability or a nonrecourse liability

i. Recourse Liability. A liability is a recourse liability to the extent that the obligation is a recourse liability under the Section 752 regulations. A partner's share of a recourse liability equals the partner's share of the liability under Section 752.

ii. Nonrecourse Liability. A liability is a nonrecourse liability to the extent that the liability is treated as a nonrecourse liability under the Section 752 regulations. A partner's share of a nonrecourse liability is determined by applying the "excess nonrecourse liability" percentage from Reg. Sec. 1.752-3(a)(3).

iii. Planned Reductions. A partner's share of a liability immediately after a partnership assumes or takes subject to the liability is determined by taking into account a subsequent reduction in the partner's share of the liability if (a) at the time that the partnership assumes or takes subject to a liability, it is anticipated that the transferring partner's share of the liability will be subsequently reduced, and (b) the reduction of the partner's share is part of a plan that has as one of its principal purposes minimizing
the extent to which the assumption of or taking subject to the liability is treated as a sale under Section 707(a)(2)(B).

iv. **Transfers of More than One Property.** If the partnership assumes or takes property subject to the liabilities of more than one partner pursuant to a plan, a partner's share of the liabilities immediately after the transfers equals the sum of that partner's shares of the liabilities. However, this rule does not apply to any liability assumed or taken subject to by the partnership with a principal purpose of reducing the extent to which any other liability assumed or taken subject to by the partnership is treated as part of a disguised sale.

c. **Assumption Accompanied by Money.** If a partner pays or contributes money to the partnership and the partnership assumes or takes subject to one or more liabilities of the partner (other than qualified liabilities), the amount of those liabilities that the partnership is treated as assuming is reduced (but not below zero) by the money transferred.

d. **Tiered Partnerships.** If a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability of the lower-tier partnership retains the characterization as qualified or nonqualified that it had under the upper-tier partnership.

7. **Qualified Liabilities.** A liability is a qualified liability if it satisfies two requirements. First, if the liability is a recourse liability, the amount of the liability cannot exceed the fair market value of the transferred property. Second, a liability assumed or taken subject to by a partnership in connection with a transfer of property to the partnership by a partner is a qualified liability only to the extent that:

a. The liability was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;
b. The liability was not incurred in anticipation of the transfer of the property to a partnership but was incurred by the partner within the foregoing two-year period; 8

c. The liability is allocable (under Reg. Sec. 1.163-8T) to capital expenditures with respect to the transferred property; or

d. The liability was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business.

8. Treatment of Assumption of Qualified Liabilities. The tax consequences of the transfer of property subject to a qualified liability depends upon whether or not the transfer is otherwise treated as a disguised sale.

a. Transfer Not a Sale. If a transfer of property by a partner to a partnership is not otherwise treated as part of a sale (for example, if the transferring partner will receive a cash distribution as a result of the transfer), the partner's assumption of or taking subject to a qualified liability is ignored.

b. Transfer a Sale. If a transfer of property by a partner to the partnership is otherwise treated as a sale, then the qualified liability is treated as consideration only to the extent of the lesser of (A) the amount of consideration that the partnership would be treated as transferring if the liability were not a qualified liability, or (B) the partner's net equity percentage with respect to the transferred property.

i. Net Equity Percentage. A partner's net equity percentage with respect to an item of property

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8 For purposes of applying these rules, a liability incurred within two years of the date of the transfer is presumed to be in anticipation of the transfer unless it is subject to the next two exceptions; the taxpayer must (i) disclose such transfers, and (ii) establish that the liability was not in anticipation of the transfer on the basis of all of the facts and circumstances.
equals, in substance, the portion of the net equity in the property that the partner is deemed to otherwise have sold as a result of the transfer. In other words, if property worth $100 and subject to a qualified liability of $20 (so that the net equity in the property were $80) were transferred, and the transferring partner received a cash distribution of $40 from the partnership, then the partner would also be required to treat 1/2 of the qualified liability as consideration.

9. **Debt-Financed Transfers.** If a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under Reg. Sec. 1.163-8T to a transfer of money or other consideration to the partner within 90 days of incurring the liability, the transfer or money or other consideration is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner’s allocable share of the partnership liability.

a. **Practical Effect.** After property is transferred to a partnership, the partners can without adverse tax consequences borrow by mortgaging the property or their partnership interests, provided that the distributed proceeds do not exceed the partner’s share of the debt.

b. **Share of Debt.** The partner’s share of a liability equals the amount obtained by multiplying the partner’s share of the liability by a fraction determined by dividing (i) the portion of the liability that is allocable under Reg. Sec. 1.163-8T to the money or other property transferred to the partner, by (ii) the total amount of the liability.

i. **Effect.** The practical effect of this fraction is that if a distribution is debt financed, the distribution of the proceeds of that debt does not result in any gain to the partners if the debt is distributed pro rata.

c. **Transfers Made Pursuant to a Plan.** If a partnership transfers to more than one partner pursuant to a plan all or a portion of the proceeds of one or more partnership liabilities, all of the liabilities incurred pursuant to the plan are treated as a one liability.
10. **Refinancings.** To the extent that the proceeds of a partner or partnership liability are allocable under the rules of Reg. Sec. 1.163-8T to payments discharging all or a portion of any other liability of that partner or of the partnership, as the case may be, the refinancing debt is treated as the other liability.

11. **Transfer of Property by the Partnership to a Partner.** Rules similar to those provided for determining whether a transfer of property by a partner to a partnership is a disguised sale is applied in the inverse situation, i.e., when a partnership transfers property to a partner and there is a related transfer of consideration from the partner to the partnership.\(^9\)

12. **Disguised Sales of Partnership Interests.** The IRS has reserved the portion of the regulations which address whether a disguised sale occurs upon a transfer of a partnership interest.

VIII. **Final Regulations Under Sections 704(c)(1)(B) and 737\(^{10}\)**

A. **Part One: Section 704(c)(1)(B).**

1. **Background of Section 704(c)(1)(B).** Section 704(c)(1)(B) provides that, in the case of a distribution of contributed property to another partner within five years of its contribution to the partnership, the contributing partner must recognize gain or loss in an amount equal to the gain or loss the partner would have been allocated under Section 704(c)(1)(A) on a sale of the property by the partnership at its fair market value at the time of the distribution. Section 704(c)(2) excepts distributions of certain like-kind property to the contributing partner.

   On December 23, 1995, the IRS issued final regulations under Sections 704(c)(1)(B) and 737, effective for distributions by a partnership to a partner after January 8, 1995.

B. **Purpose of Section 704(c)(1)(B).** Section 704(c)(1)(B) is designed to prevent partners from escaping an allocation of built-in gain in a

\(^9\) Similar rules are also applied for purposes of determining whether an assumption of a liability is treated as a transfer of additional consideration.

\(^{10}\) The authors acknowledge Barksdale Hortenstine and Gregory J. Marich, Andrews & Kurth, L.L.P. for the use of portions of their outline for portions of this Section.
contributed property under Section 704(c)(1)(A) by having the partnership distribute (whether or not in a liquidating distribution) the contributed property to another partner. If this distribution was in complete liquidation of the distributee partner’s interest, the distributee partner would receive a full basis step-up in the distributed property under Section 732(b). In this case, the continuing partners could avoid a Section 734(b) step-down in the basis of the retained noncontributed property by not making a Section 754 election in such year. Even if a Section 754 election was in effect, it is quite possible that no basis step down would be required, if, for example, none of the partnership’s remaining assets had declined in value (i.e., no property contained a built-in loss).11

C. Mechanics.

1. Recognition of Gain or Loss.

   a. General Rule. If property with built-in gain or loss contributed by a partner to a partnership is distributed to another partner within five years of its contribution, Section 704(c)(1)(B) requires the contributing partner (or his successor)12 to recognize gain or loss in an amount (and character) equal to the gain or loss that would have been allocated to the contributing partner under Section 704(c)(1)(A) if the property had been sold at its fair market value13 at the time of the distribution.14

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11 Reg. § 1.755-1(b)(3).
12 Section 704(c)(3) (second sentence).
13 The final regulations provide that the fair market value that a partnership assigned to distributed property will be regarded as correct, provided that the value is reasonably agreed to among the partners in an arm’s-length negotiation and, the partners have sufficiently adverse interests. Reg. §1.704-4(a)(3). In the preamble, Treasury stated that it refused to alter this definition of fair market value because doing so would create a difference between the value applied in computing Section 704(c)(1)(B) gain and the value applied in reflecting the distribution in the partners’ capital accounts.
14 Code §§704(c)(1)(B)(i); 704(c)(1)(B)(ii).
b. **Examples.** The final regulations illustrate this general principle with the following examples:15

**EXAMPLE 1. RECOGNITION OF GAIN.**

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes $10,000 cash and Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000. Thus, there is a built-in gain of $6,000 on Property A at the time of contribution. B contributes $10,000 cash and Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. C contributes $20,000 cash.

(ii) On December 31, 1998, Property A and Property B are distributed to C in complete liquidation of C’s interest in ABC.

(iii) A is allocated $6,000 of gain under Section 704(c)(1)(A) and Section 1.704-3 on the sale of Property A at the time of the distribution ($10,000 fair market value less $4,000 adjusted tax basis). As a result, A must recognize $6,000 of gain under Section 704(c)(1)(B) on the distribution of Property A to C. B would not have recognized any gain or loss under Section 704(c)(1)(A) and Section 1.704-3 on the sale of Property B at the time of distribution because Property B, though a contributed property, did not have any built-in gain allocable to B under Section 704(c)(1)(A). As a result, B does not recognize any gain or loss on the distribution of Property B.16

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15 All of the examples contained in this outline assume that any property distributed to a partner has a fair market value at the time of such distribution equal to its fair market value at the time of its acquisition by the partnership, unless specifically stated otherwise.

16 Reg. §1.704-4(a)(5), Ex. 1.
EXAMPLE 2. EFFECT OF POST-CONTRIBUTION DEPRECIATION DEDUCTIONS.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, depreciable property with a fair market value of $30,000 and an adjusted tax basis of $20,000. Therefore, there is a built-in gain of $10,000 on Property A. B and C each contribute $30,000 cash. ABC uses the traditional method of making Section 704(c) allocations described in Section 1.704-3(b) with respect to Property A.

(ii) Property A is depreciated using the straight-line method over its remaining 10-year recovery period. The partnership has book depreciation of $3,000 per year (10 percent of the $30,000 book basis), and each partner is allocated $1,000 of book depreciation per year (one-third of the total annual book depreciation of $3,000). The partnership has a tax depreciation deduction of $2,000 per year (10 percent of the $20,000 tax basis in Property A). This $2,000 tax depreciation deduction is allocated equally between B and C, the noncontributing partners with respect to Property A.

(iii) At the end--of the third year, the book value of Property A is $21,000 ($30,000 initial book value less $9,000 aggregate book depreciation) and the adjusted tax basis is $14,000 ($20,000 initial tax basis less $6,000 aggregate tax depreciation). A's remaining Section 704(c)(1)(A) built-in gain with respect to Property A is $7,000 ($21,000 book value less $14,000 adjusted tax basis).

(iv) On December 31, 1997, Property A is distributed to B in complete liquidation of B's interest in the partnership. If Property A had been sold for its fair market value at the time of the distribution, A would have recognized $7,000 of gain under Section 704(c)(1)(A) and Section 1.704-3(b). Therefore, A recognizes $7,000 of gain on the
distribution of Property A to B under Section 704(c)(1)(B).\textsuperscript{17}

c. \textbf{Potential for Mitigating Section 704(c)(1)(B) through Valuation.}

(i) \textbf{Booking a Contributed Property at Tax Basis.} Can Sections 704(c)(1)(A) and 704(c)(1)(B) be avoided altogether if, upon the contribution of property, the partners simply agreed that the contributing partner’s capital account would be credited with the tax basis of such property (not its fair market value)? In that case, a taxable capital shift to the noncontributing partners must be avoided by the partners providing that, upon the disposition of the contributed property, 100\% of gain would first be allocated to the contributing partner until such partner had been allocated gain in an amount at least equal to the property’s original built-in gain (as agreed to by the partners upon its contribution to the partnership).

(ii) As long as the partners agree that capital accounts control the division of assets upon a liquidation of the partnership, some practitioners would argue Section 704(c) does not apply to this arrangement. The contributing partner has not enjoyed the economic benefits of a full valuation of its property. Subsequent declines in the value of the property are borne solely by the contributing partner, rather than being shared proportionately among the partners, to the extent that the property is credited to the contributing partner’s capital account at an amount that is less than its fair market value.\textsuperscript{18} Under this view, because the contributing partner has not locked-up the unrealized appreciation in the property at the time of its contribution, she should not be attributed the tax consequences attributable to

\textsuperscript{17} Reg. §1.704-4(a)(5), Ex. 2.

