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Federal Taxation on Disposition of Partnership Interests

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ON

DISPOSITION OF PARTNERSHIP INTERESTS

by

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I. INTRODUCTION.

The disposition of a partnership interest may result from various different types of transactions which affect the partner's respective interest in the partnership.

A. Direct Dispositions.

The interest may be reduced or terminated by many direct means:

1. Sale of the partner's interest;
2. An exchange of the partner's interest;
3. By liquidation of the partner's interest;
4. A gift of the partner's interest;
5. A transfer by reason of death; or
6. By liquidation of the partnership.

B. Indirect Dispositions.

As a result of the complex aggregation and entity rules which apply to partnerships, the partner's interest in the partnership may be affected as a result of various transactions within the partnership, and would be affected as a result of the distribution of assets by the partnership followed by the subsequent disposition of those assets by the partner.

C. Entity Versus Aggregate Concept.

Generally, the entity concept has been used in subchapter K in dealing with the disposition of the interests of partners.

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1. **The Partner’s Interest.**

The interest of each partner in the partnership is treated as a separate intangible asset rather than as an aggregate of the assets of the partnership. As a consequence of treating the partner’s interest as a separate asset, normal tax rules which are applied on the sale of a separate intangible asset will be applied in determining the character of gain, applicable basis, and holding period of the partner’s interest transferred.

2. **Exceptions.**

There are a number of special exceptions where the interest of each partner is treated as an aggregate of the assets of the partnership. This is particularly the case with respect to unrealized receivables and substantially appreciated inventory. I.R.C. § 751.

   a. Each partner is treated as owning his or her separate proportionate share of the underlying unrealized receivables and substantially appreciated inventory of the partnership.

   b. Under this aggregate approach, the selling partner will be treated as if he had sold the underlying assets instead of his partnership interest, as to that portion of the transfer of partner’s interest in the partnership which is attributable to the unrealized receivables and substantially appreciated inventory.

II. **SALE OR EXCHANGE OF PARTNERSHIP INTEREST.**

   A. **General Rule.**

   Since the interest of a partner in the partnership is treated as a capital asset, the sale or exchange of a partner’s interest will result in capital gain or loss to the transferor partner. I.R.C. § 741(a).

   1. **Significance of Capital Gain or Loss Treatment.**

   a. Net capital gains are subject to a maximum individual rate of 28%, as compared to a maximum ordinary income rate of 39.6%. I.R.C. § 1(h) and § 1222(11). Corporations are subject to a maximum capital gain rate of 35%, which is the
same as the maximum ordinary income rate without regard to the 5% surtax imposed by section 11(b)(1). I.R.C. § 1201(a).

b. Losses from a sale or exchange of capital assets are allowable only to the extent of gains from sales or exchanges, plus, in the case of non-corporations, an additional $3,000 of ordinary income. I.R.C. § 1211(a) and (b).

c. Net capital losses for non-corporate shareholders in excess of $3,000 of ordinary income is carried forward indefinitely for future taxable years until exhausted. Corporate capital losses can be used currently only to offset current capital gains. Corporate net capital losses are carried back three years and then forward for five taxable years. I.R.C. § 1212(a) and (b).

B. Existence of a Sale or Exchange.

1. Exchange in Benefits and Burdens.

The sale or exchange occurs when there has been a conveyance of the benefits and burdens of ownership. Roth v. Comm., 321 F.2d 607 (9th Cir. 1963).

a. Nominal Interest Retained by Transferor Partner.

A transfer will be treated as a sale or exchange even though the assignor has retained a nominal interest under state law, if there has been an irrevocable assignment under which the assignee is entitled to share in profits and losses and to receive all distributions to which the assignor would have been entitled, and where the assignor agrees to exercise any residual powers solely in favor of the assignee. Rev. Rul. 77-137, 1977-1 C.B. 178.

2. Abandonment or Worthlessness of Partnership Interest.

The abandonment or worthlessness of a partnership interest may result in either an ordinary loss deductible under section 165(a),
or a capital loss arising from the sale or exchange of a capital asset.

a. **Ordinary Loss Treatment.**

The abandonment by a partner of his interest in the partnership, or a forfeiture under the terms of the partnership agreement, will result in an ordinary loss under section 165(a) unless the conditions for a sale or exchange have been satisfied. Rev. Rul. 93-80, 1993-38 I.R.B. 5 Nov. 29, 1993); Rev. Rul. 70-355, 1970-2 C.B. 51; Tejon Ranch Co. v. Comm., T.C.M. 1985-207, 49 T.C.M. 1375; Citron v. Comm., 97 T.C. 200 (1991).

b. **Capital Loss Treatment.**

A capital loss will result if the abandonment or worthlessness of the partnership interest is treated as a sale or exchange of a capital asset. Rev. Rul. 93-80; 1993-38 I.R.B. 5 (Nov. 29, 1993).

c. **Sale or Exchange Treatment Under Section 731.**

A sale or exchange by the partner of his partnership interest will be deemed to exist if there is an actual distribution or deemed distribution to the partner under section 731. The loss would then be recognized to the partner under section 741.

(1) **General Rule.**

Section 731(a) provides that if there is a distribution by the partnership to a partner in liquidation of the partner’s interest in the partnership, any loss which is recognized will be considered as loss arising from the sale or exchange of the partnership interest. Section 741 provides that in the case of a sale or exchange of a partnership interest, then loss is recognized by the transferor partner and is generally considered as a sale or exchange of a capital asset.
(except for hot assets under section 751).

(a) No loss is recognized if property other than money, unrealized receivables or inventory is distributed. I.R.C. § 731(a)(2).

(2) Impact of Liabilities.

If the partnership has liabilities, then section 752(b) will treat the release of liabilities arising from abandonment as a distribution of money to the partner. Any such deemed distribution will cause any loss recognized from the abandonment to be a capital loss arising from the sale or exchange of a partnership interest under section 731(a)(2). Under Revenue Ruling 93-80, the entire loss will be treated as a capital loss, even though there is only a de minimis actual or deemed distribution.

(3) The effect of the section 752 liabilities rule is that any release of partnership liability to the abandoned partner will cause the loss to be a capital loss. See, O'Brien v. Comm., 77 T.C. 113 (1981); Middleton v. Comm., 77 T.C. 310 (1981) aff'd per curiam 693 F.2d 124 (11th Cir. 1982); and Yarbro v. Comm., 737 F.2d 479 (5th Cir. 1984).

d. Examples.

(1) Example 1. Assume that PRS is a general partnership in which A, B, and C are equal partners. Earlier this year, PRS became insolvent and C abandoned C's partnership interest. At the time of abandonment, PRS' only liabilities were nonrecourse liabilities of $120,000, shared equally by A, B, and C. C had an adjusted basis in his partnership interest of $180,000. C does not receive any money or property on leaving the partnership.
Since PRS has liabilities in which C shares, there is a deemed distribution of $40,000 made to C under section 752(b). The deemed distribution will reduce C's basis in his interest from $180,000 to $140,000. Because there is a deemed distribution, section 731(a) applies and any loss is recognized as a capital loss. The entire $140,000 loss from the abandonment will be treated as a capital loss, even though the deemed distribution was only $40,000. The Service applies the same rule in the event of worthlessness. See, Rev. Rul. 93-80 1991-38 I.R.B. 5.

(2) Example 2. Assume that LP is a limited partnership in which D and E are general partners and F is a limited partner. This year, LP became insolvent and F abandoned her limited partnership interest. At the time of abandonment, F had an adjusted basis of $200,000 in her partnership interest. Assume that F does not bear any economic risk of loss for any partnership liabilities and does not receive any money or property on leaving the partnership. F will realize an ordinary loss of $200,000 under section 165(a), since there has been no actual or deemed distribution from the partnership which would cause the transaction to be treated as a sale or exchange under section 731. The same rule would apply if F's partnership interest became worthless. See, Rev. Rul. 93-80, supra.

e. Evidence of Abandonment.

(1) The taxpayer must substantiate an affirmative act of abandonment. An act of abandonment or worthlessness must be evidenced by a closed and completed transaction fixed by an identifiable event and must be actually sustained during the taxable year. See, Treas. Reg. § 1.165-1(b). In Revenue Ruling 93-80 1993-38 I.R.B. 5, the Service suggests that a
written notification to the partnership is a necessary step to effect a proper abandonment. However, cases have suggested that an oral announcement may be adequate.

(2) In Echols v. Comm., 935 F.2d 703 (5th Cir. 1991), Rev'g 93 T.C. 553 (1989), the Fifth Circuit held that the partner's announcement at a partners meeting that he would no longer make contributions to the partnership toward payment of a non-recourse debt and that he would convey his partnership interest to anyone willing to assume his part of the debt payment, was a sufficient manifestation of intent to abandon the property. See also Citron v. Comm., 97 T.C. 200 (1991).

f. Worthless Partnership Interest.

(1) Revenue Ruling 93-80 acknowledges that a loss incurred from the worthlessness of a partnership interest is an ordinary loss if sale or exchange treatment does not apply under section 731. If there is an actual or deemed distribution to the partner, or the transaction is otherwise in substance a sale or exchange, then the partner's loss is a capital loss (except as provided in section 751(b).

3. A Sale or Exchange Disguised as Distribution. (Section 707(a))

If money or property is transferred directly or indirectly to the partnership by a partner and there is a related direct or indirect transfer of money or other property to another partner by the partnership, and if the transactions, when viewed together, are properly characterized as a sale, they will be treated as a transaction between the partners acting in their individual capacities other than as members of the partnership. I.R.C. § 707(a)(2)(B) (1984).

Otey contributed real property with a basis of $18,500 and fair market value of $65,000 under an agreement where the partnership was to borrow $65,000 and distribute the proceeds to Otey. When completed, the distribution of $64,750 was not taxable to Otey because his basis in his partnership interest (basis in property contributed plus his share of partnership liabilities) exceeded the money distributed. The Tax Court recognized the transaction as a partnership contribution and distribution, finding: (1) it was in the form of a contribution; (2) the real property contributed was the only asset for the business of the partnership, and without it, it would be difficult to have a transaction between the partnership and a partner, not acting as a partner; (3) there was no guarantee that Otey would be paid the $65,000; and (4) the transaction was the customary way of capitalizing a partnership when one partner has a greater share of capital than his share of profits. See also, Pak Realty Co. v. Comm., 77 T.C. 412 (1981), Jupiter Corp. v. United States, 2 Ct. Cl. 58 (1983); Communications Satellite Corp. v. United States, 625 F.2d 997 (Ct. Cl. 1980). Compare, Colonnade Condominium Inc. v. Comm., 91 T.C. 793 (1988), where a transfer of partnership interest from a corporate general partner to its shareholders in exchange for their assumption of the obligation to make annual capital contributions was treated as a sale or exchange under sections 741 and 1001, rather than a nontaxable admission of new partners to an existing partnership.

c. **Recent Case Treated as Disguised Sales.**

In *Jacobson v. Comm.*, 96 T.C. 577 (1991), aff'd per curiam, 92-1 U.S.T.C. ¶50, 236 (8th Cir. 1992), the Tax Court held that a contribution of property by one partner followed immediately by a distribution of cash contributed by the other partner was a sale when there was no valid business purpose for the transaction and the economic substance was not in accord with its form. The contributing partner had been trying to sell the property for two years prior to the transaction.

