

2013

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Repository Citation

Sowell, James B., "I Want Out – Tax Considerations In Exiting a Partnership" (2013). *William & Mary Annual Tax Conference*. 693.
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I Want Out – Tax Considerations In Exiting a Partnership

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November 8, 2013
Williamsburg, VA

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Forms of Exit

- **Exit for cash**
 - Sale
 - Redemption
- **Exit for property**

Exit for Cash

- **Sale of partnership interest**

Issues for Seller

- **Gain or loss recognized**
 - Amount realized
 - Adjusted basis of partnership interest
- **Character of gain or loss**
- **Holding period of partnership interest**
- **Availability of installment method**
- **Loss disallowance**

Issues for Purchaser and Other Partners

- **Basis adjustments**
 - Amortization/anti-churning
- **Share of section 704(c) gain or loss**
- **Termination of partnership**

Hypothetical Partnership

- Partnership (“PRS”) owns and operates a sporting goods store.
- Three partners: Donovan (50%), Mike (25%), and Dan (25%).
- Each partner acquired his interest for cash upon the formation of PRS in 1992.
- Capital call was made on July 1, 2013. Donovan contributed \$150, and Mike and Dan each contributed \$75. (Contribution doubled the value of each partner’s partnership interest.)
- Donovan’s partnership interest has a fair market value of \$300 and adjusted basis of \$200. Mike’s and Dan’s interests each have a fair market value of \$150 and adjusted basis of \$100.

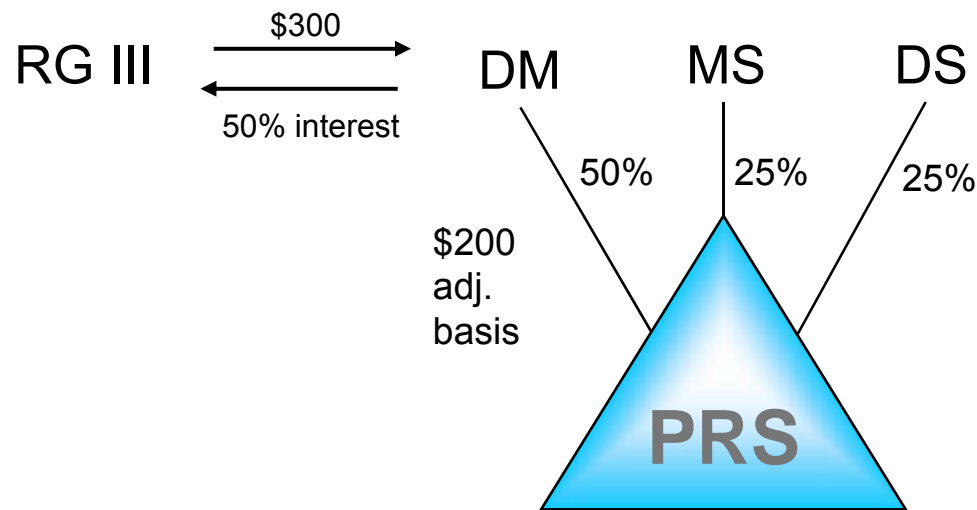
Hypothetical Partnership

■ Partnership Balance Sheet

<u>Assets</u>			<u>Liabilities & Capital</u>		
	<u>Tax</u>	<u>Book</u>		<u>Tax</u>	<u>Book</u>
Cash	\$300	\$300	Liabilities	0	0
Inventory	\$50	\$100	Capital		
.			Donovan	\$200	\$300
Land & Bldg	\$50	\$100	Mike	\$100	\$150
Goodwill	<u>\$0</u>	<u>\$100</u>	Dan	<u>\$100</u>	<u>\$150</u>
Total	\$400	\$600		\$400	\$600

■ \$40 of straight-line depreciation previously taken with respect to building

Sale of Entire Interest – Gain Recognized



- Donovan sells his entire interest in PRS to RG III for \$300 cash.
- Gain recognized is \$100. Amount realized (\$300) – adjusted basis (\$200).

Sale of Entire Interest – Character

- **General rule: gain or loss from the sale or exchange of a partnership interest is capital. IRC §741.**
- **However, to the extent that the amount is received in exchange for the partner's share of unrealized receivables or inventory items (i.e., section 751 property), such amount will be treated as an amount realized from the sale or exchange of property other than a capital asset. IRC §751(a).**
- **A partner's income or loss from section 751 property is equal to the income or loss from section 751 property that would have been allocated to the partner (to the extent attributable to the interest sold) if the partnership had sold all of its property for fair market value immediately prior to the partner's sale of its partnership interest. Treas. Reg. §1.751-1(a)(2).**

Sale of Entire Interest – Character

- In the exchange, inventory is a section 751 asset. If the inventory were sold for its fair market value (\$100), the gain recognized by the partnership would be \$50. One-half of that gain, or \$25, would be allocated to the interest disposed of by Donovan.
- Of the \$100 gain recognized by Donovan, \$25 would be ordinary income and \$75 would be capital gain.

Sale of Entire Interest – Holding Period

- **If a partner sells its entire interest in a partnership, any capital gain or loss will be divided between short-term and long-term in the same proportions as the holding period of the partnership interest is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less. Treas. Reg. §1.1223-3(c)(1).**
- **A partner will have a divided holding period when the partner acquires portions of an interest (1) at different times or (2) at the same time via contributions of property that give rise to different holding periods. Treas. Reg. §1.1223-3(a).**

Sale of Entire Interest – Holding Period

- The portion of a partnership interest to which a holding period relates is determined by reference to a fraction:

**Fair market value of portion of partnership interest
to which holding period relates**

Fair market value of entire partnership interest

- **Treas. Reg. §1.1223-3(b)(1).**

Sale of Entire Interest – Holding Period

- **On July 1, 2013, Donovan contributed \$150 to PRS. Immediately after the contribution, the value of Donovan’s interest was \$300.**
- **As a result of the cash contribution, one-half of Donovan’s interest is considered to have been held for one year or less. This is the case even though Donovan did not increase his proportionate interest in PRS as a result of the contribution. Treas. Reg. §1.1223-3(f), Ex.4.**
- **Accordingly, one-half of the \$75 capital gain recognized by Donovan on the sale of his partnership interest is short-term and one-half is long-term.**

Sale of Entire Interest – Unrec. Sec. 1250 Gain

- **As a result of the 1997 Act, there are multiple capital gains rates. While most long-term capital gains are taxed at 20%, unrecaptured section 1250 gain is taxed at a rate of 25%. In addition, collectibles gain is taxed at a rate of 28%.**
- **Section 1250 capital gain means the capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100%.**
- **Rules similar to section 751(a) apply in determining the characterization of long-term capital gain recognized in connection with the sale of a partnership interest. Treas. Reg. §1.1(h)-1(b).**

Sale of Entire Interest – Unrec. Sec. 1250 Gain

- PRS has taken \$40 of straight-line depreciation with respect to the building.
- If the real property (i.e., section 1250 property) were sold for its fair market value (i.e., \$100), \$25 of capital gain would be allocated to Donovan.
- One-half of Donovan's interest in PRS has a long-term holding period, so one-half of that gain (i.e., \$12.50), would be long-term capital gain under the section 1(h) regulations. Cf. Treas. Reg. §1.1(h)-1(f), Ex. 5.
- PRS has taken \$40 of straight-line depreciation with respect to the building. That accounts for 4/5 of the gain. Accordingly, it appears that 4/5 of the long-term capital gain with respect to the building (i.e., \$10) would be treated as section 1250 capital gain.