\textsuperscript{18} It should be noted that the partners’ failure to extend their special allocation of gain to a book-up (as well as an actual sale) substantially weakens their position against a taxable capital shift occurring upon the contribution of the property.
unrealized appreciation until she is actually allocated gain on the sale of the property.

(iii) Before analyzing this arrangement under Section 704(c), it must be noted that the partners' failure to book a contributed property into the capital accounts at its fair market value clearly results in the loss of the partnership's ability to rely on the substantial economic effect safe harbor of Section 704(b) to sustain the validity of its allocations. The Section 704(b) capital account maintenance rules clearly require that contributed property be credited to the partners' capital accounts at fair market value. See Section 1.704-1(b)(2)(iv)(b)(1); Section 1.7041(b)(2)(iv)(d)(1).

(iv) Section 704(c)(1)(A) is somewhat ambiguous on this issue. It can be read to apply to the disparity between the fair market value and tax basis of a contributed property, regardless of whether such value was relied upon to establish the partners' capital accounts. On the other hand, the mandatory allocations required by Section 704(c) appear to be premised on the notion that the contributing partner has effectively locked-up the economic benefits of his contributed property by taking the value of that property into account in setting his share of partnership capital. Though the statute may be ambiguous, the recently finalized Section 704(c) regulations are not. Section 1.704-3(a)(3) specifically provides that a partnership failing to maintain capital accounts in accordance with the Section 704(b) safe harbor must comply with Section 704(c) by maintaining a book capital account that reflects the fair market value of contributed property on the date of its contribution and that is subsequently adjusted for cost recovery and other events that affect the book basis of the property. This provision requires that all contributed property be treated as if credited to the capital account of the contributing partner at fair market value, regardless of the actual economic agreement of the partners.
By requiring that contributed property be booked at its fair market value, the Section 704(c) regulations prevent taxpayers from booking contributed property in at its tax basis in order to avoid Section 704(c)(1)(B) upon a later distribution of the contributed property to a non-contributing partner.

d. Special Issues Regarding Recognition of Gain or Loss.

(i) Reverse 704(c) Gain Allocations. Section 704(c)(1)(B) does not apply to built-in gain that is not otherwise subject to Section 704(c)(1)(A). Thus, postcontribution appreciation that has accrued in a contributed property, and that has been booked into the partners’ capital account as a result of a revaluation of the partnership’s assets (i.e., a "book-up"), is not triggered by a distribution of such property to a partner not allocated any portion of such appreciation. This holds true despite the fact that the Section 704(b) regulations require that any such built-in gain (i.e., reverse 704(c) gain) be allocated in accordance with Section 704(c) principles.

(ii) Interface of Section 707(b)(1)(A) and 704(c)(1)(B).

(a) It is not clear to what extent, if any, the recognition of loss under Section 704(c)(1)(B) is affected by the loss disallowance rules of Section 707(b)(1)(A). If a contributed property containing a built-in loss is distributed to a partner with more than a 50% interest in partnership profits or capital, Section 707(b)(1)(A) may prevent the contributing partner from recognizing the built-in loss. This issue appears to turn on whether the loss disallowance rule of Section 707(b)(1)(A) can appropriately be treated as a rule that affects the character of the loss.

(b) Section 704(c)(1)(B)(i) provides that a contributing partner recognizes a loss equal to the loss that would have been allocated to such partner under Section 704(c)(1)(A) had the contributed property been sold by the
partnership at its fair market value at the time of its distribution. Moreover, a loss incurred by a partnership on the sale of property to a controlling partner, as to which a deduction is disallowed under Section 707(b)(1)(A), is still recognized for federal income tax purposes under Section 1001(c), is still allocated among the partners under Sections 702, 703, 704(b) and 704(c), and still reduces each recipient partner's outside basis in his partnership interest under Section 705.19

(c) Section 707(b)(1) like Section 267(a)(1) limits the deductibility of a loss otherwise recognized by a partnership. Accordingly, since the measurement of a contributing partner's loss under Section 704(c)(1)(B)(i) depends on the amount of loss that would be recognized in the sale that is deemed to occur under this section, the possible application of Section 707(b)(1) to the deemed sale should not have any impact on the amount of the loss determined under section 704(c)(1)(B)(i) because Section 707(b)(1) does not affect the recognition of the loss but rather its deductibility.

(d) On the other hand, under a very strained interpretation of the statute, one could view Section 707(b)(1) as affecting the character of a loss recognized by a contributing partner under Section 704(c)(1)(B). That is, the character of a loss could be construed to include its deductibility or nondeductibility, as well as its character as ordinary or capital. Under this interpretation, Section

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19 See Sections 1001(c) and 705(a)(2)(A); Regs. §§1.704-1(b)(2)(iv)(i)(3) and 1.312-7(b)(1); Rev. Rul. 96-10, 1996-4 I.R.B. 26 (a Section 707(b)(1) disallowed loss treated as a nondeductible, noncapitalized expenditure under Section 705(a),(2)(B)); Rev. Rul. 96-11, 1996-4 I.R.B. 28 (same for Section 170 contribution of appreciated property). See also Rev. Rul. 76-175, 1976-1 CB 92.
704(c)(1)(B)(ii) would require that any loss otherwise recognized under Section 704(c)(1)(B) be disregarded as nondeductible. As will be discussed, Section 704(c)(1)(B) expressly determines the character of a Section 704(c)(1)(B) loss as if the partnership's deemed sale of the contributed property was made to the distributee partner.

(e) Section 704(c)(1)(B) should be interpreted as ignoring the loss disallowance rule of Section 707(b)(1). Section 704(c)(1)(B)(i) provides that by describing the hypothetical sale as a sale to the distributee-partner (adding the words "to the distributes" in flagrant disregard of the omission of those words from the statute). In taking this approach, regardless of whether the Section 707(b)(1) loss disallowance rule is considered a character rule, Treasury has attempted to engraft such rule onto Section 704(c)(1)(B) in the final regulations.

(f) Treasury stopped short of allowing the distributee partner the benefits of a complete interface with Section 707(b)(1). Section 707(b)(1) (flush language) provides that the transferee in an actual sale is entitled to the Section 267(b) gain reduction on a subsequent sale of the transferred property. In the context of Section 704(c)(1)(B), however, there is not an actual sale; the sale is only deemed to occur for purposes of determining the amount and character of any gain or loss recognized by the contributing partner. Treasury did not provide any guidance to the distributee-partner that would allow that partner to reduce its future gain on a sale by the amount of the contributing partner's disallowed loss.

(iii) Related Distributions.

(a) IRS has attempted to address distributions of multiple properties to one partner or
distributions of different properties to more than one partner over a period of time as part of the same distribution under general principles of taxation, such as the step transaction doctrine. To this end the final regulations refer to distributions that are "part of the same distribution." This change was made for simplification purposes only, but was not intended as a substantive change to the scope of a distribution for tax purposes and, as under current law, distributions do not need to be contemporaneous to be part of the same distribution.

(iv) **Fungible Property.** The regulations do not contain an exception for distributions of fungible property. IRS rejected this proposed change, stating that the contributed property may be fungible from an economic perspective but such property is generally not fungible for tax purposes because each contributed property will have its own individual tax basis.

2. **Character of Gain or Loss.** Section 704(c)(1)(B) gain or loss has the same character as the gain or loss that would have resulted if the distributed property had been sold by the partnership to the distributee partner at the time of the distribution.\(^ {20} \)

3. **Basis Rules.**

   a. **Contributing Partner’s Basis in the Partnership Interest.** A contributing partner that recognizes gain or loss under Section 704(c)(1)(B) is entitled to increase the basis, or required to decrease the basis, of its partnership interest by the amount of gain or loss it recognizes under Section 704(c)(1)(B).\(^ {21} \) This increase or decrease is taken into account in determining (a) the contributing partner’s

\(^ {20} \) Section 1.704(c)(1)(B)(ii), Reg. §1.704-4(b)(1). As discussed, the reference to a sale "to the distributee partner" can have real significance for federal income tax purposes.

\(^ {21} \) Reg. §1.704-4(e)(1).
adjusted tax basis under Section 732 for any property distributed to the partner in a distribution not otherwise subject to Section 737 that is part of the same distribution as the distribution of the contributed property (other than like-kind property described in Section 1.704-4(d)(3)), and (b) the amount of gain recognized by the contributing partner under Section 731 or Section 737, if any, on a distribution of money or property to the contributing partner that is part of the same distribution as the distribution of the contributed property.

b. **Partnership’s Basis in Partnership Property.** The partnership is entitled to increase the basis, or required to decrease the basis, of the distributed Section 704(c) property by the gain or loss recognized by the contributing partner under Section 704(c)(1)(B). The basis adjustment to the property is deemed made immediately prior to the distribution, after which the usual distribution rules are applied to the distributee.\(^2\) This basis adjustment to partnership property is not elective and must be made regardless of whether the partnership has an election in effect under Section 754. Any adjustment to the bases of partnership property (including any adjustment attributable to the distributed property) under Section 734(b) pursuant to a Section 754 election must be made after (and must take into account) the adjustments to basis made under this rule.

D. **Special Rules and Exceptions.**

1. **Constructive Terminations of Partnerships.**

   a. **Current Regulations Under Section 708.**

   (i) A constructive distribution of partnership property to a contributing partner pursuant to a Section 708(b)(1)(B) termination will not result in a recognition of Section 704(c)(1)(B) gain to the contributing partner.\(^2\) However, the constructive

\(^2\) Reg. §1.704-4(e)(2).

\(^2\) Reg. § 1.704-4(c)(3). See also 1989 Senate Finance Committee Report (the "Senate Report").
recontribution will begin a new five-year period running with respect to any built-in gain and built-in loss property that the partners are deemed to recontribute to the new partnership under the existing Section 708 regulations, but only to the extent that the pre-termination built-in gain or loss on such property would not have been allocated to the contributing partner under Section 704(c)(1)(A) on a sale of the contributed property to an unrelated party immediately before the termination. Nevertheless, Section 704(c)(1)(B) will apply under this rule to gain accruing in the property between the date it was acquired by the terminated partnership and the date it was deemed contributed to the reconstituted partnership pursuant to the Section 708(b)(1)(B) termination (regardless of whether such property was originally contributed to the partnership or acquired in some other manner).24

(ii) In general, Sections 704(c)(1)(B) and 737 do not apply to property contributed to a partnership on or before October 3, 1989.25 A constructive termination after October 3, 1989, does, however, appear to trigger the application of those Sections to property contributed to a partnership on or before October 3, 1989, but only to the extent that such property has built-in gain or loss that is not already subject to Section 704(c)(1)(A).

b. Proposed Regulations Under Section 708.

(i) On May 9, 1996, the IRS issued proposed regulations under Section 708(b)(1)(B) that are to be effective for terminations of partnerships occurring on or after the date that such regulations are published in final form.

(ii) The Proposed 708 Regulations include amendments to the final regulations under Sections 704(c)(1)(B)


25 Reg. §1.704-4(c)(2).

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and 737 specifically providing that a termination under Section 708(b)(1)(B) will not begin a new 5-year period. Once the proposed regulations are effective, no new 5-year clock will be started with respect to postcontribution appreciation in the assets of a partnership terminated under Section 708(b)(1)(B).

2. **Distributions of Like-Kind Property.**

   a. If Section 704(c) property is distributed to a partner other than the contributing partner, and like-kind property (within the meaning of Section 1031) is distributed to the contributing partner no later than the earlier of (1) the 180th day after the date of distribution of the contributed property, or (2) the due date (determined with regard to extensions) for the contributing partner’s tax return for the year in which the distribution was made, the amount of gain or loss, if any, that the contributing partner would otherwise have recognized under Section 704(c)(1)(B) is reduced by the amount of built-in gain or loss in the distributed like-kind property in the hands of the contributing partner immediately after the distribution.\(^{26}\)

   The contributing partner’s basis in the distributed like-kind property is determined as if the like-kind property were distributed in an unrelated distribution prior to, the distribution of any other property distributed as part of the same distribution and is determined without regard to the increase in the contributing partner’s adjusted tax basis for his partnership interest under Section 704(c)(1)(B).

   b. The final regulations, in a clarification requested in comments to the proposed regulations, contain a cross-reference to Section 1.707-3 (dealing with disguised sales) in order to confirm that the disguised sale provisions can apply to a distribution, even if the distribution would otherwise have qualified for the Section 704(c)(2) like-kind exception. Any such distribution recharacterized as an exchange under Section 707(a)(2)(B) could still qualify for nonrecognition of gain or loss upon satisfaction of all of the technical requirements of Section 1031.