4. **Tax on Distribution of Other Property Within 5 Years of Contribution of Appreciated Property.** (New Section 737)

If a partner contributes appreciated property to a partnership and within 5 years the partnership distributes other property to the contributing partner, that partner will recognize gain to the extent the FMV of the distributed property (other than money) exceeds the partner’s adjusted basis in his partnership interest. The adjusted basis of the interest is first reduced (but not below zero) by money received in the distribution. Section 737, enacted as part of the Energy Policy Act of 1992 (P.L. 102-486, October 24, 1992).

a. The recognized gain is limited to the contributing partner’s net pre-contribution gain. This is the net gain which would have been recognized by the contributor under section 704(c)(1)(B) if all of the property that had been contributed by the partner during the prior 5 years and that was held by the partnership immediately before the distribution were distributed to another partner. § 737(b).

b. The gain recognized under section 737(a) is in addition to gain recognized under section 731. § 737(a).

c. The amount of gain recognized to the contributing partner is reflected a basis increase in the partner’s interest in the partnership immediately before the distribution. An appropriate adjustment is also made in the partnership’s basis in
the contributed property. § 737(c)(1) and (2).

d. Section 737 is aimed at taxing certain distributions which escape the recognition provisions of sections 704(c)(1)(B) and 707.

(1) Section 704(c)(1)(B) is avoided by not distributing the same property contributed by the partner. See § 737(d).

(2) Section 707(a) requires a facts and circumstances determination that there is a disguised sale and is limited by a regulatory two-year presumption.

5. Liquidation of the Partner's Interest.

The liquidation of a partner's entire interest in the partnership by means of a distribution from the partnership is not treated as a sale or exchange. I.R.C. § 761(d).

C. Determination of Gain or Loss.

1. Determination of the Amount Realized.

a. General Rule.

On the sale of a partnership interest, the amount realized is the sum of any money received, plus the fair market value of property (other than money) received. I.R.C. § 1001(b).

b. Relief from Liabilities.

The amount realized includes the selling partner's share of any partnership liabilities.

(1) General.

I.R.C. section 752(d) provides that in the case of a sale or exchange of an interest in a partnership, liabilities will be treated in the same manner as liabilities are treated in connection with a sale or exchange which is not associated with partnerships. Thus, the selling
partner's relief from any liabilities of the partnership, whether assumed, or merely nonrecourse encumbrances against the property, are treated as part of the purchase price. Crane v. Comm., 331 U.S. 1 (1947).

(a) Example.

Assume A has a basis of $40,000 in partnership X and that her share of partnership liabilities is $20,000. If she sells her interest in the partnership for $50,000, then the amount realized is $70,000 ($50,000 cash, plus $20,000 relief from liability).

(2) Nonrecourse Liabilities.

The full amount of any nonrecourse indebtedness of the partnership is applied in determining the partner's share of partnership indebtedness, even if the liability exceeds the fair market value of partnership properties. I.R.C. § 7701(g). See Tufts v. Comm., 461 U.S. 300 (1983). I.R.C. section 7701(g), added in 1984, is not dependent upon the transferor including the nonrecourse debt in basis.

(3) Deficit Capital Account.

The sale of a partnership interest in a partnership that has a deficit capital account makeup provision for substantial economic effect purposes under section 704(b), may find the deficit treated as a liability assumed by the buyer, and therefore an amount realized if the purchasing partner takes on responsibility for any deficit in the capital account.

(a) Capital Accounts Maintenance.

Maintenance of capital accounts is required under Treasury Regulation section 1.704-1(b)(2)(iv). The capital account represents the taxpayer's
investment in the partnership and includes money and property contributed by him and allocations to him of partnership income and gain, and is decreased by money and property distributed to him and allocations of partnership expenditures and losses to him. A negative capital account generally represents the excess of the partner’s share of the partnership liabilities over the basis of his partnership interest.

(b) Cases.

(i) See, Hirsch v. Comm., T.C.M. 1984-52, 47 T.C.M. 1006, where selling partners agreed to be liable to the continuing partners for 25 years for the amount in the seller’s deficit account to the extent of any cash payment which the taxpayer would have been required to make as a continuing partner. Under the facts, the Tax Court concluded that there was no relief of liabilities. See also, Seay v. Comm., T.C.M. 1992-254, where Hirsch was not applied when there was no evidence of continued liability for the deficit capital account.

(ii) In Goldfine v. Comm., 80 T.C. 843 (1983), the Tax Court suggested that neither the UPA nor the ULPA require a negative capital account restoration payment, although such provisions are frequently used to satisfy the substantial economic effect allocation requirements of the section 704(b) regulation. See also,
2. **Character of Gain or Loss.**
   
   a. **General Rule.**

   In the case of a sale or exchange of an interest in a partnership, gain or loss is recognized as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751. I.R.C. § 741.

   (1) **Partnership Interest as Separate Asset.**

   In this respect, the sale of a partnership interest is treated as the sale of a separate asset. For this purpose, the partnership is treated as a separate entity and the partnership interest is treated as a separate investment asset.

   (2) **Collapsible Partnership Income.**

   Section 751 partially re-casts a transfer of a partnership interest by treating the sale, in part, as a sale of unrealized receivables and substantially appreciated inventory of the partnership. The amount of money or property received by the Selling partners which is attributable to such receivables or inventory of the partnership will be treated as realized from the sale of property which is not a capital asset. I.R.C. § 751(a). These "hot assets" are discussed infra.

3. **Holding Period.**

   a. **General.**

   The holding period of the selling partner is determined based upon the period of time he has held the partnership interest, without regard to the partnership’s holding period of its assets. **Allan S. Lehman v. Comm.,** 7 T.C. 1088 (1946); Rev. Rul. 68-79, 1968-2 C.B. 310. As such, it is not affected by future adjustments to
the partner's interest and profits and losses, Julius H. (Groucho) Marx v. Comm., 29 T.C. 88, 101 (1957), or by subsequent capital contributions which do not increase the partner's interest in profits or losses.

b. Long Term Capital Gain.

The transferring partner will have a long or short term capital gain depending on whether his partnership interest has been held for more than one year. I.R.C. § 1222.

(1) Commencement of Holding Period.

(a) Money.

The holding period for a partnership interest acquired in exchange for a cash contribution commences at the time of the contribution. Treas. Reg. § 1.1223-1(a).

(b) Property.

The holding period for a partnership interest acquired in exchange for a contribution of property will include the period for which the contributed property was held by the partner. I.R.C. §§ 1223(1) and 722.

(i) The carryover holding period applies only to capital assets and section 1231(b) assets.

(ii) A partnership interest acquired in exchange for a contribution of unrealized receivables or inventory would have a holding period commencing at the time of contribution.

(c) Services.

The holding period of a partnership interest acquired in
connection with the performance of services would commence upon receipt of the interest. I.R.C. § 83(a).

(i) If the interest is subject to a substantial risk of forfeiture, the partner will not be recognized as a partner until the transfer or lapse of the substantial risk of forfeiture, unless an election is made under I.R.C. section 83(b). I.R.C. § 83(f); Treas. Reg. § 1.83-4(a).


a. General.

The partner has a single basis in his entire partnership interest. Whether acquired all at once or at different times and including all general partner and limited partner interests owned by the person. Rev. Rul. 84-52, 1984-1 C.B. 157.

In this sense, the partnership is treated differently than a corporation where basis is allocated to each share of stock whenever it is purchased, each share representing a separate investment unit in the corporation with its own purchase price.

b. Basis Adjustment on Sale of Partial Interest.

In the event of a sale of a partial interest, several different rules are applied in determining the portion of a partnership interest basis allocable to the sale. Rev. Rul. 84-53, 1984-1 C.B. 159.

(1) Partnership Without Liabilities.

In a simple partnership without multiple interests or liabilities, the basis of the portion sold is that amount which bears the same ratio, which the percentage of his interest sold, bears to the percentage of his basis in the partnership interest.
If A with a basis of $100 sells 25% of his interest, the basis in the portion sold is $25.

(2) **Partnership With Liabilities.**

In the event that the partnership has outstanding liabilities, then Revenue Ruling 84-53 requires more complex calculations. The basis attributable to the debt and the applicable basis without regard to the debt are independently determined and then recombined.

(a) **Basis in Excess of Liabilities.**

If the selling partner’s basis is more than the selling partner’s share of partnership liabilities, then the excess basis is allocated according to the ratio of the fair market values of the transferred portion of the Partner’s interest to the entire partnership interest and the rest of the basis is allocated in accordance with (b) below.

(b) **Basis Less Than Liabilities.**

If the selling partner’s basis is less than the selling partner’s share of the partnership liabilities, then the adjusted basis allocated to the transferred portion of the partnership interest will equal the partner’s pro rata share of the partnership liabilities which is treated as having been transferred on the disposition.

c. **Basis in Section 751 Assets.**

On the sale of a portion of a partnership interest allocable to section 751 assets, special rules will be applied, taking into account the inside basis of the hot assets in the hands of the partnership. Treas. Reg. § 1.751-1(a)(2).
Unrealized Receivables.

The partnership's basis in unrealized receivables is zero, plus costs or expenses attributable to the receivables and paid or accrued but not previously taken into account into the partnership's account under the partnership's method of accounting. Treas. Reg. 1.751-1(c).

The partnership's basis in substantially appreciated inventory is determined in accordance with the partnership's method of inventory accounting. Treas. Reg. § 1.751-1(d)(1).

III. TIME FOR RECOGNITION OF GAIN OR LOSS.

A. General Rule.

Gain or loss is recognized at the time of the sale or exchange of a partnership interest. I.R.C. § 1001(c).

B. Installment Sales.

1. Application to Partnership Interest.

A partner's interest may be sold on the installment method to the extent the method is otherwise available. I.R.C. § 453.

2. Application of Dealer Disposition and Non-Dealer Real Property Restrictions to Sales of Partnership Interests.


(1) "Dealer Disposition."

(a) Any disposition of personal property by a person who regularly sells or otherwise disposes of personal property on the installment plan, or

(b) Any disposition of real property which is held by the taxpayer for sale to customers in an ordinary course of the
(2) **Farm Property, Time Shares and Residential Lots.**

Farm property, time shares and residential lots may be excepted from dealer restrictions but are subject to an interest charge on the deferral. I.R.C. § 453(b)(3).

b. **Non-Dealer Real Property Restrictions.**

Non-dealer real property used in the taxpayer's trade or business or held for the production of rental income is subject to an interest charge on the deferred tax liability if the sales price exceeds $150,000 and the face amount of all installment obligations at the close of the taxpayer's year exceeds $5,000,000. I.R.C. § 453(a).

(1) Personal use property, farm property, time shares and residential lots are excepted.

(2) The interest charge applies to the deferred tax liability on the portion of the obligation in excess of $5,000,000 at the close of the taxable year. I.R.C. § 453A(a) and (c).

c. **Sale of Partnership Interest as a Dealer Disposition or Non-Dealer Real Property Distribution.**

The sale or exchange of a partnership interest may be treated as a dealer disposition or a non-dealer real estate disposition to the extent that a sale of the assets of the partnership would be subject to such installment sale restrictions. See H. Rptr. 99-841, 99th Cong. 2d Sess. II-299 for adoption of this position under repealed allocable installment indebtedness rules.

3. **Recapture of Depreciation.**

The selling partner's share of partnership asset depreciation subject to recapture, which
is taxed as a result of the transfer, is recognized in the year of the disposition of the partnership interest. I.R.C. § 453(i).

4. **Section 751 Assets.**

   a. **IRS Aggregate Approach.**

   The Service has concluded that the installment method is not available for that portion of the sales price which is attributable to substantially appreciated inventory. Rev. Rul. 89-108, I.R.C. 1989-37. Applying an aggregate approach, the Service concluded that since the installment method would not be available if an individual sold inventory, it should not be available on the sale of a partnership interest to the extent of the partner’s share of substantially appreciated inventory of the partnership.

   b. **Case Law Entity Approach.**

   *Petroleum Corp. of Texas, Inc. v. U.S.*, 939 F.2d 1165 (5th Cir. 1991), adopted an entity approach, recognizing that the sale of a partnership interest is the sale of personal property eligible for installment reporting under section 453. As payments are received, there would be an ordinary income allocation to the partner attributable to the substantially appreciated inventory.