Sale of Entire Interest – End Result

- **The \$100 of gain recognized by Donovan on the sale of his partnership interest would be taxed as follows:**
 - \$25.00 of ordinary income
 - \$37.50 of short-term capital gain
 - \$10.00 of unrecaptured section 1250 gain (potentially taxable at 25% rate)
 - \$27.50 of 20% rate long-term capital gain.

Issues of Interest to Purchaser

- **RG III will want PRS to have a section 754 election in effect for the year of transfer. This will permit him to enjoy a \$100 positive basis adjustment under section 743(b) with respect to the PRS property.**
- **Because Donovan and RG III are unrelated, the portion of RG III's section 743(b) basis adjustment that is attributable to goodwill will be amortizable over 15 years. Treas. Reg. §1.197-(h)(12)(v).**
- **If Donovan had a share of section 704(c) property (which he does not in this case), RG III would succeed to his share. Treas. Reg. §§1.704-3(a)(7); 1.704-4(d)(2); 1.737-1(c)(2)(iii).**

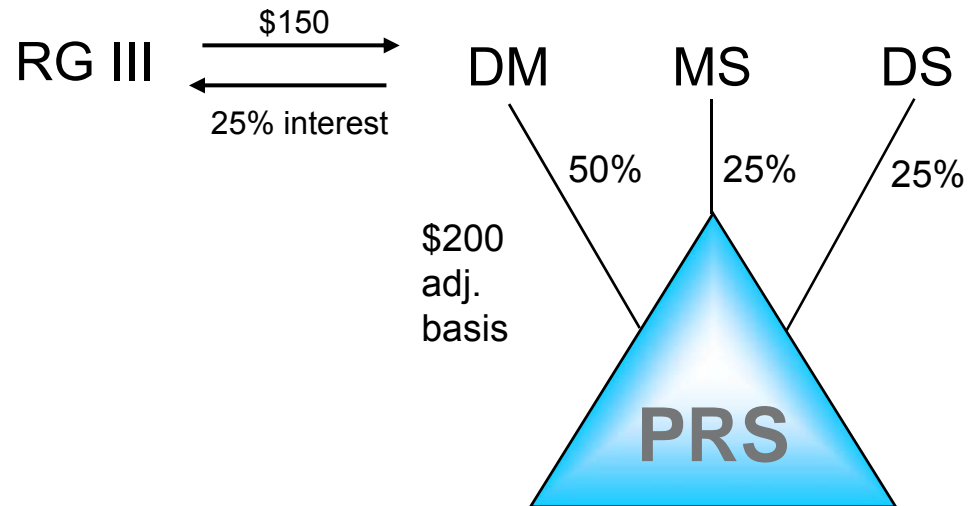
Issues of Interest to Purchaser and Remaining Partners – Partnership Terminations

- A partnership will be treated as terminated if, within a 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. IRC §708(b)(1)(B); see generally E. Sloan, M. Opper, and T. Lee, Let's Get Technical: Partnership Terminations, 2013 Tax Notes Today 200-3 (pt. 1); 2013 Tax Notes Today 205-6 (pt. 2).
- Primary consequences are: (1) short taxable year for partnership; (2) restart depreciable lives of tangible assets; and (3) trigger section 481 adjustments.
- Because RG III acquired a 50% interest in the capital and profits of PRS, there was a termination under section 708(b)(1)(B).
- This affects Mike and Dan, as well as RG III.

Issues of Interest to Purchaser and Remaining Partners – Partnership Terminations

- **Ways to avoid terminations under section 708(b)(1)(B).**
 - 50% partner retains a de minimis interest for a year and a day. PLRs 9805017, 8517022, and 8404027.
 - Have remaining partner or partners contribute capital so that transfer is not 50% of capital and profits. Cf. PLR 9148041.
 - Combination of sale and redemption transactions.

Sale of Partial Interest



- Instead of selling his entire interest, Donovan sells only one-half of his interest in PRS to RG III for \$150 cash.

Sale of Partial Interest

- Rev. Rul. 84-53, 1984-1 C.B. 159, provides that the adjusted basis of the interest sold generally should be determined based on the following formula:

$$\text{Total adjusted basis} \times \frac{\text{Fair market value of interest transferred}}{\text{Total fair market value of interest}}$$

- If the partner also has a share of partnership liabilities under section 752, the portion of the partner's basis attributable to liabilities initially is excluded in undertaking the calculation described above. The amount of liabilities considered discharged upon transfer (under section 752(d)) then is added to determine the total adjusted basis of the interest transferred.
- The holding period of the interest sold generally is divided in the same proportions that it would be if the entire interest were sold. Treas. Reg. §1.1223-3(c)(1). (May specifically identify units sold for holding period purposes in limited situations involving PTPs.)

Sale of Partial Interest

- **Adjusted basis = \$100**

$$\text{\$200 (total AB)} \times \frac{\text{\$150 (FMV of int. sold)}}{\text{\$300 (Total FMV of int.)}}$$

- **Gain recognized of \$50 = \$150 (amt. real.) - \$100 (adj. basis)**
- **Proportionate breakdown between section 751(a) ordinary income and short-term, long-term, 25% rate, and 20% rate gain is the same as for sale of entire interest.**

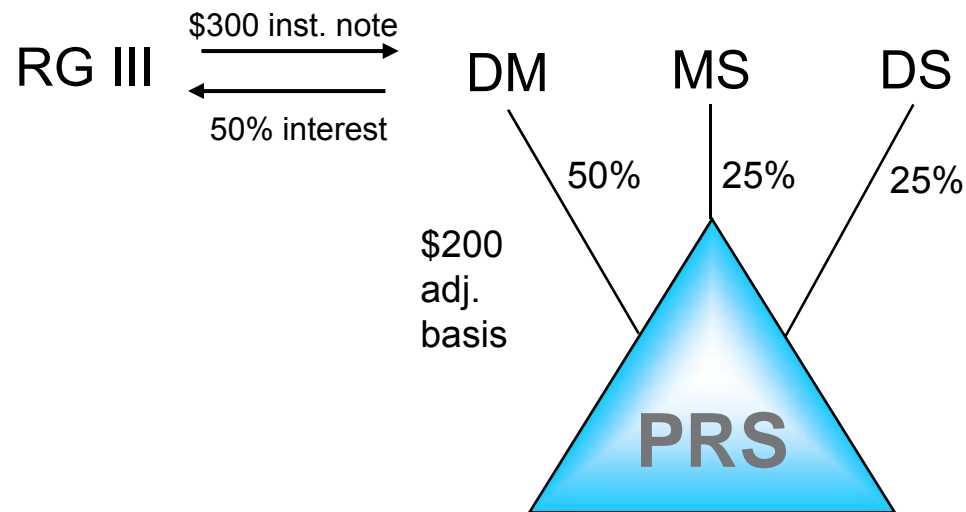
Sale of Partial Interest

- Rev. Rul. 84-53, 1984-1 C.B. 159, provides a different basis allocation methodology when the transferring partner has a negative tax capital account (i.e., share of liabilities in excess of adjusted basis):

$$\text{Total adjusted basis} \times \frac{\text{Liabilities considered discharged upon transfer}}{\text{Total liabilities attributable to interest}}$$