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\(^{26}\) Reg. §1.704-4(d)(3).
3. **Certain Liquidations.**
   
a. Section 704(c)(1)(B) does not apply to a distribution of an interest in Section 704(c) property to a partner other than the contributing partner in a liquidation of the partnership if (a) the contributing partner receives an interest in the Section 704(c) property contributed by that partner (and no other property); and (b) the built-in gain or loss in the interest distributed to the contributing partner, determined immediately after the distribution, is equal to or greater than the built-in gain or loss on the property that would have been allocated to the contributing partner under Section 704(c)(1)(A) and Section 1.704-3 on a sale of the contributed property to an unrelated party immediately before the distribution.\(^ {27}\)

4. **Incorporation of a Partnership.**
   
a. Section 1.704-4(c)(5) provides that Section 704(c)(1)(B) does not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is liquidated as part of the incorporation transaction.\(^ {28}\)

   b. There are three methods by which a partnership may be incorporated:
      
      (i) The partnership may contribute its assets to the corporation and liquidate.

      (ii) The partners may contribute their partnership interests to the corporation, and the partnership then liquidates.

\(^ {27}\) Reg. §1.704-4(c)(2). It should be emphasized that this exception does not apply to the extent the contributing partner receives an interest in any property other than its contributed property on the liquidation. This makes the exception very limited in its application.

\(^ {28}\) See Reg. §1.737-2(c) for a similar rule in the context of Section 737.
(iii) The partnership may distribute all its assets to the partners in complete liquidation, and the partners then contribute those assets to the corporation.

c. In Rev. Rul. 84-111, 1984-2 CB 88, the IRS adopted the position that the method selected by the partnership and its partners would be respected for tax purposes. The final regulations under Sections 704(c)(1)(B) and 737 have effectively elevated this position to regulatory guidance.

d. Under the final regulations, Sections 704(c)(1)(B) and 737 do not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), so long as the partnership is completely liquidated as part of the incorporation transaction.

5. **Complete Transfer to Another Partnership.**

a. Similarly, Section 704(c)(1)(B) does not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in Section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement. A subsequent distribution of Section 704(c) property by the transferee partnership to a partner of the transferee partnership is subject to Section 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to Section 704(c)(1)(B).

b. If a partnership were to distribute undivided interests in all its property to its partners in complete liquidation and the partners then contributed that property to another partnership, the benefit of the exception would be unavailable. In this context at least, the form selected by the partners has substance. In light of the Services's apparent reluctance to issue a published Ruling extending

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29 Reg. §1.704-4(c)(4).

30 See Reg. §1.737-2(b) for a similar rule in the context of Section 737.
the holding of Rev. Rul. 84-111 to partnership rollups, these provisions are most encouraging.

c. It is important to note that this complete transfer exception clearly provides that a partnership’s transfer of its assets to another partnership, followed by a liquidating distribution of the interests in the transferee partnership, will not trigger the recognition of Section 704(c)(1)(B) gain by the original contributing partners. In addition, Section 1.704-4(c)(4) specifically states that a subsequent distribution by the transferee partnership to its partners is subject to Section 704(c)(1)(B) to the same extent that a distribution by the transferor partnership would have been subject to such provision. Clearly, this should be read to limit the application of Section 704(c)(1)(B) to the original built-in gain in the contributed property at the time of its contribution to the transferor partnership, thereby preventing a new five-year clock from starting with respect to existing Section 704(c)(1)(A) gain and forestalling the application of Section 704(c)(1)(B) to any postcontribution appreciation inherent in the transferor partnership’s property at the time of the transfer. What is puzzling, however, is why, in connection with proposing the new Section 708 regulations, Treasury believed it was necessary to propose an amendment to the Section 704(c)(1)(B) regulations to specifically provide that a new 5-year clock would not commence with respect to any postcontribution appreciation upon the contribution of assets that the proposed Section 704(c)(1)(B) regulations would deem to occur on a constructive termination. Though this proposed amendment may have only been intended as a clarification, its existence tends to support a negative inference that the pre-existing exception for complete transfers would not itself have prevented the commencement of a new clock with respect to this postcontribution appreciation.

6. **Undivided Interests.** Section 704(c)(1)(B) does not apply to a distribution of an undivided interest in property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same

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31 Reg. §1.704-4(c)(6). See Reg. §1.737-2(d)(4) for the application of Section 737 in a similar context.
property. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

7. **Nonrecognition Transactions**

a. Section 1.704-4(d)(1) property received by the partnership in exchange for Section 704(c) property in a nonrecognition transaction is treated as Section 704(c) property for purposes of Section 704(c)(1)(B) to the extent that the property received is treated as Section 704(c) property under Section 1.704-3(a)(8).

b. This rule should apply to a partnership's receipt of a corporation's stock in return for its transfer of a contributed property to such corporation. Thus, the stock received should constitute a contributed property. As a result, the distribution of any portion of such stock to a noncontributing partner should trigger the application of Section 704(c)(1)(B), unless the stock is received and distributed in an incorporation of the partnership. In this latter case, the incorporation exception may apply. Further, even if not distributed in connection with the incorporation of the partnership, the contributing partner may get relief from Section 704(c)(1)(B) gain recognition under Section 1.704-4(c)(2) as long as sufficient shares of the stock are also distributed to the contributing partner in a complete liquidation of the partnership to absorb the contributing partner's built-in Section 704(c)(1)(A) gain.

8. **Transfers of a Partnership Interest.** The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of Section 704(c)(1)(B) to the extent of the share of built-in gain or loss allocated to the transferee partner.\(^{32}\)

9. **Anti-Abuse Rule.**

a. The final regulations state that the rules of Section 704(c)(1)(B) and the regulations thereunder must be

\(^{32}\) Reg. §1.704-4(d)(2).
applied in a manner consistent with the purpose of Section 704(c)(1)(B). Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of Section 704(c)(1)(B), the final regulations provide that the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve a tax result that is consistent with the purpose of Section 704(c)(1)(B).\textsuperscript{33} Whether a tax result is inconsistent with the purpose of Section 704(c)(1)(B) is determined based on all the facts and circumstances. The final regulations include two examples illustrating this point.\textsuperscript{34}

10. **Effective Date.**

a. Section 1.704-4 applies to distributions by a partnership to a partner after January 8, 1995.

E. **Overlap of Section 704(c)(1)(b) and Section 737.**

1. **General.** As discussed below, Section 737 applies when a contributing partner receives a distribution of property from a partnership while the partnership still owns property contributed by such partner within the preceding five-year period. Generally, gain is recognized by such partner to the extent of the built-in gain in the contributed property that would be allocated to the contributing partner under Section 704(c)(1)(B) had such property been distributed to a noncontributing partner.

2. **Interface Between Section 704(c)(1)(B) and Section 737.**

a. Section 704(c)(1)(B) and Section 737 will often overlap. Certainly, if the property distributed to the contributing partner itself contains built-in gain and such property was originally contributed to the partnership by another partner, the distribution of any portion of such property to the contributing partner during the five years following the contribution of such distributed property will result in the partner who contributed such distributed property also

\textsuperscript{33} Reg. §1.704-4(f)(1).

\textsuperscript{34} Reg. §1.704(f)(2) Ex. 1 and Ex. 2.
recognizing Section 704(c) gain under Section 704(c)(1)(B).

b. The final regulations under Sections 704(c)(1)(B) and 737 provide for certain special rules dealing with the interface between these Sections.

(i) **Section 704(c)(2) Exception.** In a situation where a contributing partner’s ("A") contributed property is distributed to another contributing partner ("B") at the same time as B’s contributed property is distributed to A, the like-kind exchange exception of Section 704(c)(2) may apply to reduce, if not eliminate, A’s gain under both Sections 704(c)(1)(B) and 737.\(^{35}\) The remainder of this discussion assumes that the two distributed properties are not like-kind in quality or character.

(ii) **Basis Adjustments.** As noted above, Section 704(c)(1)(B) basis adjustments, if part of the same distribution as the Section 737 property distribution, are taken into account before gain is computed under Section 737.\(^{36}\)

(iii) **Net Precontribution Gain.** Section 1.737-1(c)(2)(iv) provides that net precontribution gain under Section 737(b) is reduced by any gain recognized under Section 704(c)(1)(B) in a distribution that is part of the same distribution as the Section 737 property distribution. In other words, the step-up in the partnership’s basis in contributed property that occurs as a result of the contributing partner’s recognition of Section 704(c)(1)(B) gain will be deemed to occur immediately before the distribution to the contributing partner that triggers gain under Section 737. See Section 1.737-1(e) ex. 3 for an illustration of this rule.

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\(^{35}\) Reg. §§1.704-4(d)(3), 1.737-1(c)(2)(v).

\(^{36}\) Reg. §§1.704-4(e)(1), 1.737-1(b)(3), 1.737-3(a).
F. **Overlap of Section 704(c)(1)(b) and Section 707(a)(2)(b).**

1. **General.**
   a. The determination of whether a sale, rather than a contribution, of an asset to a partnership has occurred depends largely upon the entrepreneurial risk to which the contributing partner is subject while a participant in the partnership. The more entrepreneurial risk such partner is subject to, and the lesser the degree of certainty with which the contributing partner can predict the amount and timing of any ultimate distribution of cash or some other asset in the future, the higher the probability that such partner’s initial conveyance to the partnership will be characterized as a contribution and not a sale.\(^{37}\)

   b. If, based on relevant facts and circumstances, a sale is found to have occurred, the Section 707(a)(2)(B) regulations are clear that such sale is deemed for all tax purposes to have occurred at the time of the initial conveyance of the property to the partnership.\(^{38}\) Those same regulations deem the contributing partner to have received a payment right, rather than a partnership interest, at that time and any subsequent related transfer of cash or property to the contributing partner will be characterized as a payment in satisfaction of the partnership’s purchase obligation arising out of the disguised sale.\(^{39}\)

   c. Thus, the related distribution of cash or property that constitutes part of a disguised sale transaction is not a distribution to a partner acting in a partner capacity and cannot be characterized as a partnership distribution under Section 731.

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\(^{37}\) Reg. §1.707-3(b)(2).

\(^{38}\) Reg. §1.707-3(a)(2).

\(^{39}\) *id.*
2. **Interface Between Section 704(c)(1)(B) and Section 707(a)(2)(B).**

   a. Section 1.704-4(a)(2) makes it clear that there is no interface between the disguised sale regulations and Section 704(c)(1)(B). Once the IRS is successful in recharacterizing a transaction as a disguised sale of the appreciated property, all Section 704(c)(1)(B) built-in gain with respect to that property is eliminated. The contributing partner would already be characterized as having exchanged the property in a taxable transaction with the partnership (or the other partner) at the outset and having triggered a recognition of the built-in gain.

   b. The final regulations clarify that Section 704(c)(1)(B) applies only to the extent that a transaction is a distribution under Section 731. References in the proposed regulations to transactions and distributions not subject to Section 704(c)(1)(B) (such as Section 751(b)) have been deleted.

   c. Because the timing and magnitude of the gain recognition under the two rules usually will differ, and because the IRS’s opportunity to successfully apply the disguised sale recharacterization will vary greatly depending upon the facts of each case, the IRS can be expected to assert both Section 704(c)(1)(B) and the Section 707 disguised sale rules as the basis for alternative arguments on audit or in litigation. These provisions should not, however, overlap.

G. **Section 737.**

1. **Background of Section 737.** The Energy Policy Act of 1992 added Section 737 to the Code. Section 737 requires a partner who contributes appreciated property to a partnership to recognize gain on a subsequent distribution of other property to the contributing partner within five years of the contribution of the property to the partnership to the extent of the lesser of (i) the net precontribution gain on the property contributed by the partner, or (ii) the excess of the value of the distributed property over the adjusted basis of the partner’s interest in the partnership.

   On December 23, 1995, Treasury issued final regulations under Section 737 with the final Section 704(c) regulations, effective
for distributions by a partnership to a partner after January 8, 1995.