5. **Relief From Liabilities.**

   The relief of liabilities attributed to the selling partner, under section 752(b) is treated as a money received by the selling partner to the extent it exceeds the basis of his interest in the property. Rev. Rul. 76-483 1976-2 C.B. 131.

6. **Losses.**

   The installment method is not available on the sale of partnership interests at a loss. I.R.C. § 453(a).
C. Recognition of Suspended Losses.

1. Losses Suspended Under Section 704(d) Basis Limitation.
   a. General.

   A partnership distributive share of partnership loss (including any capital loss) is allowed as a current deduction only to the extent of the adjusted basis of the partner’s interest at the end of the partnership year in which the loss is incurred. Any excess loss is carried forward indefinitely until there is sufficient basis available to permit the deduction of the loss. I.R.C. § 704(d). Treas. Reg. 1.704-1(d).

   b. Excess Loss Over Basis Not Allowed on Sale.

   The partner’s suspended loss arising from the basis limitation are not allowed as a result of the sale of his partnership interest.

2. At-Risk Limitations.
   a. General.

   Under section 465, losses are allowed only to the extent of the aggregate account to which the taxpayer is at risk for activities engaged in by the taxpayer on a trade or business or for the production of income. Any loss in excess of the amount at-risk is carried forward by the taxpayer.

   b. Suspended Section 465 Losses.

   Any gain recognized on the disposition of a partner’s interest in the partnership is treated as income from the activity of the partnership subject to the section 465 at-risk rules, for the purpose of consuming any suspended at-risk losses. Prop. Reg. § 1.465-66.

3. Passive Activity Losses or Credits.

   Upon the disposition of the partner’s entire interest in the partnership to an unrelated
person in a fully taxable transaction, the partner may deduct any suspended passive activity losses or credit. I.R.C. § 469(g).

a. **Installment Sales.**

In the case of an installment sale, suspended passive activity losses are recognized proportionately in the same ratio as gain is recognized. I.R.C. § 469(g)(3).

D. **Disallowed Losses.**

No deduction is allowed on losses from sales or exchanges of property (other than an interest in the partnership) directly or indirectly between a partnership and a person owning more than a 50% interest in profits or capital, or between two partnerships in which the same person controls more than 50% of the capital or profits interest. I.R.C. § 707(b)(1). In the case of a subsequent sale by the related person then the transferee will recognize gain only to the extent the gain exceeds the previously disallowed loss to the transferor. I.R.C. §§ 707(b)(1) and 267(d).

A similar rule applies to sales between a corporation and partnership, more that 50% of which is owned by the same person. I.R.C. § 267(b)(10).

IV. **ALLOCATIONS BETWEEN SELLING PARTNER AND TRANSFEREE.**

A. **General Rule.**

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, in accordance with any method prescribed in the regulations. I.R.C. § 706(d).

1. **Retroactive Allocations Prohibited.**

Although partners may reallocate partnership items among themselves so long as they have substantial economic effect, the partners cannot make any reallocation which will have the effect of causing a retroactive allocation. I.R.C. §§ 704(b) and 706(d).
B. **Taxable Year of Selling Partner.**

1. **Closing Books on Sale of Entire Interest.**

   The partnership’s taxable year closes with respect to a partner upon the sale or exchange of his entire interest in the partnership. I.R.C. § 706(c)(2)(A).

2. **Partner’s Final Partnership Taxable Year.**

   Upon the sale of the partner’s entire interest in the 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 items of income, gain, loss, deduction, or credits under section 702(a), and any guaranteed payments under section 707(c), for his partnership taxable year which ends on the date of the sale. Treas. Reg. § 1.706-1(c)(2)(ii).

   a. The allocation of items of income to the selling partner occurs whether or not he has received a distribution on his share of net income for the year. The selling partner is not taxed on post-sale income of the partnership, whether or not the selling price is measured from post-sale income. See *Johnson v. Comm.*, 21 T.C. 733 (1953); *Baxter v. Comm.*, 433 F.2d 757 (9th Cir. 1970).

C. **Method of Allocation.**

1. **General Rule.**

   The transferor and transferee partners may allocate tax items between the pre-sale and post-sale, in accordance with methods authorized in the regulations. I.R.C. § 706(d); Treas. Reg. § 1.706-1(c)(2)(ii).

   a. The transferor partner’s distributive share of items may be estimated by taking his pro rata part of the amount of each item he would have included in his taxable income had he remained a partner until the end of the taxable year.

   b. A proration may be made based on the portion of the taxable year that has elapsed prior to the sale.
c. A proration may be based on any other method that is reasonable.


2. Example.

a. Assume that partnership ABC is on a calendar year and that partner A sells his partnership interest on June 30. A has an adjusted basis in his interest of $5,000, and his pro rata share of partnership income up to June 30 is $15,000. He sells his interest for $20,000.

b. Since A has sold his entire interest, the partnership year with respect to him closes on June 30, pursuant to section 706(c)(2).

c. The $15,000 is includable in his income as his distributive share of partnership income and increases his basis by $5,000 to $20,000, pursuant to section 705.

d. Since his adjusted basis of $20,000 equals his selling price of $20,000, there is no gain to A on the sale of his interest.

e. The purchaser of this partnership interest will include in his income, as his distributive share for the year, his pro rata share of partnership income for the remainder of the partnership taxable year.

Treas. Reg. § 1.706-1(c)(2)(ii), Example.

3. Cash Basis Items are Prorated Over Taxable Year.

"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 to new partners for the cash basis items. I.R.C. § 706(d)(2)(C) and (D).
a. **General Rule.**

Each partner's distributive share of any allocable cash basis item is determined by assigning the appropriate portion of each item to each day of the period to which it is attributable and then by allocating that portion of the item among the partners in accordance with their respective interests in the partnership on that day. I.R.C. § 706(d)(2).

b. **Allocable Cash Basis Items.**

Allocable cash basis items mean any of the following items with respect to which the partnership uses the cash receipts and disbursements method of accounting:

1. Interest;
2. Taxes;
3. Payments for services or for the use of property; and
4. Any other item of a kind specified in the regulations, when appropriate, to avoid significant misstatements of income to the partners.


c. **Items Attributable to Periods Not Within Taxable Year.**

1. If any portion of an allocable tax basis item is attributable to a period before the taxable year, the portion will be assigned to the first day of the taxable year, or if any portion is allocable to a period after the taxable, the portion will be assigned to last day of the taxable year.

2. Any portion which is assigned to the first day of the taxable year will be allocated among the persons who were partners during the period to which the portion is attributable in accordance with their varying interests during the period, and any portion allocated to a person who was
not a partner on the first day will be capitalized by the partnership and treated in the manner provided in section 755.

I.R.C. § 706(b)(2)(D).

D. Lower Tier Partnerships.

If there is a sale of a partner's interest in an upper tier partnership, and the partnership is a partner in another lower tier partnership, a flow-through approach is used to determine the allocation of a lower tier partnership tax items among the upper tier partnership members. I.R.C. § 706(d)(3).

E. Termination of Partnership Year.

1. Fifty Percent Change in Ownership Rule.

The partnership will be considered as terminating for federal income tax purposes, if there is a sale or exchange of 50% or more of the total interest in partnership capital and profits within a 12-month period. I.R.C. § 708(b)(1)(B).

a. Re-transfers of the same interest are not counted toward the 50% change in ownership rule. Treas. Reg. § 1.708-1(b)(1)(ii).

b. There must be a 50% or more change in both capital and profits interests in order for a termination to result. Treas. Reg. § 1.708-1(b)(1)(ii).

c. When interests are sold on different dates, the percentages to be added are determined as of the date of each sale, for purposes of the floating 12-month period.

d. The termination rule applies only as to sales or exchanges within the 12-month period. A disposition by gift, bequest, inheritance, or the liquidation of a partnership interest is not a sale or exchange subject to this rule. Treas. Reg. § 1.708-1(b)(1)(ii).

2. Effect of Termination.

If the partnership is terminated as a result of the sale or exchange of an interest, the
partnership is deemed to have distributed its properties to the purchaser and the remaining partners in proportion to their respective interests in the partnership properties, and immediately thereafter they are deemed to have contributed the properties to a new partnership, either for continuation of the business or for its dissolution and winding up. Treas. Reg. § 1.708-1(b)(IV).

a. Termination of the partnership taxable year may cause a bunching problem if the partnership and partners have different fiscal years. The partnership must be on a year permitted under section 706(b) or section 444.

b. New elections must be made.

c. Generally, there is no gain resulting from adjustments to liabilities because there are simultaneous offsetting adjustments under sections 752(a) and (b).

d. New special allocations may be required for "new" contributions of property under section 704(a).

e. Depreciation schedules may have to be changed. For example, pre-ACRS property would become used property under Treasury Regulation section 1.167(c)-1(a)(6).

f. Special inside basis adjustments may be required as a result of the application of a section 754 election to a deemed section 734 distribution, or a deemed distribution of property affected by a special partnership basis adjustment under section 732(d).

g. New rules are applied for section 197 intangibles. Since there is a technical termination under section 708(b)(1)(B) and a deemed re-contribution to the "new" partnership, the section 197 intangible rules treat the liquidation as a nonrecognition distribution under section 731.

(1) The transferee is treated as the transferor to the extent the adjusted basis of the section 197 intangibles immediately after the termination does not exceed the adjusted basis
before the termination (the transferred basis). I.R.C. § 197(f)(2).

(2) If a section 754 election is in effect, and there is a section 743 increase in basis, then the increased basis portion of the amortizable section 197 intangibles will have a new 15-year amortizable life.

3. Merger or Consolidation.

In the case of a merger or consolidation of two or more partnerships, the resulting partnership is considered a continuation of any merging or consolidating partnerships whose members own a more than 50% interest in the resulting partnership. I.R.C. § 708(b)(2). Treas. Reg. 1.708-1(b)(2)(i), Rev. Rul. 68-289, 1968-1 C.B. 3314 and Rev. Rul. 77-458, 1977-2 C.B. 220.

a. Liquidating distributions by other merging partnerships of 50% or more of the capital and profits interests in the resulting partnership do not cause the resulting partnership to terminate under section 708 (b)(1)(B). Rev. Rul. 90-17, 1990-1 C.B. 13.

V. SPECIAL ADJUSTMENTS TO BASIS.

A. General Rule.

The basis of partnership property is not adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of the partner. I.R.C. § 743(a).

1. Problem Created.

As a result of transfers of partnership interests, the transferee will typically have a basis in his partnership interest (the outside basis) which differs from his share of the basis of the assets owned by the partnership (the inside basis). The disparities may lead to distorted tax consequences to the acquiring partner.
2. **Example.**

Assume that Partnership X has the following assets and that A and B are equal partners:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$4,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>Total</td>
<td>$6,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

**Capital**

<table>
<thead>
<tr>
<th></th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$3,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>B</td>
<td>$3,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Total</td>
<td>$6,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

Assume A sells his partnership interest to C for its fair market value, $5,000. Upon the subsequent sale of inventory by the partnership for $8,000, $4,000 of gain will be recognized. C's 50% distributive share of the income from the sale is $2,000. This is unfair to A and C. C has previously paid $4,000 attributable to the full fair market value of the inventory and should not be taxed again on its sale. A has paid a tax on the appreciation in the inventory through the gain recognized on his sale to C.

**B. Optional Basis Adjustment.**

Section 743(b) permits the partnership to adjust the inside basis of its assets to reflect the purchase price paid by the acquiring partner. The inside basis adjustment will apply only as to the acquiring partner and is available only if the partnership has made a permanent election to adjust basis on such transfers.