- For example, assume a person has an adjusted basis with respect to its partnership interest of \$100x and has a share of liabilities under section 752 equal to \$1000x. The liability is allocated pursuant to a partner guarantee.
- This person transfers one-half of its partnership interest but retains full responsibility pursuant to the guarantee.
- As a result of the continued obligation under the guarantee, this person would not be considered discharged from any portion of its liability share as a result of the transfer. Thus, no portion of the partner's adjusted basis would be allocated to the transferred interest. Similarly, no portion of the partnership liabilities would be treated as amount realized under section 752(d).

Sale of Entire Interest - Installment Note



- Instead of selling his interest for cash, Donovan sells for a three-year installment note. Note provides for three annual payments of \$100 (plus adequate stated interest). (No payment will be received in the taxable year of sale.)

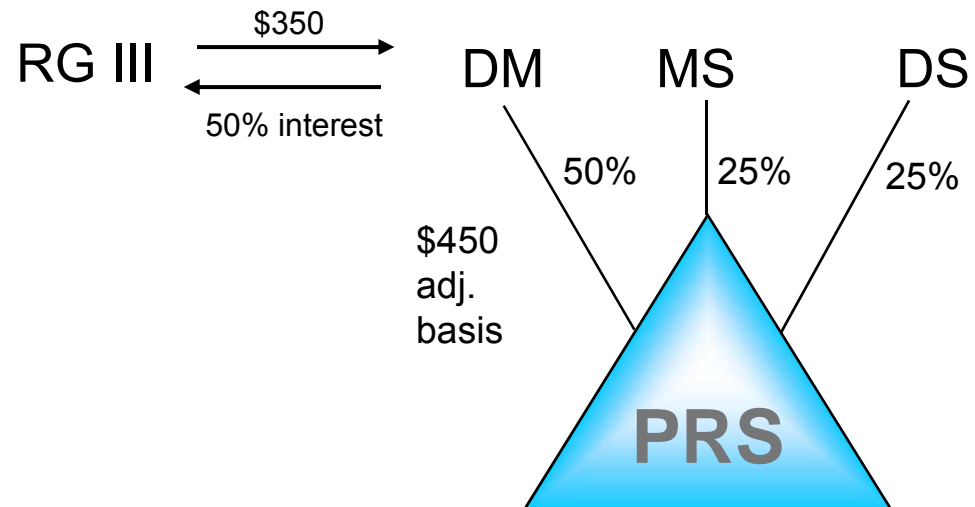
Sale of Entire Interest - Installment Note

- The sale of inventory property is not eligible for installment reporting. Rev. Rul. 89-108, 1989-2 C.B. 100, provides that income from the sale of a partnership interest may not be reported on the installment method to the extent that it represents income attributable to the partnership's inventory. See also *Mingo v. Commissioner*, T.C. Memo. 2013-149 (denying eligibility for installment method to the extent of gain attributable to unrealized receivable related to customer receivables for consulting services).
- Treas. Reg. §1.453-12 requires front loading of 25% rate gain under the installment method.

Sale of Entire Interest - Installment Note

- **\$25.00 of ordinary income is not eligible for installment treatment and will be recognized in the year of sale.**
- **The remaining \$75 of gain should be recognized as the payments are received.**
- **Assume that payments attributable to the inventory are treated as spread evenly over three years. Accordingly, the remainder of the property is treated as being acquired for a \$250 note with equal payments being made over three years.**
- **In the year of the first payment, \$12.50 would be short-term capital gain, \$10 would be 25% rate long-term capital gain, and \$2.50 would be 20% rate long-term capital gain.**
- **In the following two years, \$12.50 would be short-term capital gain, and \$12.50 would be 20% rate long-term capital gain.**

Sale of Entire Interest – Capital Loss



- Suppose PRS also owned shares of stock in an old internet company with an adjusted basis of \$500 and a value of \$100.
- The adjusted basis of Donovan's interest now would be \$450 (\$200 + \$250) and the value of his interest would be \$350 (\$300 + \$50). Accordingly, Donovan would have a \$100 overall loss in his interest.

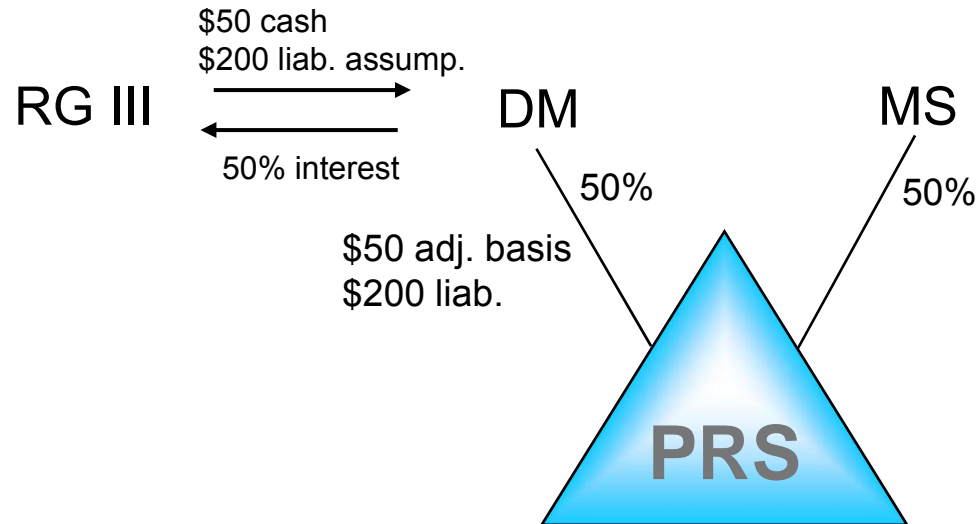
Sale of Entire Interest – Capital Loss

- However, section 751(a) and 1(h) rules create ordinary income and 25% rate gain to the extent that such income and gain is present with respect to the property of the partnership. Treas. Reg. §§1.1(h)-1(f), Ex. 4, 1.751-1(g), Ex. 1. Accordingly, Donovan still would recognize ordinary income and section 1250 capital gain. Donovan's residual capital loss would be greater than \$100.
- What if Donovan and RG III were brothers? See IRC §267(a)(1).
- What if the partnership does not make a section 754 election?