2. **Purpose of Section 737.** The 1992 Conference Report (the "Conference Report") accompanying the enactment of Section 737, noted that "the committee is concerned that a partner who contributes appreciated property to a partnership may be able to avoid or defer the recognition of Sections 704(c)(1)(A) and 704(c)(1)(B) gain with respect to that property through the mechanism of having the partnership distribute other partnership property to him in partial or complete redemption of his interest while the partnership continues to own the contributed property."\(^{40}\) Section 737 was intended to serve as a backstop to the gain recognition provisions under Section 704(c)(1)(B) which, in turn, are aimed at preventing taxpayers from avoiding the recognition of Section 704(c) built-in gain by distributing an appreciated property to a noncontributing partner.\(^{41}\) As will be discussed, the effective date of Section 737 was retroactive in that it piggybacks off of the effective date of Section 704(c)(1)(B).

Despite Treasury's view to the contrary, any distribution to which Section 737 may apply (i.e., distributions of noncontributed property to a contributing partner), whether liquidating or nonliquidating, simply cannot serve as a device that would allow a contributing partner to avoid the ultimate recognition of her built-in gain. The Section 732 basis rules ensure that the contributing partner's built-in gain rolls over into the distributed property. Absent Section 737, though, a distribution of property to a contributing partner would allow the contributing partner to shift her built-in gain from the contributed property to the distributed property. Consequently, if the policy of Section 737 is related at all to Section 704(c), it is as an antislanting rule (or anti-basis strip rule). Many believe that Section 737 was never intended to reinforce the Section 704(c) rules, but that its real purpose was to backstop the disguised sale rules of Section 707(a)(2)(B).

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\(^{41}\) Both Section 737 and Section 704(c)(1)(B) also serve as back-ups to the disguised sale rules of Section 707(a)(2)(B).
H. **Mechanics.**

1. **General.** If a partner contributes appreciated property to a partnership and receives a distribution of other property from the partnership within five years of such contribution, the contributing partner recognizes gain (but not loss) in an amount equal to the lesser of (i) the excess distribution, or (ii) the net precontribution gain of the contributing partner.\(^{42}\)

2. **Excess Distribution.**

   a. The excess distribution is the amount, if any, by which the fair market value of the distributed property (other than money) exceeds the contributing partner’s adjusted tax basis in its partnership interest immediately before the distribution, reduced (but not below zero) by any money received in the distribution.\(^{43}\)

   b. In determining the amount of the excess distribution, the contributing partner’s adjusted tax basis in its partnership interest includes any basis adjustment resulting from the distribution that is subject to Section 737 (for example, adjustments required under Section 752) and from any other distribution or transaction that is part of the same distribution.\(^{44}\) The excess distribution calculation, however, does not take into account any adjustment to the contributing partner’s outside basis for gain recognized under Section 737 or for any property distributed to the partner (other than property previously contributed to the partnership by the distributee partner).\(^{45}\)

**EXAMPLE 1. DETERMINATION OF EXCESS DISTRIBUTION.**

(i) On January 1, 1995, A, B, and C form general partnership ABC as equal partners. A contributes
Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $4,000. B and C contribute $10,000 in cash each.

(ii) The partnership purchases Property B, nondepreciable real property with a fair market value of $9,000, subject to a $9,000 nonrecourse liability. This nonrecourse liability is allocated equally among the partners under Section 752, increasing A’s adjusted tax basis in A’s partnership interest from $4,000 to $7,000.

(iii) On December 31, 1998, A receives, in a current distribution from the partnership, $2,000 in cash and Property B, subject to the $9,000 liability.

(iv) In determining the amount of the excess distribution, the adjusted tax basis of A’s partnership interest is adjusted to take into account the distribution of money and the shift in liabilities. A’s adjusted tax basis is therefore increased to $11,000 for this purpose ($7,000 initial adjusted tax basis, less $2,000 distribution of money, less $3,000 (decrease in A1’s share of the $9,000 partnership liability), plus $9,000 (increase in A’s individual liabilities)). As a result of this basis adjustment, the adjusted tax basis of A1’s partnership interest ($11,000) is greater than the fair market value of the distributed property ($9,000), and therefore, there is no excess distribution. Accordingly, A recognizes no gain under Section 737.

c. The contributing partner’s adjusted tax basis in his partnership interest is determined as of the last day of the partnership’s taxable year if the distribution to which Section 737 applies is properly characterized as an advance or drawing against the partner’s distributive share of income.\(^\text{46}\)

\(^{46}\) Reg. §1.737-1(b)(3)(ii).
d. Section 1.737-3(a) states that the basis increase under Section 737(c)(1) for the amount of any gain recognized by the partner under Section 737(a) does not apply for purposes of determining gain under Section 731(a) on the distribution of money (including marketable securities) in the same or a related distribution. It should be pointed out, however, that for transactions not subject to Section 737(c)(1) as amended by the 1994 GATT legislation, this result is subject to doubt. Before GATT, Section 737(c)(1) (second sentence) provided that the basis increase applied for all purposes except Section 737(a), presumably including Section 731.

3. **Net Recontribition Gain.** The net precontribution gain of the contributing partner is equal to the net gain (if any) that would have been recognized by the contributing partner, pursuant to Section 704(c)(1)(B) and Section 1.704-4, if all property which had been contributed to the partnership by the contributing partner within five years of the distribution, and which is still held by the partnership immediately prior to the distribution, were distributed by the partnership to another partner (other than to a partner who owns, directly or indirectly, more than 50 percent of the capital or profits interest in the partnership). For this purpose, built-in losses inherent in any property contributed within the preceding five-year period are netted against built-in gains in any other such property in determining net precontribution gain.

a. **Reverse 704(c) Gain.** Because net precontribution gain is limited to the gain that would have been recognized under Section 704(c)(1)(B) from a distribution of the contributed

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47 Reg. §1.737-1(c)(1) and Section 737(b)(1) are intended to allow built-in loss property to be netted against built-in gain property in computing net precontribution gain. As will be discussed, the parenthetical clause set forth above is not in the statute. Treasury added the limitation that the deemed sale is not to a controlling partner so to ensure the hypothetical distributee partner is not a partner described in Section 707(b)(1) (even if the sole noncontributing partner is, in fact, a controlling partner). Treasury sought to avoid evoking the loss limitation rules of Section 707(b)(1) and, in doing so, prevent a netting of built-in gains and losses in determining the contributing partner’s net precontribution gain.

48 See Conference Report.
properties, and Section 704(c)(1)(B) gain is limited to gain otherwise allocable under Section 704(c)(1)(A). Section 737 will not trigger the recognition of a partner’s share of reverse 704(c) gain that is required to be allocated in accordance with Section 704(c) principles.

b. **Section 734(b)(1)(A) Adjustments.** A partnership may distribute money to a contributing partner in the same distribution that it also distributes property subject to Section 737. If the partnership has a Section 754 election in effect at the time of such distribution, the partnership is entitled to step up its basis in undistributed property under Section 734(b)(1)(A) to the extent of any gain resulting from the distribution of such money under Section 731. The Section 737 regulations provide that, for purposes of determining the amount of Section 737 gain, the contributing partner’s net precontribution gain is reduced by any basis adjustments under Section 734(b)(1)(A) made to Section 704(c) property contributed by the contributing partner as a result of money distributed in the same transaction.\(^{49}\) In effect, the regulations treat the money as having been distributed first and as having given rise to the Section 734(b)(1)(A) inside basis adjustment before the Section 737 property distribution occurs. The purpose of this rule is, in a sense, to equate property distributions with cash distributions. For example, if A contributes property with a value of $100 and a basis of zero and receives back, within 5 years, other property worth $110, only $100 is subject to tax under Section 737. If, however, A received other property worth $100 and $10 cash and a Section 754 election was in effect, A should not recognize $100 of gain under Section 737 and an additional $10 of gain under Section 731. Subject to the rules under Sections 734(b) and 755, the final regulations leave A with $100 of gain in both cases.

By omitting any reference to Section 734(b)(1)(B) adjustments that result from property distributions to the contributing partner in a transaction giving rise to Section 737 gain, Section 1.737-1(c)(2)(ii) infers that any such adjustments otherwise made with respect to the

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\(^{49}\) Reg. §1.737-1(c)(2)(ii).
contributed properties of the partnership are not taken into account in determining net precontribution gain. As will be discussed, this negative inference is confirmed in Section 1.737-3(b)(4) which specifically provides that net precontribution gain is determined before any adjustments arising under Section 734(b)(1)(B) from distributions of property in a transaction giving rise to the application of Section 737. Any adjustments under Section 734(b)(1)(B) from such transaction must be made only after any basis adjustments to contributed properties have been made to reflect the recognition of Section 737 gain. This ordering rule appears to apply to all Section 734(b)(1)(B) adjustments, whether attributable to the property distribution that triggers the application of Section 737 or the distribution of a contributed property that is not subject to Section 737 even if it is distributed in the same transaction.

c. **Transfers of a Partnership Interest.** The transferee of all or a portion of a contributing partner’s partnership interest succeeds to the transferor’s net precontribution gain, if any, in an amount proportionate to the interest transferred.\(^{50}\)

d. **Section 704(c)(1)(B) Gain Recognized in a Related Distribution.** As noted above, a contributing partner’s net precontribution gain is determined after taking into account any gain or loss recognized by the partner under Section 704(c)(1)(B) and Section 1.704-4 (or that would have been recognized by the partner except for the like-kind exception in Section 704(c)(2) and Section 1.704-4(d)(3)) on an actual distribution to another partner of Section 704(c) property contributed by the contributing partner that is part of the same distribution as the distribution to the contributing partner.\(^{51}\)

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\(^{50}\) Reg. §1.737-1(c)(2)(iii).

\(^{51}\) Reg. §1.737-1(c)(2)(iv).
EXAMPLE 2. APPLICATION OF SECTION 704(c)(1)(B)
AND SECTION 737 TO SAME DISTRIBUTION.

Assume A contributes nondepreciable Property A1 (FMV-50, Basis) and nondepreciable Property A2 (FMV-50, Basis-0) to AB in exchange for a 50% interest. Assume B contributes nondepreciable Property B1 (FMV-50, Basis-50) and nondepreciable Property B2 (FMV-50, Basis-50) to AB. Properties A1 and A2 are not like-kind in character to Properties B1 and B2. If AB distributes Property B1 to A and Property A1 to B in the same distribution, both Sections 704(c)(1)(B) and 737 are triggered by the distribution. Section 1.737-1(c)(2)(iv) (discussed above) effectively provides that the $50 step-up in basis to Property A1 that is required by Section 1.704-4(c)(3) as a result of the $50 of gain that A recognizes upon the distribution of Property A1 to B will be deemed to occur immediately before the distribution of Property B1 to A, and thus must be taken into account in computing A’s Section 737 gain. In that case, A’s net precontribution gain of $100 ($50 in Property A1 and $50 in Property A2) is reduced to $50 solely in Property A2. Although A still has $50 of net precontribution gain at the time A1’s Section 737 gain is computed, because A1’s outside basis in its AB interest is also stepped-up by $50 of Section 704(c)(1)(B) gain prior to determining A1’s Section 737 gain, A will not have any excess distribution under Section 737 and will not recognize any gain under Section 737 (i.e., recognition of the gain inherent in Property A2 will not be accelerated by the distribution of Properties A1 and B1).

e. Section 704(c)(2) Like-Kind Exception Disregarded. A contributing partner’s net precontribution gain is determined without regard to the provisions of Section 704(c)(2) and Section 1.704-4(d)(3) in situations in which the property contributed by the contributing partner is not actually distributed to another partner in a distribution related to the Section 737 distribution.  

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52 Reg. §1.704-4(e)(1).

53 Reg. §1.737-1(c)(2)(v). Clearly, in the case where both the contributed (continued...)
4. **Basis Rules Following Application of Section 737.**

a. **Contributing Partner’s Basis in Partnership Interest.** For all purposes other than in determining gain under Section 737(a), the adjusted basis of a contributing partner’s interest in a partnership is increased by any gain which that partner is required to recognize under Section 737.\(^\text{54}\) The increase in the contributing partner’s basis in his partnership interest is deemed to occur immediately before the distribution of the property.\(^\text{55}\)

b. **Contributing Partner’s Adjusted Tax Basis in Distributed Property.** The contributing partner’s adjusted tax basis in the distributed property is determined under Section 732(a) or (b), as applicable. The increase in the contributing partner’s adjusted tax basis in the partnership interest that results from such partner’s recognition of gain under Section 737 is taken into account in determining the contributing partner’s adjusted tax basis in the distributed property (other than property previously contributed by the partner) because such adjustment is deemed to occur immediately prior to the distribution.\(^\text{56}\) The contributing partner’s adjusted tax basis in distributed property that the partner previously contributed to the partnership is determined as if it were distributed in a separate and independent distribution prior to the distribution that is subject to Section 737.\(^\text{57}\)

\(^{53}\) (continued)

property is distributed to the noncontributing partner and the like-kind noncontributed property is distributed to the contributing partner, the net precontribution gain should be reduced to the same extent that the potential gain under Section 704(c)(1)(B) has been reduced pursuant to Section 704(c)(2).