1. **Consequence of Basis Adjustment.**

An increase in the basis of partnership assets as to the transferee partner would increase the allocation of depreciation and depletion deductions allocated to him and would reduce the transferee partner's share of gain on the sale of partnership assets.
a. **Example.**

Assume in the above example that the inside basis of the assets of Partnership X is $6,000 and the fair market value is $10,000. C purchases A’s 50% interest for $5,000. If the partnership makes the election permitted under sections 743(b) and 754, the inside basis of partnership assets is adjusted as to C only. If X had inventory with a pre-transfer basis of $4,000 and FMV of $8,000, the basis of the inventory attributable to C is changed to $4,000, but the basis attributable to B ($2,000) remains the same. If the inventory is sold for its fair market value ($8,000), then B will have income of $2,000 and C will have no gain.

b. **Distributions.**

Upon the distribution to the partners of assets carrying an optional basis adjustment, the special basis adjustment will be carried through to the transferee partner as part of the carryover basis under section 732. Treas. Reg. §§ 1.732-2(b) and 1.743-1(b). If Partner A receives a distribution of property with respect to which Partner B has a special basis adjustment, A will not take into account B’s special basis adjustment and the partnership will allocate B’s special basis adjustment on that property to other property retained by the partnership. Treas. Reg. § 1.743-1(b)(2)(ii).

C. **Determination of Optional Basis Adjustments.**

1. **General Rule.**

The amount of the section 743(b) optional basis adjustment in partnership assets is the difference between the transferee partner’s basis in his partnership interest and his proportionate share of the adjusted basis of the assets of the partnership. I.R.C. § 753(b).

a. **Increase in Adjusted Basis.**

If the basis in his interest exceeds his proportionate share of the basis of the
partnership assets, the adjustment will increase his share in the basis of partnership assets.

b. Decrease in Basis.

The adjusted basis of the partnership assets will be decreased if the transferee’s purchase price is less than his proportionate share of the basis of partnership assets.

2. Partner’s Share of Adjusted Basis of Partnership Assets.

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 liabilities. Treas. Reg. § 1.743-1(b)(1).

3. Difference in Capital and Profits Interest.

If there is a difference in the transferor partner’s interest in capital and profits, then the optional basis adjustment will be measured based on the partnership interest of the transferor. See Treas. Reg. § 1.743-1(b)(1) (ii) Example (2).


a. General Rule.

Increase or decrease in the adjusted basis of partnership assets is first allocated between two classes of properties, (i) capital assets and section 1231(b) assets used in the trade or business, and (ii) all other properties, and then the amount is allocated within each class to specific properties in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of the partnership properties. I.R.C. § 755(a) and (b).

(1) Increase in Basis.

If there is an increase in basis to be allocated to partnership assets, the increase must be allocated only to those assets within the class whose values exceed their bases and
in proportion to the difference between the value and the basis of each. No portion of the increase is made to the basis of any asset with a basis which equal or exceeds its fair market value. Treas. Reg. § 1.755-1(a)(1)(ii).

(2) **Decrease in Basis.**

If there is a decrease in basis to be allocated among partnership assets, the basis must be allocated to those assets in the class whose bases exceed their fair market value and in proportion to the difference between the basis and the value of each. No decrease is made to the basis of any asset whose fair market value equals or exceeds its adjusted basis. Treas. Reg. § 1.755-1(a)(1)(iii).

(3) **Goodwill.**

A portion of the special basis adjustment must be allocated to partnership goodwill to the extent that goodwill exists and is reflected in the value of the price at which the partnership interest is sold. Treas. Reg. § 1.755-1(a)(1)(iv).

b. **Application of Section 1060.**

Section 1060 applies special allocation rules for applicable asset acquisitions involving the transfer of assets of a trade or business where the transferee’s basis in the assets is determined wholly by reference to the consideration paid for the assets.

(1) **Section 1060 vs. Section 755.**

Section 1060(d) provides that in the case of a transfer of an interest in a partnership, section 1060 will apply for the purpose of determining the value of section 197 intangibles for purposes of applying section 755. Section 1060(d)(2) makes it clear that if section 755 applies then any transfer will be treated as an
applicable asset acquisition for purposes of section 1060.

(2) Regulations.

Under Temporary Regulation section 1.755-1(T), which coordinates sections 1060 and 755, all property other than goodwill (now section 197 intangibles) is to be valued on the basis of the facts and circumstances applying the normal section 755 test.

(3) Allocation to Partnership Section 197 Intangibles.

The value of partnership section 197 intangibles is deemed equal to the amount required which when added to the value of all other partnership properties will generate an amount available at the partnership level with which to liquidate the partnership interest of the transferee. Thus if the transferee purchased his 1/2 interest for $500,000 and the value of the partnership assets (other than goodwill) is $800,000, goodwill will have an assigned value of $100,000, the amount which when combined with other assets would generate a $500,000 amount for liquidating the partner's interest. Section 1060 overruled United States v. Cornish, 348 F.2d 175 (9th Cir. 1965), which allocated the purchase price among the fair market value of tangible assets and non-depreciable intangible assets other than goodwill.

5. Amortizable Section 197 Intangibles.

a. General.

Certain acquired intangibles known as "amortizable section 197 intangibles" can be amortized over a 15-year period after acquisition. These intangibles include goodwill, going concern value, know-how, covenants not to compete, patents, and other similar properties. The new amortization rules became effective for acquisitions after August 10, 1993 (an
b. **Section 743(b) Adjustment for "Acquired" Intangibles.**

If there is an increase in the basis of section 197 intangibles held by the partnership as a result of a section 743 optional basis adjustment in connection with a purchase of a partnership interest, then the amount of the section 743(b) basis adjustment increase attributable to section 197 intangibles of the partnership will be amortizable by the partnership over the next 15 years. See, H.R. Rep. No. 11, 103d Cong., 1st Sess. (1993).

D. **The Election.**

1. **General.**

A partnership may make an optional basis adjustment under section 743(b) only if it files an election under section 754. The election must apply to both dispositions under section 743(b) and to distributions under section 734(b). Once made, adjustments are required on all distributions to partners and all transfers of partnership interests by sale, exchange or death during the year for which the election is made and all subsequent years. Treas. Reg. § 1.754-1(a).

2. **Time and Method of Making Election.**

The election must be made by the partnership on the partnership return for the taxable year during which the transfer occurs. The return must be a timely filed return (including extensions) under Treasury Regulation section 1.6031-1(e). If a valid election has previously been made and not revoked, a new election is not required to be made for the current year. Treas. Reg. § 1.754-1(b).

3. **Waiver of Time Restriction.**

Since the time and manner of making the election is prescribed by regulations, a partnership which has failed to make a timely election, may seek a waiver of the time
restriction pursuant to Treasury Regulation section 1.9100-1.

4. Revocation.

A section 754 election may be revoked only with the approval of the District Director where the partnership return is required to be filed based upon an application filed not later than 30 days after the close of the partnership taxable year with respect to which the revocation is to take effect. Treas. Reg. § 1.754-1(c).

E. Optional Adjustments to Basis on Death.

The optional basis adjustments of section 743 apply upon the death of a partner, as well as upon the sale or exchange of a partnership interest.

1. The Problem.

The special adjustment is necessary since, under section 1014(a) the basis of the partnership interest of the successor partner will be the fair market value of that interest on the date of the deceased partner's death (or optional valuation date). The adjustment to the inside basis of the partnership is necessary to reflect the stepped-up basis of the successor and provide for proper allocations upon subsequent distributions of sales or death.

VI. EXCHANGES OF PARTNERSHIP INTERESTS.

A. Like Kind Exchanges.

1. Statutory Prohibition.

The exchange of partnership interests does not qualify for nonrecognition as a like kind exchange of property held for productive use or investment. I.R.C. § 1031(c)(2)(D).

2. Pre- Contribution or Post- Distribution Exchanges.

Like kind exchanges by partners after distribution from the partnership or before contribution to the partnership will qualify under section 1031.
a. In Magnuson v. Comm., 753 F.2d 1490 (9th Cir. 1985), aff'd 81 T.C. 767 (1983), the Court recognized a like-kind exchange where the Magnusons exchanged their fee interest in Iowa Street property for a 10% interest in Plaza property from NER. The same day the Magnusons and NER conveyed their respective interests in Plaza to a new limited partnership. The Magnusons acquired a general partnership interest.

(1) The IRS argued that the Magnusons did not hold Plaza for investment.

(2) The Tax Court concluded that the contribution was a continuation of the Magnusons' investment unliquidated, but in a modified form, and therefore held for investment. Before the contribution the Magnusons and NER shared the property as tenants-in-common and afterwards as partners.

(3) The 9th Circuit also emphasized that the partnership must intend to retain the property for investment and that the total assets of the partnership must be predominately of like kind to the taxpayers' original investment.

b. In Mason v. Comm., T.C.M. 1988-273, 55 T.C.M. 1134. Two partnerships dissolved and then there was an exchange of qualified like-kind properties by the former partners.

c. In Chase v. Comm., 92 T.C. No. 53 (1989), a purported distribution of property by the partnership to the partner for the purpose of a section 1031 exchange was disregarded due to the substance over form doctrine.

d. In Bolker v. Comm., 81 T.C. 782 (1983), aff’d 760 F.2d 1039 (9th Cir. 1985), involving a section 333 liquidation and subsequent exchange, the court held that a transitory holding was sufficient to establish investment interest for section 1031 purposes.

e. In Maloney v. Comm., 93 T.C. 93 (1989), a section 1031 exchange was approved where
the Corporation engaged in the exchange on December 28, followed by the adoption of a section 333 plan of liquidation 5 days later on January 2, 1979.

B. Intra-Partnership Exchanges.

1. Exchange of General Partnership Interest for Limited Partnership Interest.

In Revenue Ruling 84-52, General Partnership X was converted to Limited Partnership X and Partners A and B converted their general partnership interests into limited partnership interests and retained their same respective interests in profits, losses and capital. The Service treated the exchange as a nontaxable contribution of property under section 721 and held there was no termination of the partnership. Rev. Rul. 84-52, 1984-1 C.B. 157.

2. No Change in Liabilities.

If there is no change in the partner's share of liabilities, there would be no change in the adjusted basis of the partners.

3. Change in Liabilities.

If there is a change in the partner's share of partnership recourse or nonrecourse liabilities, any reduction in the partner's share of liabilities would be a deemed distribution of money under section 752(b), reducing basis under section 733 and causing capital gain under section 731 if the distribution exceeds basis. Any increases in the partner's share of liabilities would be a deemed contribution of money under section 752(a) with an appropriate increase in basis under section 722.

4. Holding Period.

There is no change in the holding period of any partner's interest on the exchange. I.R.C. § 1223(1).

5. No Termination of Entity.

Since a section 721 contribution is not treated as a sale or exchange, a termination will not occur under section 708. Treas. Reg. § 1.708-1(b)(1).
6. **Other Consequences.**

The conversion of general and limited partnership interests may cause the partner’s interest to be affected by various tax considerations, such as the at-risk rules, section 465(b), the passive activity loss rules, section 469(h)(2), or the right to be a designated tax matters partner, section 6231(a)(7).

C. **Transfer of Partnership Interest in One Partnership in Exchange for Interest in Another Partnership.**

The Service has held the contribution of a limited partnership interest to another limited partnership is a qualified section 721 contribution. Rev. Rul. 84-115, 1984-2 C.B. 118. There was no allocation to section 751 assets, since section 721 supersedes section 751.

D. **Conversion Into a Limited Liability Company.**

1. **General Law Partnership.**

The Service has ruled that the conversion of a general partnership law firm into a limited Liability company does not affect its classification as a partnership for tax purposes and does not trigger a termination of the partnership under section 708. P.L.R. 93-50-013.

   a. The Service examined the state limited liability company statute and determined that the limited liability company, into which the partnership merged, should not be treated as an association taxable as a corporation under the Treasury Regulation section 301.7701-2(b)(1) classification rules.

   b. The limited liability company was treated as a continuation of the same general partnership in a different form, citing Revenue Ruling 84-52, 1984-1 C.B. 157.

   c. **Limit on Liability.** The conversion of a professional law partnership into a limited liability company generally would not limit the malpractice liability of the negligent attorney, and in some states, may not limit the attorney’s contractual liabilities. However, other members of
the firm will generally avoid tort liability and may limit contract liability through the conversion to a limited liability company.