Sale of Entire Interest – Liability Relief

- **Mike and Donovan entered into a real estate partnership (“PRS”) in 1968. Acquired depreciable real property for \$400.**
- **Borrowed \$400 on a nonrecourse basis to acquire the property. Balloon note is due in 2018, with interest-only payments until maturity.**
- **Property has been depreciated for tax purposes so that, in 2013, the adjusted basis is \$100.**
- **Value of property is now \$500.**
- **Mike and Donovan each has a \$50 adjusted basis in his partnership interest. Each has a \$200 share of liabilities under section 752. (Losses attributable to depreciation have been taken using debt basis. Creates a “negative tax capital account.”)**

Sale of Entire Interest – Liability Relief



- **Donovan sells his entire interest to RG III for \$50 cash.**
- **Section 752(d) provides that, where a partnership interest is sold or exchanged, liabilities will be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.**

Sale of Entire Interest – Liability Relief

- Amount realized is \$250: \$50 cash + \$200 (share of liability shifted to RG III).
- Gain recognized = \$200 (\$250 amount realized - \$50 adjusted basis).
- Note that, if Donovan had sold his interest for an installment note, the liability relief would be treated as a payment received in the first year. Rev. Rul. 76-483, 1976-2 C.B. 131.

Rev. Rul. 99-6 – Sale of Interest to Sole Remaining Partner

- **Where a partner sells its entire partnership interest to the sole remaining partner:**
 - The transferor is treated as selling a partnership interest, but
 - The transferee is treated as acquiring assets.
- **Sections 741 and 751 apply to determine character of gain or loss to transferor.**
- **Section 754 election is not necessary for transferee to get a step-up (or suffer a step-down) in the acquired assets.**
- **Be careful of section 197 anti-churning rules where remaining partner was a greater than 20% partner before the transfer.**
- **For a broad discussion of issues implicated under Rev. Rul. 99-6, [see NYSBA Tax Section Submits Report on Partnership Guidance, 2011 Tax Notes Today 114-19.](#)**

Rev. Rul. 99-5 – Sale of Interest in Single Member LLC

- **A sale of less than all of the interests in a single member LLC creates a partnership for federal tax purposes.**
- **The transaction is treated as a sale of an undivided interest in the entity's assets to the transferee.**
- **The transferor and transferee then are deemed to contribute their relative shares of the LLC's assets to a newly-formed partnership.**
- **Creates new seven-year period for sections 704(c)(1)(B) and 737, and a two-year period for purposes of the disguised sale rules under section 707(b).**

Rev. Rul. 99-5 – Sale of Interest in Single Member LLC

- **Be careful of section 197 anti-churning rules if transferor will have a greater-than 20% interest in the newly-formed partnership. May be better off forming an “in-house” partnership and selling an interest in the pre-formed partnership to benefit from favorable anti-churning rules for section 743(b) basis adjustments. See Treas. Reg. §1.197-2(k), Ex. 19.**

Exit for Cash

- **Redemption/partial liquidation**

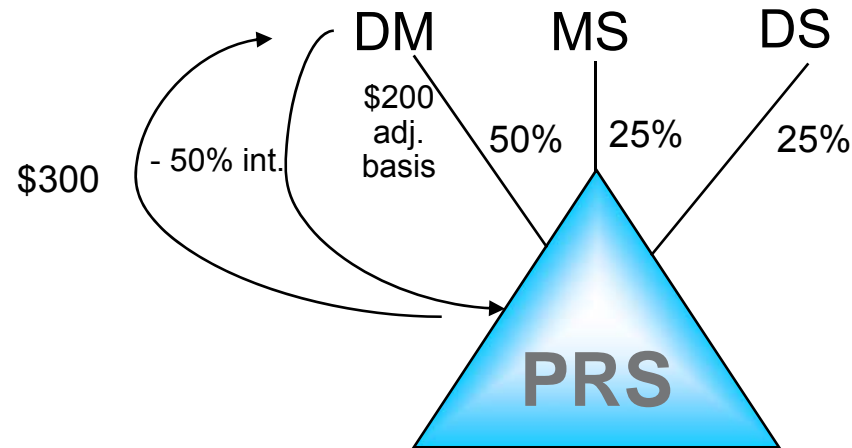
Disposition of Entire Interest

- **Instead of having RG III purchase Donovan's interest, Mike and Dan decide that they would prefer to run the partnership themselves.**
- **Two options for taking out Donovan:**
 - Mike and Dan can each purchase one-half of Donovan's interest.
 - PRS can distribute \$300 cash in redemption of Donovan's interest.

Distinguishing Between Sales and Redemptions

- Taxpayers have quite a bit of flexibility in structuring buy-outs of a partner.
- Of primary importance is the form of the transaction. See generally Foxman v. Commissioner, 41 T.C. 535 (1964), aff'd, 352 F.2d 466 (3d Cir. 1965); Cooney v. Commissioner, 65 T.C. 101 (1975).
- The source of funds also may be a factor. Cf. Priv. Ltr. Rul. 9715008 (Dec. 4, 1996); Prop. Reg. §1.707-7 (proposed regulations on disguised sale of partnership interests; now withdrawn).

Redemption of Entire Interest – Gain



- PRS redeems Donovan's entire interest for \$300.
- Generally, gain is recognized in connection with a partnership distribution only to the extent that the cash distributed exceeds the partner's basis in his interest immediately before the distribution. I.R.C. §731(a)(1).
- However, it is important to take section 751(b) into account in analyzing partnership distributions.

Redemption of Entire Interest – Section 751(b)

- **Section 751(b) applies where a partner receives more or less than his share of “hot assets” (i.e., substantially appreciated inventory or unrealized receivables) in connection with a distribution.**
- **Inventory held by PRS is substantially appreciated, and thus is a hot asset. Donovan receives all cash (i.e., not a hot asset). Accordingly, section 751(b) treats Donovan as receiving part of his cash in exchange for his share of hot assets.**
 - Proposal in House Ways and Means Committee Chairman Camp’s Small Business Discussion Draft would eliminate “substantially appreciated” requirement for inventory to be treated as a “hot asset” for purposes of section 751(b). See Camp’s Third Tax Reform Discussion Draft Suggests Passthrough Changes, 2013 Tax Notes Today 49-23.
- **Donovan is treated as receiving, in a current distribution, inventory with a value of \$50 (\$100 x .50) and a basis of \$25 (\$50 x .50). Treas. Reg. §1.751-1(b)(3)(iii). Donovan takes a carryover basis in the inventory under section 732(a)(1).**

Redemption of Entire Interest – Section 751(b)

- Donovan then is treated as transferring the inventory back to PRS in exchange for \$50 cash (i.e., the property that he actually received in the distribution). Treas. Reg. §1.751-1(b)(3)(iii).
- Donovan recognizes \$25 of ordinary income in the exchange.
- PRS takes a \$50 basis in the inventory that is deemed to be transferred back to PRS.