\(^{54}\) Reg. §1.737-3(a).

\(^{55}\) Section 737(c)(1).

\(^{56}\) Reg. §1.737-3(b)(1).

\(^{57}\) Reg. §1.737-3(b)(2).
EXAMPLE 3. PARTNERS BASIS IN DISTRIBUTED PROPERTY.

(i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of $10,000 and an adjusted tax basis of $5,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $10,000. C contributes $10,000 in cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes $5,000 of gain under Section 737, an amount equal to the excess distribution of $5,000 ($10,000 fair market value of Property B less $5,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of $5,000 ($10,000 fair market value of Property A less $5,000 adjusted tax basis of such property).

(iii) A's adjusted tax basis in A's partnership interest is increased by the $5,000 of gain recognized under Section 737. This increase is taken into account in determining A's basis in the distributed property. Therefore, A's adjusted tax basis in distributed Property B is $10,000 under Section 732(b).

c. Partnership’s Adjusted Tax Basis in Partnership Property. The partnership’s adjusted tax basis in eligible property is increased by the amount of gain recognized by the contributing partner under Section 737.58

(i) Eligible property is property that:

(a) entered into the calculation of the distributee partner’s net precontribution gain;

58 Section 737(c)(2); Reg. §1.737-3(c)(1).
(b) has an adjusted tax basis to the partnership less than the property’s fair market value at the time of the distribution;

(c) would have the same character of gain on a sale by the partnership to an unrelated party as the character of any of the gain recognized by the contributing partner under Section 737; and

(d) was not distributed to another partner in a distribution subject to Section 704(c)(1)(B) and Section 1.704-4 that was part of the same distribution as the distribution that is subject to Section 737.69

(ii) For purposes of allocating a partnership’s Section 737 basis increase in eligible property, all eligible property of the same character is treated as a single group.60 The basis increase is allocated among the separate groups of eligible property in proportion to the character of the gain recognized under Section 737.61 The basis increase is then allocated among property within each group in the order in which the property was contributed to the partnership by the partner, starting with the property contributed first, in an amount equal to the difference between the property’s fair market value and its adjusted tax basis to the partnership at the time of the distribution.62

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69 Reg. §1.737-3(c)(2)(i) - (iv).
60 Reg. §1.737-3(c)(3).
61 id.
62 id.
EXAMPLE 4. PARTNERSHIP'S BASIS IN PARTNERSHIP PROPERTY AFTER A DISTRIBUTION SUBJECT TO SECTION 737.

(a) On January 31, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

<table>
<thead>
<tr>
<th>Property</th>
<th>Fair Market Value</th>
<th>Adjusted Tax Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A1</td>
<td>$1,000</td>
<td>$500</td>
</tr>
<tr>
<td>Property A2</td>
<td>4,000</td>
<td>1,500</td>
</tr>
<tr>
<td>Property A3</td>
<td>4,000</td>
<td>6,000</td>
</tr>
<tr>
<td>Property A4</td>
<td>6,000</td>
<td>4,000</td>
</tr>
</tbody>
</table>

(b) The character of gain or loss on Properties A1, A2, and A3 is long-term, U.S.-source capital gain or loss. The character of gain on Property A4 is long-term, foreign source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of $15,000. C contributes $15,000 cash.

(c) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the Partnership. A recognizes gain of $3,000 under Section 737, an amount equal to the excess distribution of $3,000 ($15,000 fair market value of Property B less $12,000 adjusted tax basis in A1's partnership interest) and A1's net precontribution gain of $3,000 ($15,000 aggregate fair market value of the property contributed by A less $12,000 aggregate adjusted tax basis of such property).

(d) The character of A1's $3,000 of gain is as follows: $2,000 is long-term foreign-source capital gain ($3,000 total gain under Section 737 multiplied by $2,000 net long-term, foreign-source capital gain divided by $3,000 total net precontribution gain) and $1,000 is long-term, U.S.-source capital gain ($3,000 total gain under Section 737 multiplied $1,000 net long-term, U.S.-source capital gain divided by $3,000 total net precontribution gain).
(e) The partnership must increase the adjusted tax basis of the property contributed by A by $3,000. All property contributed by A is eligible property. Properties A1, A2, and A3 have the same character and are grouped into a single group for purposes of allocating this basis increase. Property A4 is in a separate character group.

(f) Because $2,000 of the gain recognized by A was long-term, foreign-source capital gain, $2,000 of the basis increase must be allocated to a long-term, foreign-source capital assets. The adjusted tax basis of Property A4 is therefore increased from $4,000 to $6,000. Because $1,000 of the gain recognized by A is long-term, U.S.-source capital gain, $1,000 of the increase must be allocated to Properties A1 and A2. No basis increase is allocated to Property A3 because its fair market value is less than its adjusted tax basis. The $1,000 basis increase is allocated between Properties A1 and A2 based on the unrealized appreciation in each asset before such basis adjustment. As a result, the adjusted tax basis of Property A1 is increased by $167 ($1,000 x $500/$3,000) and the adjusted tax basis of Property A2 is increased by $833 ($1,000 x $2,500/$3,000).

(iii) The final regulations' adopt a FIFO method to allocate the basis increase to properties contributed to the partnership at different times even though FIFO is not mandated by the statute. A pro rata approach or even a LIFO approach would have been equally supportable. The obvious purpose of this rule is to preserve the Section 704(c) taint for the longest period possible. For example, if A contributed Property 1 in Year 1 and Property 2 in Year 2 and receives other property in Year 5, allocation of the basis increase to Property 2 would shelter a second property distribution in Year 6 from the application of Section 737, whereas allocation of the basis increase to Property 1 preserves the taint on Property 2 for purposes of determining the consequences of the Year 6 distribution.
(iv) The basis adjustment to partnership property is not elective and must be made regardless of whether the partnership has a Section 754 election in effect.\(^6\) Any adjustments to the bases of partnership property (including eligible property) under Section 734(b) pursuant to a Section 754 election (other than basis adjustments under Section 734(b)(1)(A) described in the following sentence) must be made after (and must take into account) the adjustments under these rules to the contributing partner's basis in its partnership interest and the partnership's basis in partnership property.\(^6\) Basis adjustments under Section 734(b)(1)(A) that are attributable to distributions of money to the contributing partner that are part of the same distribution as the distribution of property subject to Section 737 are made before the adjustments to the contributing partner's basis in its partnership interest and the partnership's basis in partnership property.\(^6\)

(v) Any increase to the adjusted tax basis of partnership property is recovered using any applicable recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the type adjusted) placed in service at the time of the distribution.\(^6\)

5. **Character of Gain.**

   a. The character of the gain recognized under Section 737 is determined by, and is proportionate to, the character of the partner's net precontribution gain.\(^6\)

\(^6\) Reg. §1.737-3(c)(4)

\(^6\) *id.*

\(^6\) *Id.*

\(^6\) Reg. §1.737-3(d).

\(^6\) Section 737(a); Reg. §1.737-1(d).
b. All gains and losses on Section 704(c) property are netted according to their character, and any character with a net negative amount is disregarded. Character is determined as if the Section 704(c) property had been sold by the partnership to an unrelated third party at the time of the distribution. This rule differs from the rule applicable under Section 1.704-4 where character is determined as if the sale had been by the partnership to the distributes. Because the only distributee in a Section 737 transaction is the contributing partner, the final regulations under Section 737 rightfully posit a sale to an unrelated third party. For this purpose, "character" includes any item that would have been taken into account separately by the contributing partner under Section 702(a) and Section 1.702-1(a). 68

I. Special Rules and Exceptions.

1. Section 737 Not Triggered if Contributed Property Distributed Back to the Contributor.

   a. If a contributed asset is distributed back to the contributing partner, that asset will neither be (a) taken into account in determining the fair market value of the distributed property for purposes of calculating Section 737 gain, nor (b) taken into account in determining net precontribution gain. 69

   b. If the contributed asset that is distributed back to a contributing partner consists of an interest in an entity (e.g., a corporation), the exception noted above does not apply to the extent that the value of the entity is attributable to property contributed to it after such property was contributed to the partnership. 70 This exception to the exception only applies if the property contributed by the partnership to the entity is not itself property that was originally contributed by the contributing

68 See Reg. §1.737-1(e) for an example of this character rule.

69 Section 737(d)(1); Reg. §1.737-2(d)(1).

70 id.
partner to which the interest in the distributed entity is attributable.

c. Note that the rule for interests in a contributed entity requires a tracing of assets to determine the value and basis of any asset contributed to the entity by the contributing partner. 71

2. Constructive Terminations of Partnerships.

a. The final regulations provide that a constructive distribution of partnership property to a contributing partner pursuant to a Section 708(b)(1)(B) termination will not result in a recognition of gain to the contributing partner under Section 737. 72 The final regulations do, however, provide that a Section 708(b)(1)(B) termination will start a new five-year period running with respect to the built-in gain property that each partner is deemed to recontribute to the new partnership. Although this rule does not apply to built-in gain or loss that was already subject to Section 704(c), it does apply to gain accruing in property between the date it was acquired by the terminated partnership and the date it was deemed contributed to the reconstituted partnership pursuant to the Section 708(b)(1)(B) termination. 73

b. Recently proposed amendments to both the Sections 704(c)(1)(b) and 737 regulations, as well as Proposed 708 Regulations, will avoid these consequences from constructive terminations under Section 708. See subsection D.1.b above.

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71 Reg. §1.737-2(e) illustrates the previously contributed property rule with two examples.

72 Reg. §1.737-2(a). Because the application of Section 737 is limited to the definition of "net precontribution gain" for purposes of Section 704(c)(1)(B), the provisions of the final regulations under Section 704(c)(1)(B) relating to constructive terminations are also relevant under Section 737.

73 Reg. §1.704-4(a)(4)(i).
3. **Nonrecognition Transactions.**

a. In deceptively simple provisions, Sections 1.737-2(d)(3) and 1.704-4(d)(1) provide that property received by a partnership in exchange for Section 704(c) property in a nonrecognition transaction is treated as the Section 704(c) property for purposes of Sections 704(c)(1)(B) and 737 to the extent that the property received is treated as Section 704(c) property under Section 1.704-3(a)(8).

b. Section 1.704-3(a)(8) provides the following rules:

**Disposition of property in nonrecognition transaction.** If a partnership disposes of Section 704(c) property in a nonrecognition transaction in which no gain or loss is recognized, the substituted basis property (within the meaning of Section 7701(a)(42)) is treated as Section 704(c) property with the same amount of built-in gain or loss as the Section 704(c) property disposed of by the partnership. If gain or loss is recognized in such a transaction, appropriate adjustments must be made. The allocation method for the substituted basis property must be consistent with the allocation method chosen for the original property. If a partnership transfers an item of Section 704(c) property together with other property to a corporation under Section 351, in order to preserve that item’s built-in gain or loss, the basis in the stock received in exchange for the Section 704(c) property is determined as if each item of Section 704(c) property had been the only property transferred to the corporation by the partnership.

c. Query whether Section 1.704-3(a)(8) permits creating separate blocks of stock in a single equity interest consisting of Section 704(c) stock and non-Section 704(c) stock, or whether a pro rata portion of each share disposed of is subject to the Section 704(c) taint. The concept of a single equity interest having separate bases is inconsistent with the applicable rules under Section 358. See Rev. Rul. 85-164, 1985-2 C.B. 117 (no designation of contributed property to specific shares of stock received in exchange; pro rata approach mandated).
d. If designation of Section 704(c) shares and non-Section 704(c) shares is permitted, and the Section 704(c) taint can be captured solely in a single class of shares, then query whether the rules contained in Sections 1.737-2(b) and -2(c) (discussed below) are but limited subsets of the potential relief available here. Section 1.737-2(b) deals with transfers to another partnership, and Section 1.737-2(c) deals with a partnership roll-up where the partnership completely liquidates. If designation and segregation is permitted (the final regulations are silent on this issue), then relief from the application of Section 737 is potentially much broader than as set forth in the final regulations.