2. **Limited Partnership.**

The Service has concluded that the conversion of a limited partnership into a limited liability company was not a sale or exchange and did not cause a termination of the partnership. P.L.R. 9132042.

VII. **COLLAPSIBLE PARTNERSHIPS -- SALES OR EXCHANGES INVOLVING SECTION 751 "HOT ASSETS."**

A. **General Rule.**

The amount of money or fair market value of property received by a transferor partner in exchange for all or part of his partnership interest is considered as an amount realized from the sale or exchange of property other than a capital asset to the extent the money or property received is attributable to unrealized receivables of the partnership, or inventory items of the partnership which have appreciated substantially in value.

B. **Purpose.**

Section 751 was enacted "to prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests." S. Rep. No. 1622, 83d Cong. 2d Sess. 98 (1954).

1. **Comparison with Collapsible Corporations.**

Although the goal of section 751 is similar to the corporate collapsible provisions of section 341, they operate entirely differently. For example, section 341 is generally an all or nothing test which depends upon a subjective view to sell stock prior to a 2/3 realization at the corporate level, while section 751 is a mechanical test which operates only as to hot assets, and without regard to any intent.

C. **Unrealized Receivables.**

1. **General Definition.**

The term unrealized receivables includes, to the extent not previously included in income under the partnership's method of accounting,
any rights (contractual or otherwise) to payment for:

a. goods delivered, or to be delivered, to the extent the proceeds would be treated as received from the sale or exchange of property other than a capital asset; or

b. services rendered or to be rendered. I.R.C. § 751(c).

2. Goods Delivered or to be Delivered.

The concept applies only to goods when the proceeds would be treated as received from the sale of other than a capital asset.

a. Depreciable Property or Real Property Used in the Business.

Depreciable property or real property held for business use for one year or less is an unrealized receivable under section 751(c) because it does not qualify as a section 1231(b) property entitled to capital gain treatment.

b. Installment Sales.

Deferred gain on the installment sale of a capital asset or section 1231 property is not an unrealized receivable.

c. Work in Progress.

Unrealized receivables include the right to payment for work or goods begun but incomplete at the time of the sale.

(1) Basis includes all costs or expenses attributable thereto which have been paid or accrued but not previously taken into account under the partnership method of accounting. Treas. Reg. § 1.751(c)(2).

3. Services Rendered or to be Rendered.

a. Examples.

(1) Unbilled fees for work in progress has been treated as an unrealized receivable based upon the right in quantum meruit to receive payment for
incomplete work. Logan v. Comm., 51 T.C. 482(1968).

(2) Amounts received by selling partners based upon their share of the value of the partnership's management contract with a life insurance company were attributable to the right to payment for services to be rendered. Rev. Rul. 58-394, 1958-2 C.B. 374.

(3) The "right to render services for the term of the (management employment) contract and to earn ordinary income in the future" has been held to be an unrealized receivable even though the agreement did not obligate the partnership to render any future services. Le doux v. Comm., 77 T.C. 293 (1981) aff'd per curiam, 695 F.2d 1320 (11th Cir. 1983).

4. Receivables Previously Included in Income.

The term unrealized receivables does not include any receivables previously included in income under the partnership's method of accounting.

a. Inventory Receivables.

Receivables from the sale of inventory is not generally treated as an "unrealized receivable" because the taxpayer is required to use the accrual method of accounting as to inventory. Treas. Reg. § 1.446-1(c)(2).

5. Post 1954 Additions to Unrealized Receivables.

Since 1954, Congress has expanded the definition to include numerous specific items, to the extent the amounts would be treated as ordinary income to the partnership if sold by the partnership at fair market value. I.R.C. § 751(c), Treas. Reg. § 1.751-1(c)(4), Prop. Reg. § 1.75-1-1(c)(4)(6).

a. Potential Recapture on Section 1245 Property.

I.R.C. § 1245(a)(1).
b. Potential Recapture on Section 1250 Property.
I.R.C. § 1250(a)(1).

c. Potential Gain on the Sale of Mining Property.
I.R.C. § 617(f)(2).

d. Potential Gain on the Sale of Stock in a DISC.
I.R.C. § 995(c).

e. Potential Gain on the Sale or Exchange of Stock in Certain Foreign Corporations.
I.R.C. § 1248(a).

f. Potential Gain on the Sale of Farm Recapture Property and Farm Land.
I.R.C. §§ 1251(e)(1) and 1252(a).

g. Potential Gain on the Sale of Franchises, Trademarks or Trade Names.
I.R.C. § 1253(a).

h. Potential Gain on the Sale of Oil, Gas or Geothermal Property to the Extent of Intangible Drilling Expenditures.
I.R.C. § 1254(a).

These items are not treated as unrealized receivables for the purpose of determining the character of payments to a retiring partner or deceased partner successor under section 736 as a result of an amendment to section 751(c) in the Revenue Reconciliation Act, effective January 5, 1993.

6. Agreement as to Value.

An arms length agreement between the buyer and seller as to the amount of the purchase price attributable to unrealized receivable will generally be accepted by the Service. Treas. Reg. § 1.751(c)(3).
D. **Substantially Appreciated Inventory.**

1. **Inventory Items.**

   Inventory includes:

   a. **Property Described in Section 1221(1).**

      Inventory includes stock in trade, inventory and property held primarily for sale to customers in the ordinary course of business. I.R.C. 751(d)(2)(A).

   b. **Any Other Property Which is Not a Capital Asset or Section 1231 Property.**

      Inventory includes any other property which on sale or exchange would be considered as property other than a capital asset and other than property described in section 1231. I.R.C. § 751(d)(2)(B).

      (1) **Accounts and Notes Receivable.**

         Under the section 1221(4) list exclusions from "capital assets," accounts and notes receivables acquired in the ordinary course of business for services rendered or the sale of goods would not be capital assets on section 1231 property and would therefore be inventory, as well as unrealized receivables.

   c. **Foreign Investment Company Stock.**

      Any stock in a foreign investment company which would be taxable as ordinary income under section 1246(a) if sold. I.R.C. § 751(d)(2)(C).

   d. **Property Attributed to Dealer Partner.**

      Any property held by the partnership which if held by the selling partner would be considered as property described in a, b, or c, above. I.R.C. § 751(c)(2)(D).
2. **Substantial Appreciation.**

a. **General.**

Inventory items are section 751 assets only if they have appreciated substantially in value. There is substantial appreciation when their fair market value exceeds 120% of the adjusted basis of such property to the partnership.

(1) **Example No. 1.**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>9,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Other Assets</td>
<td>9,000</td>
<td>15,000</td>
</tr>
<tr>
<td></td>
<td>$27,000</td>
<td>$39,000</td>
</tr>
</tbody>
</table>

In this example, the inventory is substantially appreciated since its FMV ($15,000) is more than 120% (actually 167%) of its adjusted basis ($9,000).

(2) **Example No. 2.**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>9,000</td>
<td>9,000</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>-0-</td>
<td>3,000</td>
</tr>
<tr>
<td>Other Assets</td>
<td>9,000</td>
<td>15,000</td>
</tr>
<tr>
<td></td>
<td>$27,000</td>
<td>$36,000</td>
</tr>
</tbody>
</table>

In this example, the inventory has also substantially appreciated because unrealized receivables (which have not previously been taken into income) are treated as "inventory" under sections 751(d)(2)(B) and 1221(4). The "inventory" has a FMV more than 120% of its adjusted basis ($12,000 > $9,000).
E. **Tiered Partnerships.**

In determining whether property of a partnership is an unrealized receivable or an inventory item, a partnership is treated as owning its proportionate share of any other partnership in which it is a partner. I.R.C. § 751(f).

F. **Mechanics of Applying Section 751.**

1. **Amount Realized Attributable to Section 751 Assets.**
   a. **Allocation Required.**

   The amount realized by the selling partner must be allocated between the section 751 assets of the partnership (unrealized receivables and substantially appreciated property) and the remaining assets of the partnership.

   (1) **General.**

   Generally, the portion of the selling price allocable to section 751 assets will be the selling partner's proportionate interest in the section 751 assets. § 1.751-1(g)
   Example (1).

   (2) **Agreement as to Allocation.**

   An arms length agreement between the selling partner and purchaser allocating the selling price between the section 751 assets and remaining assets will be respected by the Service. Treas. Reg. § 1.7511(a)(2).

   (a) **Planning.**

   The seller will want a low allocation to hot assets to minimize ordinary income on sale and the purchasers will want a high allocation to basis in the hot assets in order to minimize ordinary income on the subsequent sale by the partnership (assuming a section 754 election).
(b) Terms of Allocation Agreement.

Sound practice suggests that the parties use an allocation agreement on the sale of a partnership interest. The agreement should include:

(i) an allocation to each potential recapture property. The recapture regulations are applied on an item by item basis. Treas. Reg. §§ 1.1245-1(a)(1) and 1.1250-1(a)(1);

(ii) an allocation to other unrealized receivables as a class;

(iii) an allocation to inventory items as a class. A separate allocation may be necessary to determine substantial appreciation; and

(iv) an allocation to other partnership assets.

(c) "Strong Proof" Test.

Cases have generally required "strong proof" to upset the allocations prescribed in the agreement. Ullman v. Comm., 264 F.2d 305 (2d Cir. 1959); Schultz v. Comm., 294 F.2d 52 (9th Cir. 1961).

b. Section 1060 Asset Acquisitions.

In the case of a transfer of an interest in a partnership, the section 1060 asset acquisition allocation rules must be applied for the purpose of determining the value of section 197 intangibles (including goodwill). I.R.C. § 1060. Under Temporary Regulation section 1.755-1(t), all other property is valued based on the facts and circumstances applying the normal section 755 tests.
c. Effect of Allocation.

(1) The amount allocable to section 751 assets will be treated as an amount realized from the sale or exchange of property other than a capital asset. I.R.C. 751(a).

(2) The balance of the purchase price allocated to the remaining assets will qualify for capital gain or loss treatment from the sale or exchange of a capital asset. I.R.C. § 741(a).

2. Allocation of Selling Partner’s Basis to Section 751 Assets.

a. General Rule.

Generally, basis is allocated to the section 751 assets, based upon the basis of the assets in the hands of the partnership.

(1) The Regulation.

The regulations provide that the portion of the partner’s adjusted basis in his partnership interest allocated to section 751 assets is the amount equal to the basis the section 751 assets would have under section 732 (including subsection d) if the selling partner had received the section 751 assets in a distribution immediately prior to the sale. Treas. Reg. § 1.751-1(a)(2).

(2) Section 732.

Under section 732, the distributee partner generally has a transferred basis from the partnership, provided that it cannot exceed the adjusted basis of the partner’s interest in the partnership. I.R.C. § 732(a).

(3) Section 732(d).

Section 732(d) permits a section 743(b) basis adjustment in certain instances when a section 754 election has not been made, if
property (other than money) is distributed to the partner within two years after the transfer. See also, Barnes v. U.S., 253 F.Supp. 116 (S.D. Ill. 1966).

3. Determination of Ordinary Income or Loss From Section 751 Assets.
   
a. General.

   The selling partner’s ordinary income (or loss) attributable to section 751 assets is the difference between the portion of the amount realized for section 751 assets and the portion of the transferor’s basis allocable to section 751 assets. I.R.C. § 751(a).

4. Determination of Balance of Gain or Loss from Sale of Partnership Interest.

   The selling partner’s capital gain or loss under section 741 resulting from the sale or exchange of the partnership interest is the difference between the balance of the amount realized and the balance of the selling partner’s basis.