Redemption of Entire Interest – After Section 751(b)

- **\$250 of \$300 cash is analyzed under the normal distribution rules.**
- **Basis in Donovan's interest was reduced by \$25 in connection with the deemed distribution under section 751(b). Accordingly, Donovan's remaining basis in his PRS interest is \$175 (\$200-\$25).**
- **Gain recognized in connection with the non-section 751(b) portion of the distribution equals \$75 (\$250-\$175). IRC §731(a)(1). Gain is all capital gain.**
- **For service partnerships that have general partners, there may be an opportunity for the partnership to make deductible payments for unrealized receivables and goodwill. IRC §736(b)(2). Partner receiving such payments has ordinary income.**
 - Proposal in House Ways and Means Committee Chairman Camp's Small Business Discussion Draft would repeal section 736. See Camp's Third Tax Reform Discussion Draft Suggests Passthrough Changes, 2013 Tax Notes Today 49-23.

Redemption of Entire Interest – Holding Period

- **Capital gain or loss recognized in connection with a partnership distribution is divided between long-term and short-term in the same proportions as the long-term and short-term capital gain or loss that the distributee partner would realize if he sold his entire interest in a fully taxable transaction. Treas. Reg. §1.1223-3(d)(2).**
- **Regulations provide for netting of cash contributions and distributions made during one-year period ending on the day of the sale or exchange. Treas. Reg. §1.1223-3(b)(2).**

Redemption of Entire Interest – Holding Period

- Remember that Donovan contributed \$150 on July 1, 2013, which caused him, in the sale context, to recognize short-term capital gain.
- In the redemption context, Donovan gets to net the \$150 cash contribution with the cash distribution received in connection with the redemption. See **Treas. Reg. §1.1223-3(f), Ex. 8.**
- Accordingly, the cash contribution is ignored, so that Donovan’s holding period is all long-term.

Redemption of Entire Interest – Unrec. Sec. 1250 Gain

- **Provisions regarding unrecaptured section 1250 gain do not apply to a transaction “that is treated, for Federal income tax purposes, as a redemption of a partnership interest.” Treas. Reg. §1.1(h)-1(b)(3)(ii).**

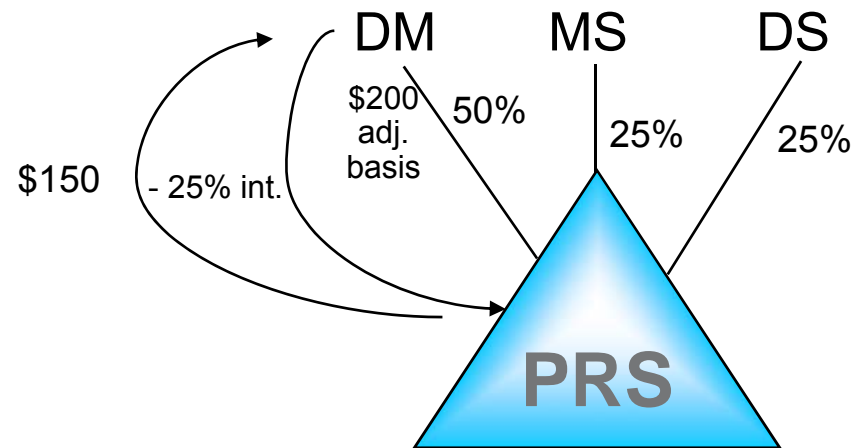
Redemption of Entire Interest – End Result

- **The \$100 of gain recognized by Donovan on the redemption of his partnership interest would be taxed as follows:**
 - \$25.00 of ordinary income
 - \$75.00 of 20% rate long-term capital gain

Issues of Interest to Remaining Partners

- **Mike and Dan will want PRS to have a section 754 election in effect. This will permit them to enjoy a \$75 positive basis adjustment under section 734(b) with respect to the PRS property. (Remember that the inventory was already stepped up by \$25 in connection with the section 751(b) deemed transaction.)**
- **Because Donovan is not related to Mike or Dan, the portion of their section 734(b) basis adjustment that is attributable to goodwill will be amortizable over 15 years. Treas. Reg. §1.197-2(h)(12)(iv).**
- **The distribution of cash is not treated as a sale or exchange of Donovan's interest for purposes of section 708(b)(1)(B). Accordingly, the redemption of Donovan (a 50% partner) will not cause PRS to terminate.**

Redemption of Partial Interest

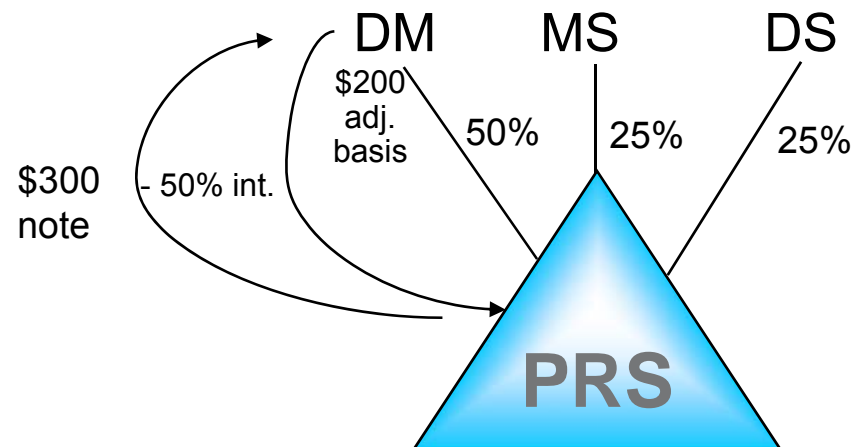


- Instead of redeeming Donovan's entire interest, PRS redeems only one-half of his interest for \$150 cash.
- Donovan's interest in PRS will be reduced from a one-half interest to a one-third interest.

Redemption of Partial Interest – Section 751(b)

- **There arguably is more flexibility in applying section 751(b) in the context of a partial redemption**
 - Revaluation of partnership assets in connection with partial redemption locks in reverse section 704(c) layer with respect to assets, such that, in many situations, there will be no “shift” in built-in gain with respect to ordinary and capital assets (*i.e.*, built-in gain is by reference to pre-redemption sharing percentages).
 - These issues are very complex. For a detailed discussion, see M. Jackel & A. Stok, Blissful Ignorance: Section 751(b) Uncharted Territory, 2003 Tax Notes Today 47-29 (Mar. 11, 2003); *see also* Notice 2006-14, 2006-1 C.B. 498 (notice soliciting comments on revisions to regulations under section 751(b)).