4. **Special Nonrecognition Exceptions.**

   a. **In General.** The final regulations provide complete exemptions from the application of Section 737 for three additional categories of cases: (a) a complete transfer to another partnership, (b) certain divisive transactions, and (c) the incorporation of a partnership. These three exceptions are discussed below.

   b. **Transfer to Another Partnership.** As to the first exception, the final regulations provide that Section 737 does not apply to a transfer by a partnership of all its assets and liabilities to a second partnership in an exchange described in Section 721, followed by a distribution of the interest in the transferee partnership in complete liquidation of the transferor partnership as part of the same plan or arrangement.\(^74\) A subsequent distribution of property by the transferee partnership to the partners of the transferee partnership who were formerly partners of the transferor partnership is subject to Section 737 to the same extent that a distribution from the transferor partnership would have been subject to Section 737.\(^75\)

   c. **Divisive Partnership Transactions.** The final regulations provide that Section 737 does not apply to a transfer by a partnership (transferor partnership) of all of the Section

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\(^74\) Reg. §1.737-2(b)(1).

\(^75\) Reg. §1.737-2(b)(3).
704(c) property contributed by a partner to a second partnership (transferee partnership) in an exchange described in Section 721, followed by a distribution as part of the same plan or arrangement of an interest in the transferee partnership (and no other property) in complete liquidation of the interest of the partner that originally contributed the Section 704(c) property to the transferor partnership.  

d. **Incorporation of a Partnership.** Like 704(c), Section 737 also does not apply to an incorporation of a partnership by any method of incorporation (other than a method involving an actual distribution of partnership property to the partners followed by a contribution of that property to a corporation), provided that the partnership is completely liquidated as part of the same plan or arrangement as the incorporation transaction.  

5. **Undivided Interests.** The distribution of an undivided interest in property is treated as the distribution of previously contributed property to the extent that the undivided interest does not exceed the undivided interest, if any, contributed by the distributee partner in the same property. The portion of the undivided interest in property retained by the partnership after the distribution, if any, that is treated as contributed by the distributee partner, is reduced to the extent of the undivided interest distributed to the distributee partner.

K. **Anti-Abuse Rule.** Section 1.737-2(c) states that the rules of Section 737 and the regulations thereunder must be applied in a manner consistent with the purpose of Section 737. Accordingly, the final regulations provide that if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of Section 737, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with

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76 Reg. §1.737-2(b)(2).

77 Reg. §1.737-2(c).

78 See Reg. §1.704-4(c)(6) for the application of Section 704(c)(1)(B) in a similar context.
the purpose of Section 737. Whether a tax result is inconsistent with the purpose of Section 737 is determined based on all the facts and circumstances. Section 1.737-4(b) Ex. 1 and 2 set forth two examples to illustrate this rule.

L. **Effective Date.**

1. The final regulations apply to distributions by a partnership to a partner after January 8, 1995. Section 737 applies to partnership distributions of property on or after June 25, 1992.

M. **Overlap of Section 737 and Section 707(a)(2)(b).**

1. **General.**
   a. The determination of whether a sale, rather than a contribution, of an asset to a partnership has occurred depends largely upon the entrepreneurial risk to which the contributing partner is subject while a participant in the partnership. The more entrepreneurial risk such partner is subject to, and the lesser the degree of certainty with which the contributing partner can predict the amount and timing of any ultimate distribution of cash or some other asset in the future, the higher the probability that such partner’s initial conveyance to the partnership will be characterized as a contribution and not a sale.
   
   b. If, based on relevant facts and circumstances, a sale is found to have occurred, the Section 707(a)(2)(B) regulations are clear that such sale is deemed for all tax purposes to have occurred at the time of the initial conveyance of the property to the partnership. Those same regulations deem the contributing partner to have received a payment right, rather than a partnership interest, at that time and any subsequent related transfer of cash or property to the contributing partner is characterized as a payment in satisfaction of the

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79 Reg. §1.737-4(a).

80 Reg. §1.707-3(b)(2).

81 Reg. §1.707-3(a)(2).
partnership's purchase obligation arising out of the disguised sale.\footnote{id} 

\textbf{c.} Thus, the related distribution of cash or property that constitutes part of a disguised sale transaction is not a distribution to a partner acting in a partner capacity. No such distribution is subject to characterization as a partnership distribution under Section 731.

\textbf{2.} \textit{Interface Between Section 707(a)(2)(B) and Section 737.}

\textbf{a.} It is not necessary to interface the Section 707 disguised sale regulations and Section 737. Once the IRS is successful in recharacterizing a suspect contribution to a partnership as a disguised sale or exchange of the contributed property to the partnership, Section 737 has no application to the partnership's related transfer to the partner taxable under Section 707(a)(2)(B).\footnote{Reg. §1.737-1(a)(2).} The contributing partner is already characterized as having engaged in a taxable exchange of the appreciated property with the partnership (or the other partner) at the outset and as having triggered a recognition of the built-in gain. In other words, there is no net precontribution gain to recognize under Section 737; nor is there a distribution to the contributing partner (in a partner capacity) to trigger application of Section 737.\footnote{In response to comments, Treasury clarified the final regulations to provide that Section 737 applies only to the extent that a transaction is a distribution under Section 731.}

\textbf{b.} Because the timing and magnitude of the gain recognition under the two rules likely will differ, and because the IRS's opportunity to successfully apply the disguised sale recharacterization will vary greatly depending upon the particular facts of each case, the IRS can be expected frequently to assert both theories of recognition independently (assuming the suspect distribution is within the prescribed 5-year period). The two provisions do not, however, overlap.
M. **Overlap of Section 737 and Section 731(c).**

1. **General.** Section 737 coordinates in a peculiar way with new Section 731(c) (treating the distribution of marketable securities as cash). In effect, these two provisions interact in a manner so that the exception in new Section 731(c)(3)(B) for the distributee’s share of the marketable securities does not apply. This strange interaction results because the portion of the marketable securities distributed that is not treated as money under new Section 731(c) is treated as property for purposes of Section 737. The legislative history to the GATT provision illustrates this principle with the following example:

For example, assume that partner A contributed property with an adjusted basis of $100 and a value of $200 to partnership X. A1’s basis in its partnership interest is $100 (Section 722). Within five years (assuming no other partnership activity), X distributes to A in a nonliquidating distribution a marketable security (which A did not contribute) with an adjusted basis of $100 and a value of $120, together with other property with an adjusted basis of $0 and a value of $20. A recognizes $40 of gain. Assuming that A’s $20 of gain on the distribution of the marketable securities is reduced by $5 under the limitation on gain recognized rule of new Section 731(c)(3)(B), A recognizes $15 of the gain by reason of new Section 731(c) and $25 by reason of Section 737. After the distribution, A1’s adjusted basis in the marketable security is $115, that is, $100 (as determined under Section 732(a)(2)), increased by $15 (the gain recognized by reason of new Section 731(c)). A1’s adjusted basis in its partnership interest is $25 ($100 reduced by $100 (the basis to the partner of the property distributed, computed without regard to Section 731(c)), and increased by $25 (the gain recognized under Section 737)). A1’s basis in the other property is $0, as under present law (Section 732(a)). The partnership’s adjusted basis in the contributed property is increased by $25 (Section 737(c)(2)).

2. **Analysis of the Example.** Absent Section 731(c), A would have been treated as receiving an excess distribution of $40 of
property and would have recognized $40 of his precontribution gain under Section 737. To the extent, however, that a distribution of marketable securities is treated as a distribution of money under Section 731(c), the amount of that distribution which is taken into account for purposes of Section 737 is reduced because Section 737 only applies to distributions of property not money. In the foregoing example, only $15 of the $20 of distributed marketable securities is effectively treated as a distribution of money due to the limitation on gain recognized rule set forth in Section 731(c)(3)(B). The resulting reduction in gain recognized under Section 731(c), however, increases the amount of the distribution which is treated as a distribution of property for purposes of Section 737 by a corresponding amount. As a result, the amount of gain recognized under Section 737 is increased from $20 to $25, eliminating any benefit to A from the gain limitation applicable under Section 731(c).

IX. Transfers by Gift or at Death.

A. Gifts of Partnership Interests. It is possible that a partner will dispose of his interest in a partnership by gift. In general, no gain or loss is recognized to the transferor or transferee upon the gift of a partnership interest.

1. Liabilities. If the transfer of the partnership interest results in a decrease in the partner's share of the liabilities of the partnership, Section 752 will result in a deemed distribution to the transferor. If the liability exceeds the donor's basis, gain would be recognized by the donor.

a. Negative Capital Account. In general, the donor partner will recognize gain equal to his negative capital account.

i. Tax Shelters. The recognition of gain under Section 752 is why partners in "burned out" tax shelters could not solve their problems simply by disposing of such interests by gift.

b. Loss. No loss is recognized when the amount of debt relief and basis adjustment is less than the partner's adjusted basis in his interest.

2. Basis. The donee will acquire a transferred basis from the donor partner, limited to the fair market value of the interest.
a. **Taxes.** Basis will be increased for any gift taxes paid in an amount which bears the same ratio to the tax paid as the net appreciation of the gift bears to the total gift.

B. **Death of a Partner.** A partner’s interest in the partnership could be transferred as a result of his or her death.

1. **Termination of the Partnership.** Unless otherwise provided in the partnership agreement, the death of a partner does not cause a termination of the partnership for tax purposes.

2. **Termination of Year.** A transfer on the death of a partner will not cause a closing of the partnership taxable year with respect to the deceased partner. In contrast, the sale, exchange or liquidation of the entire interest or a partner closes the taxable year as to the transferring partner.

3. **Allocation of Income.** The deceased partner’s distributive share of partnership income for a partnership taxable year ending after the partner’s death is taxed entirely to his estate or his successor interest. No portion of the distributive share is included in the decedent’s final tax return.

   a. **Last Return of the Partner.** The last return of the deceased partner includes only his share of partnership income for the partnership year ending with or prior to his death. Thus, income for the year of death is included in the tax return of his estate unless he dies on the last day of the partnership’s taxable year.

X. **Partnership Anti-Abuse Regulations**

A. **Background.**

1. **Substantial Business Purpose.** On December 29, 1994, the IRS adopted "anti-abuse" Regulations Section 1.701-2 (TD 8588). These Regulations permit the Service to recast a partnership transaction if a principal purpose of the transaction is to reduce substantially the present value of the partners’ aggregate Federal income tax liability.

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85 This portion of the outline is adapted from an article by Mr. Lipton in the March 1995 issue of The Journal of Taxation. See Lipton, "IRS Improves Partnership Anti-Abuse Regs., but Major Problems Remain," 82 JTAX 132 (Mar. 1995), © Warren, Gorham & Lamont.
income tax liability and the transaction is not consistent with the intent of Subchapter K. The final Regulations\textsuperscript{86} are an improvement on the original proposals. The new rules provide additional guidance to taxpayers through a multiple-part test which, if satisfied, conclusively establishes that use of a partnership in a transaction is consistent with the intent of Subchapter K. In addition, the Regulations set forth a list of factors to be considered and numerous examples, not included in the proposed regulations. The practical effect of these changes is to "bless" most partnership transactions that have a substantial business purpose.

2. **Major Problems.** The final Regulations contain several serious drawbacks:

   a. First, the "proper reflection of income" test that taxpayers must satisfy is very ambiguous and could be the source of future controversy;

   b. Several of the examples contain unrealistic facts or reach questionable conclusions;

   c. The new aggregate/entity rule introduced in the final Regulations suffers from many of the same flaws as the proposed regulations; and

   d. Questions still exist concerning the validity of the final Regulations.

B. **The Final Regulations.**

1. **Application.** The IRS has attempted to narrow the scope of the anti-abuse rules and to clarify when they could be applied.\textsuperscript{87} As a result, Section 1.701-2(b) authorizes the Service to recharacterize a partnership transaction only if:

\begin{itemize}
  \item \textsuperscript{86} For a detailed discussion of the Proposed Regulations, see Lipton, "Controversial Partnership Anti-Abuse Prop. Regs. Raise Many Questions," 81 JTAX 68 (August 1994), © Warren, Gorham & Lamont.
  
  \item \textsuperscript{87} See Letter from Leslie B. Samuels, Assistant Secretary of the Treasury (Tax Policy), to Sen. Robert Packwood (R-Ore.) dated 12/29/94, reprinted in Highlights and Documents, 1/3/95, at page 75.
\end{itemize}
a. A partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate Federal income tax liability, and

b. The transaction is not consistent with the intent of Subchapter K.

2. **Five-Part Test.** The Regulations contain a five-part test (the "intent tests"), which, if fully satisfied, conclusively establishes that a partnership transaction is consistent with the intent of Subchapter K. The five intent tests are:

a. The partnership must be bona fide;  

b. Each partnership transaction or series of related transactions (individually or collectively, "the transaction") must be entered into for a substantial business purpose;  

c. The form of each partnership transaction must be respected under substance-over-form principles;  

d. The tax consequences under Subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement; and  

e. The tax consequences under Subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must clearly reflect the partners' income.