5. Examples.
   
a. Example No. 1.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted Basis</th>
<th>PMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 9,000</td>
<td>$ 9,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>9,000</td>
<td>18,000</td>
</tr>
<tr>
<td>Other assets</td>
<td>6,000</td>
<td>9,000</td>
</tr>
<tr>
<td></td>
<td>$24,000</td>
<td>$36,000</td>
</tr>
</tbody>
</table>
**Capital** | **Adjusted Basis** | **FMV**
---|---|---
A | $8,000 | $12,000
B | $8,000 | 12,000
C | 8,000 | 12,000
---|---|---
| $24,000 | $36,000

A sells his interest to D for $12,000.

(1) A section 751 asset exists since the inventory has substantially appreciated. Its FMV is more than 120% of its adjusted basis.

(2) The amount realized by A attributable to the inventory is $6,000.

<table>
<thead>
<tr>
<th>FMV of Inventory</th>
<th>$18,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of All Assets</td>
<td>36,000</td>
</tr>
<tr>
<td>Percent of Assets Consisting of Inventory</td>
<td>50%</td>
</tr>
</tbody>
</table>

| Total Sales Price for A's Partnership Interest | $12,000 |
| Portion of A's Interest Attributed to Inventory ($12,000 x 50%) | $6,000 |

(3) A has a 1/3 interest in the partnership and therefore has an interest in 1/3 of the partnership inventories. If the partnership distributed 1/3 of the inventory to A, he would have a transferred basis of $3,000 from the partnership under section 732(a)(1).
(4) A's Interest
Attributes to Inventory $6,000

Less A's Basis
Attributes to Inventory 3,000

Gain $3,000

(5) A's Gain from the Sale of the Balance of His Partnership Interest is $1,000.

<table>
<thead>
<tr>
<th>Total</th>
<th>$751 Partnership Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling Price</td>
<td>$12,000</td>
</tr>
<tr>
<td>Less Adjusted Basis</td>
<td>8,000</td>
</tr>
<tr>
<td>Gain</td>
<td>$4,000</td>
</tr>
</tbody>
</table>

The $3,000 of gain allocated to the inventory is ordinary income and the gain allocated to other balance of A's interest is capital gain.

b. Example No. 2.

As a result of the fragmentation of the transaction, a selling partner may have both ordinary income and capital loss of the sale of the partnership interests.

For example, assume A has a $10,000 basis for his 1/3 interest in Example No. 1, above.

<table>
<thead>
<tr>
<th>Total</th>
<th>$751 Partnership Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling Price</td>
<td>$12,000</td>
</tr>
<tr>
<td>Less Adjusted Basis</td>
<td>10,000</td>
</tr>
<tr>
<td>Gain or Loss</td>
<td>$2,000</td>
</tr>
</tbody>
</table>
The Code sets forth a separate set of standards for determining the tax consequences of the liquidation of a partner’s entire interest in the partnership. I.R.C. § 736.

A. General.

1. Definitions.

a. Liquidation of a Partner’s Interest.

The "term 'liquidation of a partner's interest' means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership."

(1) In order for the section 736 liquidation of a partnership interest rules to apply, there must be a complete termination of the partner's entire interest. Treas. Reg. § 1.736-1(a)(1)(i).

(2) If a partner in a limited partnership owns both a general and a limited partnership interest, there is no liquidation of the partner’s interest unless his entire general and limited partnership interests are terminated. Chase v. Comm., 92 T.C. 53 (1989).

(3) Section 736 does not apply if the estate or other successor-in-interest of a deceased partner continues as a partner in its own right under local law. Treas. Reg. § 1.736-1(a)(1)(i).

(4) In the event of a non-liquidating sale, the normal rules of section 741 will be applied.

(5) There may be a series of distributions over several years as part of the complete termination of the partner’s interest. Treas. Reg. § 761-1(d).
b. Retiring Partner.

A person retires from the partnership when the person ceases as a partner under local law. Treas. Reg. § 1.736-1(a)(1)(ii).

(1) A partner may retire as a result of a voluntary withdrawal or as a result of expulsion from the partnership. Holman v. Comm., 66 T.C. 809 (1976), aff’d 564 F.2d 283 (9th Cir. 1977).

(2) For the purposes of subchapter K, the retiring partner, or the deceased partner’s successor-in-interest will be treated as a continuing partner until the interest in the partnership has been completely liquidated. Treas. Reg. § 1.736-1(a)(1)(ii). Thus, in the case of a two-person partnership, the partnership will continue on the withdrawal or death of one partner until the partner’s interest is liquidated. I.R.C. § 1.708-1(b)(1)(i)(a). Estate of Skaggs v. Comm., 672 F.2d 756 (9th Cir. 1982), aff’d per curiam 75 T.C. 191 (1980).

B. Purpose of Section 736.

1. Equitable Tax Treatment.

Section 736 has been structured in recognition of the need for equitable tax treatment in making partnership distributions to partners upon the liquidation of interests in the partnership. H.R. Rep. No. 1337, 83d Cong. 2d Sess. 71-72 (1954).

2. Different Elements to Distribution.

Section 736 recognizes that payment may represent many different components:

a. The partner’s interest in the properties of the partnership.

b. All other payments, which are divided between:

(1) the partner’s interest in his distributive share of partnership income; and
(2) other payments determined without regard to income, which are considered deductible guaranteed payments.

I.R.C. § 736(a) and (b)

c. Conflicting Interest Between Partners.

As a result of the conflicting interests of the partner’s, considerable latitude is granted in structuring the character of the liquidating distributions.

(1) If the payment is for the partner’s interest in partnership property, the distribution is nondeductible by the partnership and a capital transaction for the partner with no gain unless a money distribution exceeds basis under section 731.

(2) If the payment is representative of the partner’s distributable share of income, then the entire payment is income to the partner and excludable from the income of the other partners.

C. Payment in Exchange for Interest in Partnership.


Payments made in liquidation of the entire interest of a retiring partner or of a deceased partner is treated as a distribution by the partnership to the extent the payment is made in exchange for the partner’s interest in partnership property. I.R.C. § 736(b).

2. Valuation of Partner’s Interest in Partnership Property.

a. Partners’ Allocation Binding.

"Generally, the valuation placed by the partners upon a partner’s interest in partnership property in an arms-length agreement will be regarded as correct." Treas. Reg. § 1.736-1(b)(1).
b. **Gross Value.**

The partner's interest in partnership property must be valued at its gross value, not its net value (asset minus liabilities). Treas. Reg. § 1.736-1(b)(1).

c. **Liabilities.**

The withdrawing partner will be treated as receiving a constructive cash payment under sections 752(b) and 731 to the extent of the relief of the partner's share of partnership liabilities. Treas. Reg. § 1.736-1(b)(1) and (7), Example (1), Edward H. Pietz, 59 T.C. 207 (1972); Andrew O. Stilwell, 46 T.C. 247 (1966) (section 736(b) applied based on relief of liabilities when no money paid to retiring partner).

3. **Inventory.**

Payments made in exchange for the partner's property will include payments made with respect to partnership inventory, whether or not substantially appreciated. If the inventory is substantially appreciated, then the payment must take into account the application of section 751.

4. **Unrealized Receivables.**

As a general rule, payments to a partner for his interest in unrealized receivables from accounts receivable and unbilled work-in-process are considered made in exchange for the partner's interest in partnership payments. The unrealized receivables will be section 751 assets, subject to ordinary income tax treatment (a sale of other than a capital asset) in the event of a non-pro rata distribution. I.R.C. §§ 751(a), (b) and (c), discussed supra.

5. **Goodwill.**

Generally, payments made to the withdrawing partner in exchange for his interest in partnership property will include his share of goodwill and other section 197 intangibles. I.R.C. §§ 736(b)(2).

Under prior law, section 736(b)(2) provided that payments in exchange for partnership property never included the amount paid for unrealized receivables, and included goodwill only to the extent that the partnership agreement provided for a payment with respect to goodwill. As a result, such payments could be treated as guaranteed payments or distributive share items, reportable as ordinary income to the departing partner and deductible by the partnership or its equivalent as an exclusion from the income of the remaining partners.

7. General Partners in Service Partnerships.

Special rules for the treatment of unrealized receivables and goodwill continue to apply for section 736 payments made in service partnerships where capital is not a material income-producing factor for the partnership, and where the departed partner was a general partner in the partnership. I.R.C. § 736(b)(3).

These special exceptions to the new general rules will permit professional partnerships to continue the prevailing practice of treating a withdrawing partner's share of goodwill and unrealized receivables as guaranteed payments or distributive share items.

a. Capital, as a Material Income-Producing Factor.

The determination of whether capital is a material income-producing factor is to be made under principles of present and prior law. H.R. 2141, § 13262(a) (May 19, 1993).

(1) Gross Income from Services. Capital is not considered a material income-producing factor where substantially all the gross income of the business consists of commissions or other compensation for personal services. H.R. 2141, § 13262(a) (May 19, 1993).

(2) Professional Practices. The practice of a doctor, dentist, lawyer, architect or accountant will not be treated as a business in which
capital is a material income-producing factor, even though there is a substantial capital investment in professional equipment or in the physical plant where the individual conducts the professional practice, so long as the capital investment is merely incidental to the practice. H.R. 2141, § 13262(a) (May 19, 1993).

b. **Unrealized Receivables.**

The portion of the payment made to a withdrawing general partner which is attributable to the value of unrealized receivables in excess of their partnership basis is not considered in exchange for partnership property under section 736(b). Treas. Reg. § 1.736-1(b)(2).

(1) As a consequence, the partnership will treat the portion of the payment attributed to the unrealized receivables as a distributive share of income under section 736(a)(1) or as a deductible guaranteed payment under section 736(a)(2), and the withdrawing partner will have ordinary income for the value in excess of partnership basis. I.R.C. § 736(a).

c. **Goodwill.**

Payments made to the withdrawing general partner in a service partnership in exchange for his interest in partnership property do not include his share of goodwill, unless the partnership agreement expressly provides for a reasonable payment with respect to goodwill. I.R.C. § 736(b)(2), Treas. Reg. § 1.736-1(b)(3).

(1) **Goodwill as Ordinary Income.**

Payment with respect to goodwill would be taxed to the withdrawing partner as ordinary income under section 736(a), and the partnership would treat the goodwill payment as a distributive share or guaranteed payment giving rise to a deduction or exclusion equivalent, and have an exclusion or a deduction for the
payment in the absence of an agreement providing for the payment of goodwill under section 736.

If goodwill has a partnership basis, payment for goodwill is treated as a payment for property under section 736(b) to the extent of partnership's goodwill basis, even when there is no agreement. Treas. Reg. § 1.736-1(b)(3).

(2) Partnership Agreement on Goodwill.

(a) Valuation Binding.

The regulations require that the allocation to goodwill be reasonable and then provide that "Generally, the valuation placed upon goodwill by an arms-length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct." Treas. Reg. § 1.736-1(b)(3).

Recently the Tax Court upheld an agreed amount for goodwill which was lower than the Court referee's valuation, noting that Regulation section 1.736-1(b)(3) set a ceiling for reasonable value, but not a floor. Tolmack v. Comm., T.C. Memo 1991-538, 62 T.C.M. 1102.

(b) Express Provision for Goodwill Required.

The cases have generally applied section 736(b)(2)(B) literally to require an express denomination of the payment to goodwill. V. Zay Smith, 37 T.C. 1033, aff'd 313 F.2d (10th Cir. 1962); Jackson Investment, 41 T.C. 675 (1964).

(c) Amendment Regarding Goodwill.

An amendment to the agreement regarding goodwill may be made after retirement or death, since
partnership agreement amendments are effective for the taxable year if adopted anytime at or prior to the time prescribed for filing the tax return for the year (not including extensions). I.R.C. § 761(c).