Redemption of Entire Interest – Installment Note

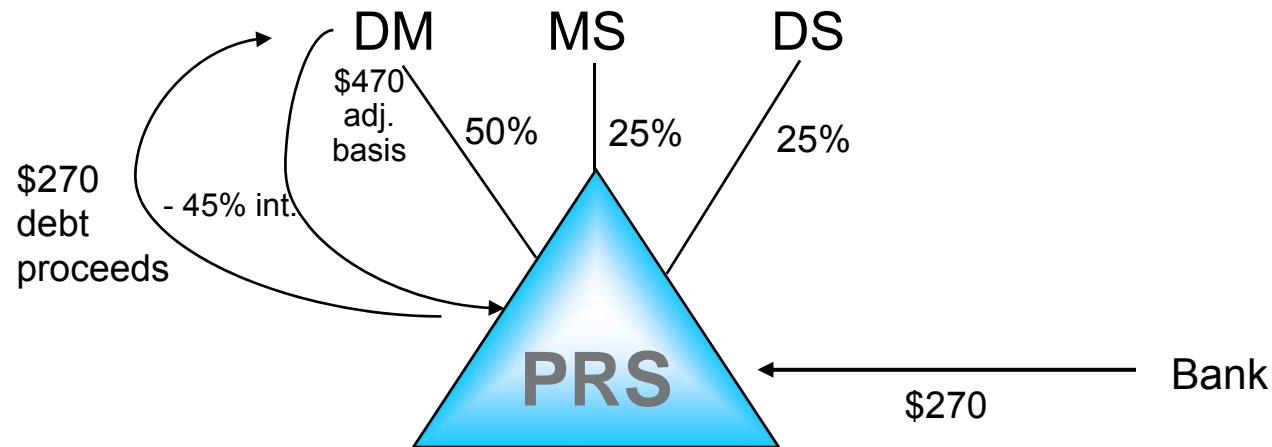


- Instead of distributing one payment of \$300, PRS distributes to Donovan an unsecured three-year note providing for annual payments of \$100.

Redemption of Entire Interest – Installment Note

- **Although Donovan may no longer be a partner for state law purposes, he is treated as a partner for federal tax purposes until he receives the last payment in liquidation of his interest. Treas. Reg. §1.736-1(a)(6); Treas. Reg. §1.761-1(d); Priv. Ltr. Rul. 8304059 (Oct. 25, 1982).**
- **Still necessary to consider section 751(b). Payments must be divided between payments made in exchange for the partner's interest in partnership property under section 736(b) and payments in exchange for substantially appreciated inventory under section 751(b). Treas. Reg. §1.736-1(a)(3).**

Redemption of Interest – Debt Financed Distribution



- Donovan wants to obtain significant cash in exchange for his interest in PRS, but he does not want to recognize gain on a current basis.
- PRS borrows \$270 and distributes the funds to Donovan. Donovan guarantees the debt.
- Donovan's interest in PRS is reduced to a 5% share of capital and profits.

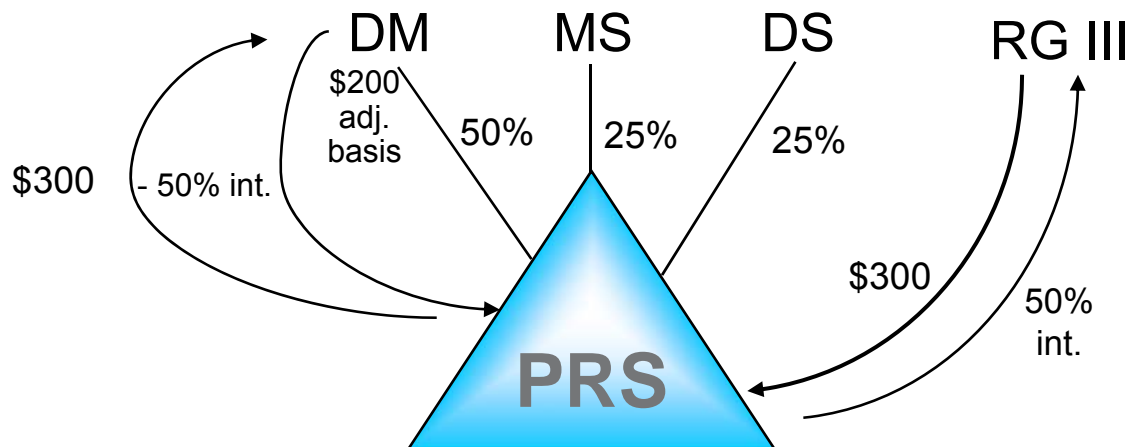
Redemption of Interest – Debt Financed Distribution

- **Donovan is treated as making a \$270 contribution to PRS. Increases basis by \$270. Still has \$200 of basis after distribution. No gain recognized.**
 - *Canal Corp.*, 135 T.C. 199 (2010), is important to consider in analyzing whether guarantee arrangement supporting debt allocation will be respected. See also ILM 201324013 (Mar. 14, 2013) (disregarding indemnification obligation).
 - 2013-2014 Treasury and IRS Priority Guidance Plan lists “[r]egulations under section 707 relating to disguised sales of property”
 - IRS representatives have made a number of statements recently relating to the scope of this project. A. Elliott, IRS to Amend Rules on Bottom-Dollar Guarantees, 2013 TNT 85-1 (May 2, 2013); A. Elliott, Official Equates Canal-Like Disguised Sale Abuses With Those of Tax Shelter Era, 2013 TNT 100-3 (May 23, 2013); A. Elliott, ABA Meeting: Recent Share-of-Liability Guidance May Extend to Partner Lender, 2013 TNT 92-6 (May 13, 2013); A. Elliott, ‘Poacher Turned Game Warden’ Warren Talks Bottom-Dollar Guarantees, 2013 TNT 112-4 (June 11, 2013); A. Elliott, ABA Meeting: Guarantors May Need to Document Net Worth, Katz Says, 2013 Tax Notes Today 186-4 (Sept. 25, 2013).

Redemption of Interest – Debt Financed Distribution

- **There arguably is a shift in Donovan’s share of hot assets as a result of the distribution, but if PRS traces the distributed proceeds to borrowed funds, Donovan may try to fall within the previously contributed property exception to section 751(b). See Treas. Reg. §1.751-1(b)(4)(i). The strength of this position is unclear. Compare Rev. Rul. 84-102, 1984-2 C.B. 119.**
 - As previously discussed (see slide 50), the revaluation of partnership assets also results in reverse section 704(c) gain layer that locks in built-in gain with respect to ordinary and capital assets, so arguably there will be no shift in ordinary and capital assets as a result of the distribution that would trigger application of section 751(b).
- **As PRS pays down guaranteed debt, Donovan will be treated, under section 752(b), as receiving distributions of cash.**
- **Donovan will begin to recognize gain when the deemed distributions exceed his basis in PRS.**

Redemption of Entire Interest – Disguised Sale



- Suppose RG III wants to join PRS and agrees to fund the \$300 buy-out payment of Donovan.
- Arguably Donovan has made a disguised sale of his partnership interest under section 707(a)(2)(B). See TAMs 200037005 and 200301004; see also Prop. Reg. §1.707-7 (proposed regulations on disguised sale of partnership interests; now withdrawn).