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88 Reg. § 1.701-2(a)(1).
89 Id.
90 Reg. § 1.701-2(a)(2).
91 Reg. § 1.701-2(a)(3).
92 Id. According to the Preamble to TD 8588, 12/29/94, the principles of Sections 446(b) and 482 apply in determining whether a transaction clearly reflects the partners' income. Under current law, the Service does not have (continued...)
3. **Proper Reflection of Income.**

a. The final Regulations refer to the tests in d. and e. above as the "proper reflection of income" requirement. The Service concedes that certain provisions of Subchapter K and the Regulations thereunder were adopted to promote administrative convenience and other policy objectives even though the application of those provisions to a transaction could, in some circumstances, produce tax results that do not clearly reflect income. The proper reflection of income tests are deemed to be satisfied, therefore, if the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.

b. The final Regulations provide no guidance as to when: (i) a transaction "properly reflects income," or (ii) the tax result was "clearly contemplated" by a Code provision except through examples (discussed below). These examples do not resolve the questions. An argument could be made that the tax results are always intended by Congress in transactions to which a Code provision directly applies, and that application of the Code is the best way to properly reflect income. In the end, the proper reflection of income test appears to be of the "we'll know it when we see it" type, which provides little or no comfort to tax practitioners. This is the vague type of

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92(...continued)

the power under Section 446 to reject, as not providing a clear reflection of income, a method of accounting that is specifically authorized in the Code or Regulations. *Williams*, 94 TC 464 (1990); *Hallmark Cards, Inc.* 90 TC 26 (1988). The final Regulations, however, apparently would give the Service the authority to override the provisions in Subchapter K in determining whether the tax consequences of partnership operations and transactions clearly reflect income.

93 Examples of these provisions include (1) the value-equals-basis rule in Reg. § 1.704-1(b)(2)(iii)(c), (2) the elective basis adjustments under Section 754, (3) the basis adjustments under Section 732, and (4) the de minimis exceptions in Regs. § 1.704-3(e)(1) and 1.752-2(e)(4).

94 Reg. § 1.701-2(a)(3).
guidance for which the proposed regulations were criticized.

4. Recharacterization of Transaction.

a. If a partnership transaction does not satisfy one of the five intent tests and the IRS believes a principal purpose of the transaction is to substantially reduce the present value of the partners’ aggregate Federal income tax liability, Section 1.701-2(b) permits the IRS to recast the transaction as appropriate to achieve tax results that are consistent with the intent of Subchapter K in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. The Service can determine that:

(1) The purported partnership should be disregarded in whole or in part, and the partnership’s assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;

(2) One or more of the purported partners should not be treated as a partner;

(3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership’s or the partners’ income;

(4) The partnership’s items of income, gain, loss, deduction, or credit should be reallocated; or

(5) The claimed tax treatment should be otherwise adjusted or modified.

As originally issued, the final Regulations would have applied if a principal purpose of a transaction was to substantially reduce the present value of any federal tax liability, including estate or gift tax liability. In Ann. 95-8, the IRS stated that the final Regulations will be amended retroactively to limit their scope to income taxes.

The Preamble to TD 8588 clarifies that the IRS does not have unbridled discretion in recharacterizing a transaction.
Section 1.701-2(c) provides that whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate Federal income tax liability in a manner inconsistent with the intent of Subchapter K is determined on the basis of all of the facts and circumstances. The final Regulations contain the following nonexclusive list of factors that should be considered:

(1) The present value of the partners' aggregate Federal income tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;

(2) The present value of the partners' aggregate Federal income tax liability is substantially less than if purportedly separate transactions designed to achieve a particular end result were integrated and treated as steps in a single transaction;

(3) One or more partners who are necessary to achieve the claimed income tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences, indemnity or loss guarantee agreements, or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners (measured by number of interests) are related, directly or indirectly, to one another;

(5) Partnership items are allocated in compliance with the literal language of the Section 704 regulations but with results that are inconsistent with the purpose of those regulations;

(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner or related party; or
The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee or a related party.

C. **Effective Date.** The presence or absence of any factor does not create a presumption that a partnership was (or was not) used in an abusive manner. Sections 1.701-2(a), (b), (c) and (d) apply to all transactions involving partnerships that occur after *May 11, 1994*. The Preamble to TC 8588 clarifies that Section 1.701-2(c) does not apply to the disposition by a Partner of an asset after the effective date if the partner received the asset from the partnership before the effective date. Nevertheless, Section 1.701-2(h) provides the Regulations do not limit the Service’s authority to assert and to rely on applicable nonstatutory principles and other statutory or regulatory authorities to challenge transactions.

D. **The Examples.** The final Regulations contain 11 examples\(^97\) to illustrate the application of the general rule in Section 1.701-2(b). Eight of the 11 describe situations where the anti-abuse rules do not apply. Section 1.701-2(d) emphasizes that these examples do not establish the boundaries of either acceptable or unacceptable types of transactions, and a change of any facts or circumstances could modify the outcome.

1. **UPREITS.** Example 4 provides that the use of an umbrella partnership owned by a real estate investment trust (an UPREIT) to avoid the recognition of income under Sections 351(e) and 357(c) does not violate the anti-abuse Regulations.\(^98\) Example 4 is referred to as the UPREIT example. Although favorable to taxpayers, this example illustrates the difficulty with the "proper reflection of income" test. The example concludes that the proper reflection of income standard is satisfied, even though the partners’ Federal income tax liability is substantially less than if the transaction were integrated and treated as a direct contribution of assets to the REIT. The basis for this conclusion is that the REIT and the partnership should be treated as bona

\(^97\) As originally issued, the final Regulations contained 13 examples; two (5 and 6) that dealt with family limited partnerships will be deleted pursuant to Ann. 95-8, *supra* note 50. These examples are not discussed herein.

\(^98\) Section 1.701-2(d), Example 4.
fide separate entities, notwithstanding that the partnership exists solely for tax reasons. Perhaps the real reason this example reaches a favorable conclusion is that the Service repeatedly assured practitioners that UPREITs, which are now a very common financing technique, would not be subject to recharacterization under the final Regulations. It is unclear whether this result would have been reached if an UPREIT were a novel transaction. On the other hand, taxpayers may be able to argue that if an UPREIT, which by its nature is formed solely to avoid tax, cannot be challenged under the final Regulations, perhaps other partnerships used for tax savings also are immune.

2. **Examples of Acceptable Transactions.** Examples 2 and 3 describe fact patterns where the transaction is consistent with the intent of Subchapter K (i.e., the facts satisfy the requirements of Section 1.701-2(a)(1), and (3)). Example 2 and 3 are summarized as follows:

a. The formation of a partnership between an S corporation, A, and a nonresident alien, B, so as to permit A and B to conduct a business through a pass-through entity while retaining A's status as an S corporation.\(^9\)

b. The use of a partnership in foreign operations to qualify for a direct foreign tax credit under Section 901, with look-through treatment under Section 1.904-5(h)(1).\(^1\)

3. **Special allocations.** Example 7 describes the use of special allocations to take advantage of the dividends-received deduction. In Example 7, corporations X and Y form a partnership to purchase stock of Z, an unrelated corporation. The partnership specially allocates the dividend income on the Z stock to X to the extent of LIBOR\(^1\) and the remainder of the dividend to Y; all other items are allocated equally. The example concludes that the requirements and purpose of Section 701(b) and the regulations thereunder are satisfied, so the IRS cannot recast the transaction.

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\(^9\) Section 1.701-2(d), Example 2.

\(^1\) Section 1.701-2(d), Example 3.

\(^1\) The London Interbank Offered Rate.
4. **Code Blessed Transactions.** Example 8 illustrates the manner in which the tests for proper reflection of income can be overridden if the results were clearly contemplated in the Code and Regulations. In this example, A and B, high-bracket taxpayers, and X, a corporation with NOLs, form a partnership to own and operate a building that qualifies for low-income housing tax credits. The partnership incurs nonrecourse indebtedness, and the partnership specially allocates the income and deductions, including all depreciation deductions attributable to the building to A and B equally in a manner that is reasonably consistent with allocations of other significant partnership items related to the building. The low-income housing tax credits are then properly allocated to A and B to follow the allocation of depreciation deductions.

The example notes that the allocations of depreciation deductions and low-income housing tax credits may not properly reflect income because of the nonrecourse nature of the indebtedness. Nevertheless, the allocation of nonrecourse deductions and tax credits is clearly contemplated by the applicable provisions of the Code, and the special allocations satisfy the literal requirements of the Section 704(b) regulations, including particularly the value-equals-basis safe harbor of Section 1.704-1(b)(2)(iii)(c). Thus, even though the partners' aggregate Federal income tax liability may be substantially less than had the partnership owned the partnership's assets directly (due to X's inability to use its allocable share of losses and tax credits), the transaction cannot be recast by the IRS.

5. **Paired Examples Describe Bad Transactions.** The Regulations also contain examples of an impermissible transaction and two "pairs" of examples in which good and bad transactions are presented.

a. **Temporary foreign partner.** Example 9 involves a "temporary partner." Pursuant to a plan to generate artificial losses, X (a foreign corporation), Y (a domestic corporation), and Z (a promoter) form partnership PRS by contributing $9,000, $990, and $10, respectively, for proportionate interests (90.0%, 9.9% and 0.1%, respectively, in PRS' capital and profits. PRS purchases offshore equipment for $10,000 and leases the equipment for $10,000 offshore for most of its projected useful life in legitimate transactions. Shortly thereafter, PRS sells its right to receive income under the lease to a third party for
$9,000 and the resulting $9,000 of income is allocated $8,100 to X, $891 to Y, and $9 to Z. PRS thereafter distributes $9,000 to X to liquidate X’s partnership interest. Immediately before making the liquidating distribution to X, PRS restates the partners’ capital accounts to reflect the partners’ capital accounts to reflect its assets, and after X’s interest is liquidated. PRS borrows an additional $8,000 so as to increase the basis of Y’s and Z’s interests in the partnership. When the equipment, subject to the lease, is then sold for its FMV of $1,000, PRS incurs a tax loss of $9,000, most of which ($8,910) is allocated to Y.

The "game" in this example is that a foreign person exempt from U.S. taxation is allocated $9,000 of income while a corresponding loss is allocated to a U.S. taxpayer. The example concludes that any purported business purpose for the transaction is insignificant in comparison to the tax benefits that would result if the transaction were respected for tax purposes, so that the partnership lacks a substantial business purpose. Further, PRS is not a bona fide partnership and the transaction would not be respected under substance-over-form principles. Accordingly, the IRS can recast the transaction as appropriate.

b. **Section 754 adjustments.** The first "pair" of examples involves the Section 754 election.

(1) Example 11 describes PRS as a bona fide partnership formed to engage in investment activities with contributions of cash from each partner. Several years after joining PRS, a partner, A wishes to withdraw. The partnership agreement entitles A to receive the balance of A’s capital account ($100) in cash or securities as mutually agreed by A and the general partner, P. P and A agree that A will receive $100 of nonmarketable securities, in which PRS has a basis of $20, in liquidation of A’s interest in PRS. PRS does not make a Section 754 election.

Following distribution, A’s aggregate basis in the securities is $100 under Section 732(b). PRS’s basis in its remaining assets is unaffected by the distribution, whereas PRS would have been required to adjust the basis in its remaining assets
downward if it had make a Section 754 election. In selecting the assets to be distributed, P and A had a principal purpose to take advantage of the tax benefits that would arise from a failure to make a Section 754 election.

The partnership is bona fide, has a substantial business purpose, and is not susceptible to a substance-over-form attack. Thus, the issue is whether the transaction satisfies the proper reflection of income requirement of Section 1.701-2(a)(3). Although the transaction does not appear to satisfy this requirement, this is the result of a failure to make a Section 754 election. This election is intended to promote administrative convenience. Thus, the IRS cannot recast this transaction.