8. **Character of Payments Under Section 736.**

   a. **Treatment as Distributions.**

      Generally, payments made in exchange for the partner's share of partnership property are treated as distributions under section 731 with capital gain or loss treatment under section 741.

   b. **Timing Factor.**

      If payments are made over a period of years, initial payments are applied first to reduce basis under section 731 until the withdrawing partner has recovered his full basis. Thus, taxable gain is deferred until basis is recovered and loss would be deferred until all payments have been made. I.R.C. § 731(a).

      (1) The regulations permit the withdrawing partner to apportion the gain or loss to each installment if the installment payments are fixed in amount. Treas. Reg. § 1.736-1(b)(6).

      (2) Income attributed to substantially appreciated inventory would be treated as distributed to the withdrawing partner and sold back to partnership. Treas. Reg. § 1.736-1(b)(4).

9. **Section 751 Assets and Liquidating Distributions.**

   a. **General Rule.**

      To the extent a partner receives a disproportionate distribution of:

      (1) partnership section 751 assets in exchange for all or part of his interest in other property (including money), or
(2) other partnership property (including money) in exchange for all or part of his interest in section 751 assets, then the transaction is treated as a sale or exchange of such property between the distributee and the partnership, as constituted after the distribution.

b. Proportionate Ownership Principle.

Each partner is treated as having an individual ownership interest in each class of partnership assets and to have an adjusted basis and fair market value attributed to his share of each class -- section 751 assets or non-section 751 assets.

(1) If a partner receives his proportionate share of each asset in a liquidating distribution under section 736(b), there is no collapsible partnership problem since the pro rata distribution represents only his interest in each class of assets.

Example: Assume partnership AB has $1,000 in money and $1,000 in substantially appreciated inventory, and that A is a 50% partner. If on liquidation A receives $500 in money and $500 of inventory, section 751(b) is not applicable because there has been no change in proportionate interests.

(2) If a partner receives a disproportionate distribution in either class, the transaction is recharacterized as a sale or exchange. The comparison is made by comparing his interest in each class after the distribution (including any continuing interest in the partnership and the assets distributed to him) with his interest before the transaction.
c. Examples.

(1) Example No. 1.

Assume that partnership ABC has two assets, cash and inventory, and A withdraws from the partnership receiving $900 in cash for her 1/3 interest.

<table>
<thead>
<tr>
<th>Capital</th>
<th>FMV</th>
<th>Assets</th>
<th>Adjusted</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$600</td>
<td>$900 Cash</td>
<td>$900</td>
<td>$900</td>
<td>$900</td>
</tr>
<tr>
<td>B</td>
<td>600</td>
<td>900 Inventory</td>
<td>900</td>
<td></td>
<td>1,800</td>
</tr>
<tr>
<td>C</td>
<td>600</td>
<td>900 Total:</td>
<td>$1,800</td>
<td></td>
<td>$2,700</td>
</tr>
</tbody>
</table>

$1,800 $2,700

The inventory is a section 751(d) asset since it is substantially appreciated inventory. Its FMV of $1,800 is more than 120% of its $900 basis.

Since A has received less than her proportionate 1/3 share of inventory, she is considered to have sold her 1/3 interest in the inventory to the partnership for cash.

A is deemed to have received her proportionate $300 in cash and a distribution of 1/3 of the inventory. She has an adjusted basis of $300 in the inventory, the basis the inventory would have had to her if distributed. Treas. Reg. § 1.751-1 (b)(3)(iii). Section 732 applies a transferred basis to inventory in a liquidating distribution.

She is then deemed to have made a constructive sale of her 1/3 interest in the inventory to the partnership for the $600 in money received in exchange for the inventory. Since her deemed basis is $300, she has $300 of ordinary income.

The partnership has no section 751(b) gain. It used $600 in cash to buy
A's share of the inventory and will have a cost basis in the inventory constructively bought from A for $600, bring the partnership's total basis to $1,200.

(2) **Example No. 2.**

Assume, instead, that the partnership distributed $900 in inventory to A for her 1/3 interest in the partnership.

Since A has received more than her share of inventory, she is considered to have received her proportionate share of cash ($300) and inventory (FMV $600, Basis $300), and then to have purchased additional inventory for $300 from the partnership. A has no section 751(b) income. A has a cost basis of $300 in the inventory purchased, and a basis in the balance of the inventory determined under the normal distribution rules of section 732.

The partnership is deemed to have sold 1/6 of the inventory for $300, with a basis of $150, in exchange for part of A's partnership interests. There is $150 of ordinary income from the sale of inventory which is attributable to partners B and C.

10. **Losses.**

   a. **General Rule.**

   Generally losses are not recognized upon distributions with respect to a partner's interest. I.R.C. § 731(a)(2).

   (1) **Exception.**

   Loss will be recognized when only money, unrealized receivables and inventory are distributed upon the liquidation of a partner's interest.

   (a) Loss is then recognized only to the extent of the excess of the adjusted basis of the partner's interest in the partnership over
the amount of money distributed plus the basis of unrealized receivables and inventory distributed, as determined under section 732.

(b) Any loss recognized on the distribution is considered loss from the sale or exchange of the partnership interest. Treas. Reg. § 1.731-1(a)(3).

(c) Example: Assume A retires with a basis in his interest of $10,000. He receives $5,000 in cash plus inventory with a basis to him under section 732 of $3,000. A will recognize a $2,000 capital loss pursuant to section 732(a)(2). Treas. Reg. § 1.731-1(a)(2) Example (1).

b. Passive Activity Losses.

Suspended passive losses may be recovered on the liquidation of the partner’s interest only to the extent of gain, unless the transaction is a fully taxable transaction under section 469(g).

(1) Guaranteed payments are characterized as interest or compensation for the purpose of the passive loss sales, except to the extent allocated to the withdrawing partner’s interest in unrealized receivables and goodwill. Temp. Reg. § 1.469-2T(e)(2)(ii).

(2) Qualified payments are characterized as active or passive depending on the character of the partnership activities in the hands of the partner when the liquidation of his interest commenced. Temp. Reg. § 1.469-2T(e)(2)(iii).

11. Adjustments to Basis.

a. Basis of Partnership Assets.

Generally the basis of the property of the partnership is not adjusted as a result of a distribution of property to a partner.
unless there has been a section 754 election. I.R.C. § 724(a).

(1) If a section 754 election is in effect, the optional basis adjustments of section 734(b) would be made.

(2) Even though the distribution has been made in exchange for the partner's interest in property under section 736(b), the transaction is not treated as a purchase entitling the partnership to a cost basis under section 1012.

(3) If there is substantially appreciated inventory or unrealized receivables and a constructive purchase under section 751, then the partnership would have a cost basis in the "purchased" inventory or unrealized receivables.

b. Basis to Withdrawing Partner.

If the partner receives property, other than money in the liquidating distribution then the basis in the property distributed (other than money) would be equal to the partner's adjusted basis in the partner's interest in the partnership reduced by money distributed (a substituted basis). I.R.C. § 732(b).

(1) Allocation.

The basis is allocated first to unrealized receivables and then inventory based upon the partnership’s inside basis and then to other assets in proportion to their adjusted basis to the partnership. I.R.C. § 732(c).

12. Adjustments to Partnership Section 197 Intangibles on Redemption of Partner's Interest.

a. Section 197 Intangibles Retained by the Partnership.

A payment to a retired partner under section 736(b) in exchange for his
interest in partnership goodwill is treated as a distribution, which will permit an optional basis adjustment to partnership assets under section 734(b).

If the partnership makes a section 754 election, then the partnership will be entitled to treat the stepped-up basis allocated to goodwill (and other section 197 intangibles) as amortizable over the 15-year period permitted under section 197.

b. **Liquidating Distribution of Section 197 Intangibles.**

Section 732(b) provides that upon the liquidation of a partner's interest, the distributed properties (other than money) will take on a substituted basis equal to the partner's basis in his partnership interest, reduced by money received.

If a section 197 intangible is distributed to the withdrawing partner in exchange for his interest under section 736(b), then the distributee partner will be treated as the transferor partnership for the purposes of applying the section 197 amortization rules to the extent that the adjusted basis of the withdrawing partner does not exceed the adjusted basis of the partnership. I.R.C. § 197(f)(2). Thus, the transferee partner would not be able to transmute pre-section 197 non-amortizable intangibles into post-enactment amortizable section 197 intangibles, except to the extent that there is an increase in the basis of the intangibles, in the hands of the former partner.

D. **Other Payments.**

1. **General Rule.**

Any payment made by the partnership in liquidation of the interest of a withdrawing partner is a payment from Partnership income under section 736(a), to the extent it is not a payment for a partnership property interest under section 736(b).
a. **Payments to General Partner of Service Partnership.**

(1) **Unrealized Receivables.** Payments made to a general partner of a service partnership for unrealized receivables are always section 736(a) income to the extent the FMV of unrealized receivables exceed the partnership's basis. Treas. Reg. § 1.736-1(a)(3).

(2) **Goodwill.** A payment made to a general partner of a service partnership for goodwill is section 736(a) income to the extent there is no agreement providing for payment for goodwill under section 736(b). Treas. Reg. § 1.736-1(a)(3).

2. **Distributive Share of Partnership Income.**

An income payment will be treated as a distributive share of partnership income if the amount of payment is determined with regard to partnership income of the partnership.

a. **Character.**

The amount and character of such income to the partner will be determined under the normal rules for determining items of income gain, loss, deductions, or credits under section 702. Treas. Reg. § 1.736-1(a)(4).

b. **Allocation.**

The allocation of the distributive share of income to the withdrawing partner will result in a concurrent exclusion of the share from the income of the other partners. Treas. Reg. § 1.736-1(a)(4).

c. **Example.**

Assume withdrawing partner A is entitled to receive 5% of the partnership net income for 3 years. In the first year, the partnership has $1,000 of capital gain and $1,000 of ordinary income. A will be allocated $50 of capital gain, $50 of ordinary income, will increase her basis
in her interest for $100 of income and
decrease it for $100 of distribution.


Income payments which are determined without
regard to income of the partnership are treated
as guaranteed payments under section 707(c).
I.R.C. § 736(a); Treas. Reg. § 1.736-1(a)(4).

a. Guaranteed payments are included in the
recipient's ordinary income under
section 61(a).

b. Guaranteed payments are deductible by the
partnership under section 162(a). Treas.
Reg. § 707-1(c). See Cagle v. Comm.,
63 T.C. 86 (1974), aff'd 539 F.2d 409
(5th Cir. 1976).

(1) The Service has ruled that a "gross
income" allocation is a guaranteed
payment. Rev. Rul. 81-300, 1981-2 CB
143.

(2) A covenant not to complete may be
obtained by providing for a
guaranteed payment which will
terminate if the withdrawing partner
engages in competition. See
Schulz v. Comm., 295 F.2d 52
(9th Cir. 1961); Goldberg v. Comm.,
23 T.C.M. 1713; and Schmitz v. Comm.,
51 T.C. 306 (1968), generally
treating payments as goodwill where
not clearly a guaranteed payment.

4. Year of Income.

Payments of ordinary income under section
736(a) are included in the recipient's income
for the withdrawing partner's taxable year
within (or with) which the partnership taxable
year ends, for which the payment is a
distributive share, or the payment is a
deductible guaranteed payment. Treas. Reg.
§ 1.736-1(a)(5).

5. Section 751 Not Applicable to Section 736(a)
Income.

The collapsible partnership rules of
section 751 do not apply to payments of income
to withdrawing partners under section 736(a).
E. Summary of Tax Consequences for Payments Upon Liquidation of Partnership Interest.

1. Unrealized Receivables.

Payments made to a partner for his interest in unrealized receivables from accounts receivable and unbilled work-in-process are treated as distributions made in exchange for the partner’s interest in the receivables. Such payments will be subject to the ordinary income collapsible partnership rules of section 751(b).