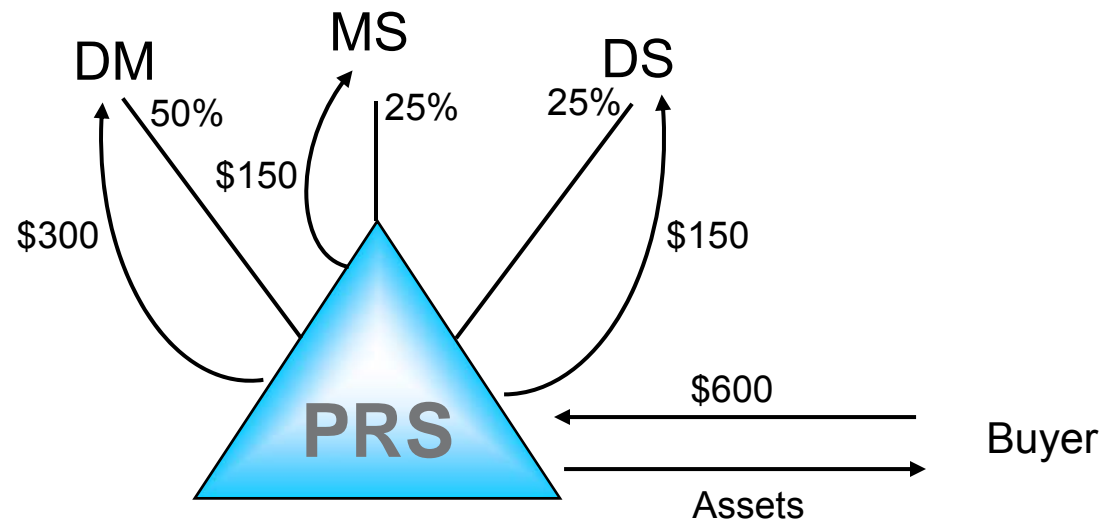
Redemption of Entire Interest – Disguised Sale

- **If Donovan has made a disguised sale, the transaction will be treated as a direct sale of the PRS interest from Donovan to RG III.**

Exit for Cash

- **Complete liquidation**
- **Sale of all partnership assets**
 - For cash
 - For installment note

Complete Liquidation – Sale of Assets for Cash

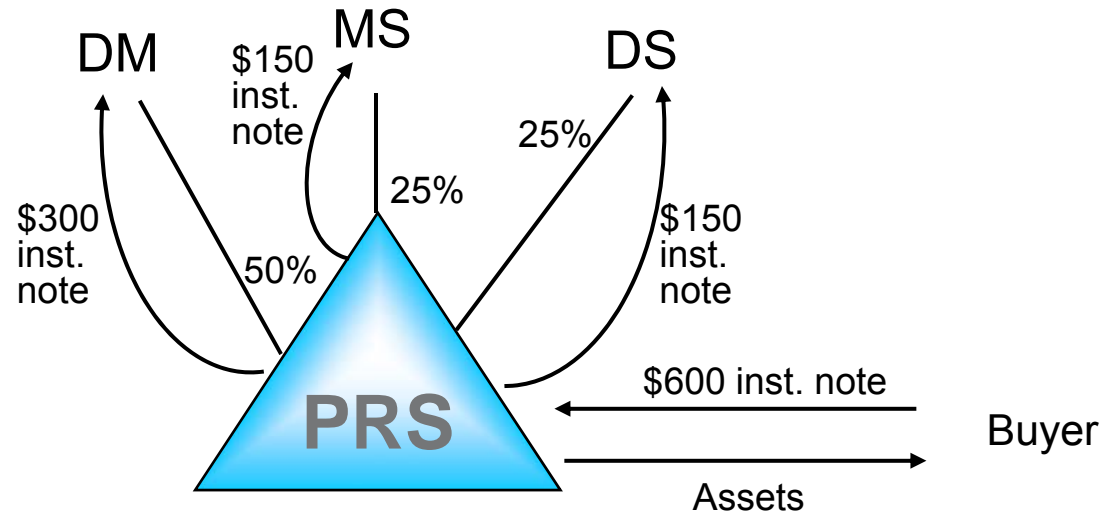


- **Donovan, Mike and Dan decide to sell the assets of PRS and wind up its business.**

Complete Liquidation – Sale of Assets for Cash

- PRS recognizes \$50 of ordinary income on sale of inventory, \$40 of section 1250 capital gain on sale of building, and \$110 of section 1231 gain on sale of land, building, and goodwill.
- Gain recognized by PRS is allocated 50% to Donovan, 25% to Mike, and 25% to Dan.
- This income allocation will increase the adjusted basis of Donovan, Mike, and Dan under section 705.
- Donovan's basis increases by \$100, from \$200 to \$300; Mike by \$50, from \$100 to \$150; and Dan by \$50, from \$100 to \$150.
- Cash distribution is analyzed under section 731. Distributions equal basis, so no gain or loss recognized.
- Might the IRS argue that transaction should be treated as a sale of partnership interests by all partners under the “sale of a going business” doctrine? See, e.g., Barran v. Commissioner, 334 F.2d 58 (5th Cir. 1964); Kaiser v. Glenn, 216 F.2d 551 (6th Cir. 1954); CCA 200224007 (Feb. 27, 2002).
 - Primary impact generally will be conversion of section 1231 gain or loss to capital gain or loss

Complete Liquidation – Sale of Assets for Installment Note



- PRS sells its assets (other than cash) for an installment note.

Complete Liquidation – Sale of Assets for Installment Note

- **Installment method is not available with respect to inventory. Thus, PRS recognizes \$50 of income immediately and \$150 of gain is deferred under the installment method.**
- **If PRS transfers an undivided interest in the installment note to Donovan, Mike, and Dan, gain should not be triggered. Reg. §1.453-9(c)(2); IRS § 453B; PLR 9853013; *but see* Reg. §§1.704-3(a)(8)(ii), 1.704-4(d)(1)(ii), and 1.737-2(d)(3)(ii) (where section 704(c) asset is sold for an installment note, that note is treated as the section 704(c) property, so distribution could invoke the anti-mixing bowl rules if property was contributed within the last 7 years).**
- **Donovan, Mike and Dan will recognize gain as the note is paid. Each partner's basis in his share of the installment note will be determined under section 732 by reference to his basis in his partnership interest.**