(2) In contrast, Example 10 describes a situation where A owns land with a basis of $100 and an FMV of $60, which A would like to sell to B. A and B devise a plan to permit the duplication, for a substantial period of time, of A's loss. A, his brother C, and his sister-in-law W form partnership PRS, to which A contributes the land and C and W each contribute $30. PRS uses the cash to purchase an investment asset. PRS also leases the land to B under a three-year lease. B has the option to purchase the land from PRS at the expiration of the lease for FMV at that time. In year 3, when the values of PRS's assets have not materially changed, PRS agrees with A to liquidate A's interest in exchange for the investment asset. Under Section 732(b), A's basis in the distributed asset is $100. Therefore, when A sells the investment asset for its FMV of $60, A recognizes a loss of $40. PRS does not make a Section 754 election. Thus, when PRS subsequently sells the land to B for its FMV of $60, PRS also recognizes a loss of $40. The loss is allocated to C and W. Although C and W would recognize an offsetting gain if PRS were liquidated, they intend to continue the existence of PRS,

102 Regs. § 1.701-2(a)(1) and (2).
thereby deferring recognition of this gain indefinitely.

The example concludes that (1) any purported business purpose is insignificant in comparison to the tax benefits that would result if the transaction were respected, (2) there is no substantial business purpose for the transaction, (3) the partnership is not bona fide, (4) the transaction is not respected under applicable substance-over-form principles, and (5) the transaction does not properly reflect income as a result of producing a double tax benefit from a single economic loss. Therefore, in addition to possibly challenging the transaction under judicial principles or other statutory authorities, such as the substance-over-form doctrine or the disguised sale rules under Section 707, the IRS could recast the transaction under Section 1.701-2(b).

This example is flawed. Arguably, there is economic substance to the transaction. Instead of purchasing the land in year 1, B has agreed to purchase the land at the end of year 3 for its FMV at that time. The value of the land could increase or decrease, so the hoped-for loss duplication might or might not occur. C and W have their equity investment at risk -- they are not protected from any risk of loss, and there is no certainty that B will exercise the option to purchase the property. Finally, B will have to pay more to own it. Thus, the facts in this example do not support the Service’s conclusion.

c. **Section 732 adjustments.** The second pair of examples addresses basis adjustments under Section 732.

(1) Example 12 describe a partnership of A, B, and C named PRS. PRS has for several years been engaged in substantial bona fide business activities. For valid business reasons, the partners agree to liquidate A’s interest in PRS, which has a value and basis of $100, by distributing nondepreciable assets with a value of $60 and a basis of $40 and related equipment with a value and basis of $40. Under Sections 732(b) and (c), A’s basis of $100 will be
allocated between the assets received in proportion to PRS's basis in such assets, or $50 each. Thus, A will have a $10 built-in gain in the nondepreciable assets and a $10 built-in loss in the equipment, which A will quickly recover through depreciation. The partners selected these assets to take advantage of the basis allocation rules in Section 732 to provide a Federal income tax timing advantage to A with no offsetting detriment to B and C. Because the basis shifting that occurs under Section 732 is clearly contemplated by that provision, the IRS cannot recast this transaction, despite the failure to satisfy the proper reflection of income.

(2) Example 13, by comparison, describes partnership PRS as a business engaged for several years in the development and management of commercial real estate. An unrelated person, X, desires to acquire PRS's undeveloped land that has a value of $95 and a basis of $5. Pursuant to a plan that is intended to permit X to acquire and hold the land but nevertheless recover a substantial portion of the purchase price, X contributes $100 to PRS for an interest therein. Subsequently, when the value of PRS's assets has not changed, PRS distributes to X in liquidation of its interest in PRS the land and another asset, which is an insignificant part of the transaction but which was chosen to obtain the desired tax results, with a value and basis to PRS of $5. Under Sections 732(b) and (c), X's basis of $100 is allocated to the two properties in proportion to their basis in the hands of PRS, or $50 each. X then sells the second asset for its value of $5 and recognizes a $45 loss. The IRS concludes that Section 732 is not intended to serve as the basis for plans or arrangements in which inconsequential or immaterial assets are included in the distribution with a principal purpose of obtaining favorable tax results by virtue of the provision's simplifying rules. As a result, the transaction does not properly reflect income. Therefore, in addition to challenging the transaction under other provisions of the Code, such as the disguised sale rule in Section 707, the
IRS could recast the transaction under the final Regulations.

The only clear distinction between the two examples in this pair is that one example results in more favorable tax results than the other. In both examples it was necessary to distribute assets with an FMV of $100 to the partner whose interest is to be liquidated, and in each two assets were distributed. Each example describes the basis shifting that occurs under Section 732, although in one instance the basis shifting was only 10% of total FMV, whereas in the other the basis shifting was 45% of FMV.

These examples illustrate the problem with the "clearly contemplated by the statute" aspect of the proper reflection of income test; there is no guidance as to when a benefit exceeds what the IRS believes was intended by Congress.

E. The Aggregate Rule.

1. The Rule. Section 1.701-2(e)(1) provides that the IRS can treat a partnership as an aggregate of its partners, in whole or in part, as appropriate to carry out the purpose of any provision of the Code or the Regulations. The aggregate rule is based on the Service’s belief that significant potential for abuse exists in the inappropriate treatment of a partnership as an entity in applying rules outside of Subchapter K to transactions involving partnerships.

Section 1.701-2(e)(2) limits the Service’s authority under the aggregate rules only if:

a. a provision of the Code or the Regulations prescribes the treatment of a partnership as an entity, in whole or in part; and

b. that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision.
2. **Effective Date.** This provision is effective for all transactions involving a partnership that occur after December 28, 1994.\(^{103}\)

3. **Examples.** Three examples illustrate the application of the aggregate rule.\(^{104}\)

   a. Example 1. Corporations X and Y are partners in PRS, which has been engaged in substantial bona fide business activities for years. PRS issues high-yield discount obligations that would have been subject to the interest deduction limitations in Section 163(e)(5) had they been issued by a corporation. Section 163(e)(5) does not require a partnership to be treated as an entity. If treated as an entity, PRS could avoid the interest limitation, thus PRS is treated as an aggregate of its partners for purposes of applying Section 163(e)(5), and X and Y are thus subject to the interest deduction limitation.

   b. Example 2. Corporations X and Y are partners in PRS, which for several years has engaged in substantial bona fide business activities. PRS purchases 50 shares of common stock of corporation Z. Six months later, Z announces an extraordinary dividend (within the meaning of Section 1059). If the Z stock were held directly by X and Y, they would have to reduce their basis in the stock under Section 1059(a). Because Section 1059(a) does not prescribe the treatment of a partnership as an entity, the aggregate rule applies, and each partner of PRS will be treated as owning its share of the stock of Z and thus subject to Section 1059.

   c. Example 3. Partnership PRS is formed by X, a domestic corporation, and Y, a foreign corporation, to conduct a bona fide business in a foreign country. X owns 40% and Y owns 60% of PRS. PRS holds 100% of the stock of Z, a foreign corporation. Pursuant to Sections 957(c) and 7701(a)(30), PRS is a U.S. person. Because PRS owns 10% or more of the voting stock of Z, PRS satisfies the definition of a U.S. shareholder under Section 951(b). Under Section 957(a), Z is a controlled foreign corporation.

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\(^{103}\) See Reg. 1.701-2(g).

\(^{104}\) Reg. § 1.701-2(f), Ex: 1-3.
(CFC) because more than 50% of its voting stock is owned by PRS. Consequently, under Section 904(d)(3), X qualifies for look-through treatment in computing its credit for foreign taxes. In contrast, if X and Y owned their interests in Z directly, Z would not be a CFC because only 40% of its stock would be owned by U.S. shareholders. Sections 957(c) and 7701(a)(30) require a domestic partnership to be treated as an entity for purposes of defining a U.S. shareholder. As a result, the IRS must respect PRS as an entity for purposes of defining a CFC, and the application of the look-through rules for foreign tax credit purposes. Further, Congress clearly contemplated that taxpayers could use a bona fide partnership to subject themselves to the CFC regime. Accordingly, the IRS cannot disregard PRS under the aggregate rule in these circumstances.

4. **Impact of the Aggregate Rule.** The aggregate rule was introduced in the final Regulations without any opportunity for notice and comment.\(^{105}\) The aggregate rule is very troubling.

For example, assume a corporation is a 1% partner in a bona fide partnership with individuals, and the partnership issue high-yield debt instruments. In example 1 above, the IRS could use the aggregate rule to disregard a partnership of two corporations and apply the interest limitations of Section 163(e)(5) to such instruments. Can the Service disregard a partnership under the aggregate rule if only one of the partners is a corporation? Would the aggregate rule apply if the corporation was a limited partner? Or is every partnership potentially disregarded for purposes of applying Section 163(e)(5) to corporate partners?

For example, debtors often form a partnership to acquire (at a discount) an obligation of the debtor; as long as the debtor owns less than 50% of the partnership, the debtor will not have cancellation of the indebtedness income under Section 108(e)(4). It is unclear whether the reference to Section 707(b) in Section 108(e)(4) requires a partnership that holds debt of one or more of the partners to be treated as an entity. If not, the debtor

\(^{105}\) The failure to provide notice and an opportunity comment calls the validity of the final Regulations into question. See *American Medical Association*, 887 F.2d 760 (CA-7, 1989).
could be treated as directly acquiring a proportionate part of the indebtedness held by the partnership, and thus incur COD.

Unlike the rest of the anti-abuse Regulations, the scope of the "Aggregate Rule" is not limited to abusive transactions—every partnership appears to be subject to it, including legitimate partnerships with no "abusive" intent. This is a significant change from prior law, under which a court would determine whether a partnership would be treated as an aggregate of its partners or any entity under all of the facts and circumstances. Through the aggregate rule, the IRS appears to be arrogating to itself the power to make this determination. The validity of this portion of the Regulations is questionable.

F. Effect of the Final Rules

1. **Practical Effect.** Most "common" transactions that have a substantial business purpose should be outside the web of the new rules. The vague "proper reflection of income" standard might, however, apply in unexpected situations. It should also be noted that the examples are explicitly limited to their particular facts, so that slight changes could lead to different results. On the other hand, the Service now has the aggregate rule to disregard any partnership unless entity treatment was "clearly contemplated" by Congress.

2. **Practitioner Response.** Due to the ambiguities in the final Regulations, practitioners should advise their clients that the tax results of any partnership transaction are not completely certain. Obviously, the new rules will be of greatest concern in transactions that are part of a plan to use a partnership to avoid income tax, such as the disappearing-partner transaction in Example 9. It is possible, however, that a revenue agent might refer to the final Regulations in any partnership audit. There is some comfort in the fact that the IRS has announced that the application of Section 1.701-2 is subject to IRS National Office review. Thus, the IRS may not apply these Regulations too often.

3. **Validity.** When the Service eventually uses Section 1.701-2 to recast a partnership transaction, a challenge to the validity of the final Regulations should be considered and can be expected. In addition to the vagueness and procedural issues discussed above, a reasonable argument can be made that the final Regulations are legislative in character and that the Service
lacked the authority under Section 7805 to issue them. The Regulations appear to be a significant expansion of current law by administrative action. The fact that the Treasury and Congress previously believed that legislation was necessary to accomplish the goal of reining in abusive partnerships raise the question of whether the Service can now change the law simply by administrative fiat.\textsuperscript{106}

XI. Planning

A. A Good Problem. The difficulty which arises in planning for the disposition of the business conducted by a partnership (or LLC) is that there are so many alternatives available. As the foregoing discussion illustrates, different rules apply to the sale of assets, a distribution of assets prior to sale, the sale of a partnership interest, the redemption of a partnership interest and disguised sales. The amount of gain, timing of gain recognition and character of income can be different depending upon the facts and circumstances.

1. Practical Effect. Because there are so many alternatives available, it is necessary for a client to reach a conclusion as to the client’s primary goals from a business perspective; this should dictate the form of the transaction. In some instances, however, tax planning can be very helpful.

B. Examples. In order to understand the planning opportunities which are created by the available alternatives, some examples are helpful.

1. Intentional Disguised Sale. Assume that a partnership wants to sell all of its assets in exchange for cash and a note; the basis in the assets is substantial, but less than fair market value. If a sale of assets is arranged, the basis must be divided between the cash and the note, resulting in too much income "up front." If, however, the transaction is treated as a disguised sale in which qualified liabilities are assumed, the basis allocation rules will cause basis to be allocated to the cash rather than an assumed qualified liability. This can significantly reduce the seller’s gain.

2. Using Section 736(a). Arguably, a retiring or withdrawing partner can receive payments under Section 736(a) -- even if the partner is not a general partner in a service partnership -- if the entire balance of the payment for his interest is properly

\textsuperscript{106} For example, Sections 707(a)(2)(B), 704(c) and 737.
allocated under Section 736(b). This can result in payments which are deductible to the buyer; the extra tax cost to the seller can be offset by sharing the tax savings.

3. **Changing Liabilities.** The type and amount of the liabilities of a passthrough entity will often restrict or expand the planning opportunities. However, the nature of a debt instrument can often be changed without significant economic consequences under the new *Cottage Savings* regulations. Changing from recourse to nonrecourse debt could alter the tax consequences of a distribution or a disguised sale.