However, if the payment for the unrealized receivable is to a general partner in a service partnership, the payment will be treated as a distributive share item or as a guaranteed payment under section 736(a).

2. Goodwill.

Payments for goodwill are treated as distributions in exchange for the partnership interest.

However, if payments are to a general partner in a service partnership, payments for goodwill are taxed as a distributive share item or as a guaranteed payment under section 736(a), unless the partnership agreement specifically provides for such payment. If the agreement provides for the payment of goodwill, then it will be treated as a distribution payment in exchange for the partnership interest.

3. Substantially Appreciated Inventory.

Payments for substantially appreciated inventory are exchange payments under section 736(b) and are subject to ordinary income tax treatment under the collapsible partnership rules of section 751(b).

a. Payments to the withdrawing partner for his interest in substantially appreciated inventory is for the purchase of the inventory and will entitle the partnership to a cost basis.
4. **Other Partnership Property.**

Payments made to the partner in exchange for other partnership properties are taxed as distributions under section 731 and will result in capital gain or loss to the withdrawing partner under section 741.

5. **Special Basis Adjustments.**

If the election under section 754 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 payments to the withdrawing partner for other partnership properties.

6. **Other Payments From Partnership Income.**

All other payments will be considered as a distributive share of partnership income to the extent determined with regard to income. The recipient will have income as determined under the partnership income rules of section 702 and the other partners will exclude this share from their income.

7. **Other Payments, Determined Without Regard to Income.**

All other payments determined without regard to income will be guaranteed payments deductible by the partnership under section 162 and reportable as income to the partner under section 61(a).

**F. Examples.**

*(Treas. Reg. § 1.736-1(b)(7) Example 1).*

1. **Example No. 1.**

*(Service General Partnership -- Fixed Total Payment)*

ABC is a professional service general partnership (a law firm) with the following balance sheet:
Assume attorney A retires from the partnership. The partnership assumes his $1,000 share of liabilities and agrees to pay him $29,000 cash; $9,000 upon termination and $10,000 each of the next two years. The total retirement price is $30,000.

a. **Payment to A for Partnership Property.**

The value of A's interest in the property of the partnership, for purposes of section 736(b) is $12,000 (1/3 of the cash of $13,000 and 1/3 of the section 1231 assets of $23,000). The unrealized receivables are not included in determining the payment for property under section 736(b).

A's basis in the partnership is $11,000 (capital account of $10,000, plus $1,000 share of liabilities).

A has a capital gain of $1,000 from the disposition of his interest in partnership properties ($12,000 value of property interest less $11,000 basis).

b. **Balance of Payment Made to A.**

The $18,000 balance of the $30,000 payments to be made to A will be treated as a guaranteed payment to A under sections 736(a) and 707(c) since the payments are determined without regard to partnership income.
c. **Annual Treatment of Payments.**

The $10,000 received each year is allocated between section 736(a) and section 736(b) payments. In the first year A receives $9,000 in cash and $1,000 as a relief of liabilities.

$4,000 is allocated as a payment for partnership property under section 736(b). ($10,000 x $12,000/$30,000.)

The $4,000 is a distribution in liquidation of A's partnership interest under section 731. The $1,000 gain from the liquidation will be taxed as capital gain when the final payment exceeds basis in the third year. A may elect to report the gain pro rata as part of each payment.

$6,000 is allocated to the guaranteed payment and is taxed to A as received. Presumably this is payment for A's share of the unrealized receivables and goodwill (there was no agreement to treat the goodwill as a section 736(b) asset).

2. **Example No. 2.**

(Non-fixed Amount)

Assume in Example No. 1 that A is to receive a percentage of annual income for three years instead of a fixed amount.

Then, all payments received by A up to $12,000 would be treated as payments for A's interest in partnership property under section 736(b).

His capital gain of $1,000 would be taxed only after he has recovered his basis under section 731.

Any payment in excess of $12,000 would be treated as a distributive share of partnership income to A under section 736(a)(1).

G. **Other Consequences.**

1. **Holding Period on Distributed Property.**

The holding period given to the withholding partner on property acquired in the
distribution includes the holding period of the partnership. I.R.C. § 735(b), § 1223.

2. Gain or Loss on Partner's Resale of Distributed Unrealized Receivables and Inventory.
   a. Unrealized Receivables.

   Gain or loss on a later disposition by the withdrawing partner of unrealized receivables distributed by the partnership will be ordinary income or ordinary loss. I.R.C. § 735(a)(1).

   b. Inventory.

   Gain or loss on a later sale by the withdrawing partner of any inventory received will be considered ordinary income or ordinary loss, if sold within 5 years of the date of distribution.

   a. Distributions in liquidation of a partner's interest are required to be made in accordance with the positive capital account balances of the partners in order to have substantial economic effect. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2).

   b. If the partnership agreement has a deficit capital account makeup requirement, it will be triggered upon liquidation of the partner's interest in the partnership. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2).

H. Comparison of Liquidation With Sale on Exchange of Partnership Interest.

1. General.

Upon the termination of a partner's interest in the partnership, there is substantial flexibility in planning. The partner may have the opportunity to choose between a liquidation of the partner's interest with the partnership or a direct sale to the other remaining partners. This flexibility is consistent with the aims of congress, recognizing the conflicting tax consequences between the parties. The Tax Court recently re-confirmed that the partners have complete flexibility to structure a termination of interest as a

2. Various Planning Considerations.

a. Upon the sale of a partnership interest, the selling partner has capital gain, except as provided in section 751. The purchaser is not entitled to a deduction on the payment of the purchase price.

b. If the partner liquidates his interest in the partnership, any gain in excess of the gain attributed to his interest in partnership properties under section 736(b) will be taxed to him as ordinary income. The partnership will be entitled to a deduction for guaranteed income payments or to exclude the amount from the income of the remaining partners under section 736(a).

c. In a liquidation, the parties to a service partnership have substantial flexibility in planning the tax consequences of goodwill. If provided in the agreement, the withdrawing general partner will have capital gain and the partnership no deduction. Conversely, if goodwill payments are not specifically provided for, the withdrawing general partner will have ordinary income and the partnership an offsetting deduction or exclusion of income for the other partners.

d. Liquidation will permit the withdrawing partner to recover basis first as a result of periodic payments received in exchange for his interest in partnership properties under section 736(b). In an installment sale gain must be reported on a pro rata basis under section 453.

e. Loss would be recognized on an installment sale. In a liquidation, recognition of loss is allowed only when payments are received in money, unrealized receivables and inventory.

f. The choice may be affected by the termination of the partnership taxable year. There is a termination upon the sale or exchange of 50% or more of the partnership interests in capital and
profits, but there is no termination of the partnership on the disposition of an interest by gift, inheritance, or the liquidation of the interest.

g. A deficit capital account restoration requirement would be triggered by a liquidation but not generally by a sale or exchange.

h. Original issue discount rules and imputed interest rules apply to sales or exchanges of partnership interests, but are not applicable to payments made in a liquidation in the partner’s interest in partnership properties.

IX. TRANSFERS TO OR FROM CORPORATIONS.

A. Transfers of Partnership Interests to a Corporation.

1. Taxable Transaction.

The transfer of a partnership interest to a corporation in exchange for stock of the corporation is a taxable exchange under section 1001. The gain realized by the partners is the FMV of the stock received and the transaction is taxable to the transferor partner under the general rules of subchapter K applicable to sales or exchanges of partnership interest.

2. Application of Section 351.

Section 351 is applied to determine whether gain or loss is recognized upon the transfer of a partnership interest to a corporation in exchange for stock of the corporation. Generally no gain or loss is recognized if the transferors of property are in at least 80% control of the corporation immediately after the exchange. I.R.C. §§ 351(a) and 368(c).

3. Partnership with Liabilities.

a. Assumption of Liabilities Under Section 357.

(1) Section 752(d) provides that in the case of a sale or exchange of a partnership interest, the liabilities will be treated in the same manner as liabilities in connection with the
sale or exchange of property not associated with partnerships.

(a) Thus, the transferor's share of partnership liabilities will be subject to the normal liability rules of section 357 in a section 351 transfer.

(2) If property is transferred to a corporation under section 351 and the corporation assumes a liability of the taxpayer or takes the property subject to a liability, then the assumption or acquisition is not treated as a money or other taxable boot. I.R.C. § 357(a).

(3) However, if the sum of the liabilities assumed or if the amount of the liabilities to which the transferred property is subject exceeds the aggregate adjusted basis of the property transferred, then the excess is considered a taxable gain. I.R.C. § 357(c).

b. Application of Section 357(c) to Partnership Interest.

(1) When the contributing partner's share of partnership liabilities exceeds the adjusted basis of his partnership interest (including his allocable share of partnership liabilities), he has a taxable gain under section 357(c) as a result of the transfer of his partnership interest to the corporation.

(2) When the contributing partner's share of partnership liabilities is less than the adjusted basis of his partnership interest, then section 357(c) is not applicable and no gain will result as a result of transferred liabilities.

(a) If the partnership has no liabilities or if the interest transferred is a limited partnership which has no nonrecourse liabilities, no gain
would be recognizable under section 357(c).

(3) The application of section 357(c) to a partnership can generally be determined by examining the capital account of the transferor partner. If the partner's capital account has a credit balance, the adjusted basis of the partner's partnership interest will exceed his partnership liabilities and there will be no gain on the transfer of partnership interest. If the partner has a negative capital account, his share of partnership liabilities will exceed the adjusted basis of his partnership interest, and he will have a gain under section 357(c). The capital account test works because a partner's share of liabilities is reflected in the basis of his partnership interest but is not reflected in his capital account.

c. Tax Avoidance.

If the purpose of the transfer of the liability is to avoid federal income tax or if there is no bona fide business purpose, then the total amount of the liability assumed or acquired would be treated as boot. I.R.C. § 357(b).

d. Cases.

In the earlier Jackson v. Comm. Ninth Circuit decision, 708 F.2d 1402 (9th Cir. 1983), the court erroneously concluded that the relief of excess liabilities in the partnership could not be a gain. Recently in Owen v. Comm., 881 F.2d 832 (9th Cir. 1989), the Ninth Circuit has suggested that Jackson was erroneous based on the conclusion that the Jackson decision was determined without the benefit of the Tufts doctrine.

B. Transfers of Partnership Interest by a Corporation.

1. Distributions in Liquidation.

Gain or loss will be recognized to the liquidating corporation on the distribution of
a partnership interest in complete liquidation as if the partnership interest were sold to the distributee at its fair market value. I.R.C. § 336(a).

a. **Treatment of Liabilities.**

For the purpose of computing gain on the distribution of a partnership interest, the fair market value of the properties transferred shall be treated as not less than the amount of the liabilities assumed or acquired by the transferee. I.R.C. § 336(b).

2. **Distribution to Shareholder.**

a. **Gain Recognized to Corporation.**

On the distribution of a partnership interest owned by a corporation to its shareholder, the corporation will recognize gain to the extent that the fair market value exceeds its basis in the partnership interest. I.R.C. § 311(b)(1).

(1) For the purpose of determining the fair market value, the fair market value of the properties transferred shall not be less than the amount of the liabilities assumed or acquired by the shareholder. I.R.C. § 311(b)(2).

(2) The Secretary is authorized to issue regulations providing that the amount of gain recognized in a section 311(b) transaction shall be computed without regard to any loss attributable to property contributed to the partnership, whose interest is being transferred. I.R.C. § 311(b)(3).

(3) The Service announced in Notice 89-37 (March 9, 1989) that, if a partnership distributes to its corporate partner, stock of that corporate partner, the distribution should be treated as a redemption of the corporate partner's own stock with property consisting of its partnership interest. Therefore, the Service intends to issue regulations
providing that section 311(b), rather than the general nonrecognition rule of section 731(a), will be applied whenever a corporate partner receives a distribution of its own stock from the partnership.