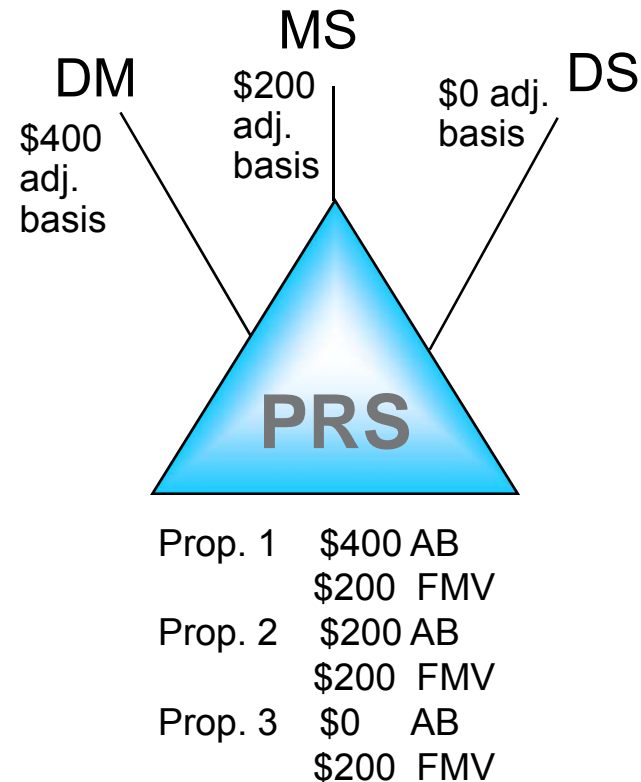
Exit for Property

- **Redemption/partial liquidation.**

Redemption of Entire Interest – Property Distribution

- **Donovan, Mike, and Dan are in a real estate partnership (PRS), formed in 2002.**
- **PRS was formed by Donovan contributing Property 1, Mike contributing Property 2, and Dan contributing Property 3.**
- **At the time of formation, each property was worth \$200 and Property 1 had a basis of \$400, Property 2 had a basis of \$200, and Property 3 had a basis of \$0. The value and basis of each property has not changed.**
- **The value of each partner's interest is \$200. Donovan's basis is \$400, Mike's basis is \$200, and Dan's basis is \$0.**

Redemption of Entire Interest – Property Distribution



- Dan wishes to receive Property 1 in redemption of his interest in PRS.

Redemption of Entire Interest – Property Distribution

- Under section 731(a), a partner generally will not recognize gain except to the extent that the cash received in the distribution exceeds the partner's basis in his partnership interest.
- Under section 732(b), where property is distributed in complete liquidation of a partner's interest, the partner will take a basis in the distributed property equal to the partner's basis in his partnership interest.
- Under section 732(c), basis is first allocated to inventory items and unrealized receivables (generally, ordinary income property) to the extent of the partnership's basis in such property.
- The remainder goes to capital and section 1231 assets, first to match the partnership's basis in the assets. Any step-up is allocated in proportion to relative appreciation in assets and then relative fair market value. Any step-down is allocated in proportion to relative depreciation and then relative adjusted basis.

Redemption of Entire Interest – Property Distribution

- **Dan would not recognize gain upon receipt of Property 1.**
 - One proposal in House Ways and Means Committee Chairman Camp's Small Business Discussion Draft would trigger gain to the partner and partnership upon distribution. See Camp's Third Tax Reform Discussion Draft Suggests Passthrough Changes, 2013 Tax Notes Today 49-23.
- **Basis of Property 1 would be reduced to \$0 in connection with distribution.**

Redemption of Entire Interest – Property Distribution

- **If PRS had a section 754 election in effect, basis of remaining property of PRS could be increased under section 734(b) by \$400 (i.e., the amount of the basis step down to Property 1).**

Redemption of Entire Interest – Property Distribution

- **What if Dan were a corporation and Property 1 was appreciated property contributed to a corporation prior to the distribution, so that stock is distributed rather than the property? See IRC §732(f).**
- **What if Donovan wishes to receive Property 3 in liquidation of his interest? If PRS did not make a section 754 election, would it be possible to avoid a basis step-down in the remaining assets?**

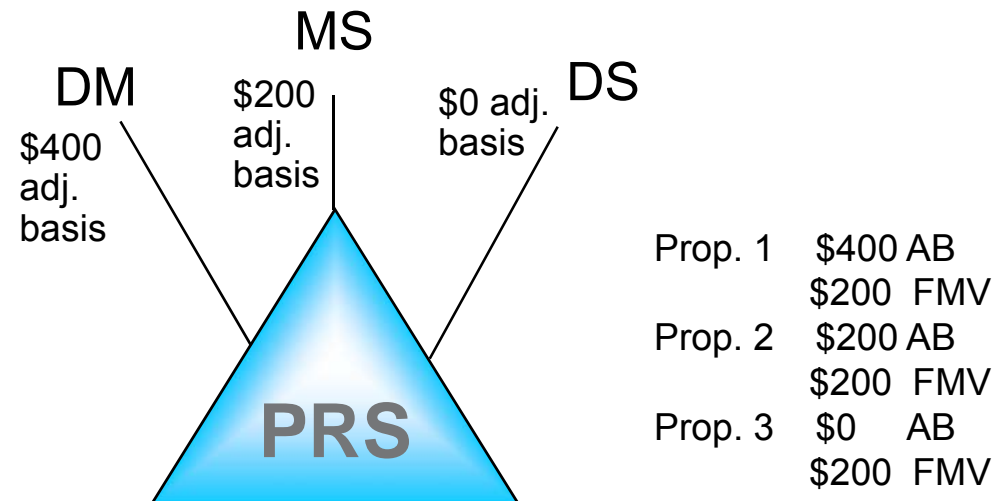
Redemption of Entire Interest – Property Distribution and Mixing Bowls

- **Suppose instead that the partnership was formed in 2009.**
- **Are inside the seven-year window in sections 704(c)(1)(B) and 737, so the anti-mixing bowl rules must be considered.**
 - One proposal in House Ways and Means Committee Chairman Camp's Small Business Discussion Draft would eliminate time limit under sections 704(c)(1)(B) and 737. See Camp's Third Tax Reform Discussion Draft Suggests Passthrough Changes, 2013 Tax Notes Today 49-23.

Redemption of Entire Interest – Property Distribution and Mixing Bowls

- **Section 704(c)(1)(B) provides for recognition of built-in gain or loss where property is contributed to a partnership and, within seven years of contribution, the property is distributed to another partner.**
- **Section 737 provides, in general, that where a partner who previously contributed section 704(c) property to a partnership receives, within seven years of the contribution, a distribution of property from the partnership, gain will be recognized in an amount equal to the lesser of (1) the value of the distributed property over the adjusted basis of the partner's interest in the partnership, or (2) the net pre-contribution gain of the partner.**

Redemption of Entire Interest – Property Distribution and Mixing Bowls



- Donovan has a \$200 section 704(c) loss in Property 1.
- That loss is recognized by Donovan under section 704(c)(1)(B).
- Donovan's basis in his partnership interest is reduced by the \$200 loss. Reg. § 1.704-4(e)(1).
- The basis in Property 1 is also reduced by \$200 immediately before the distribution. Reg. § 1.704-4(e)(2). This will affect any 734(b) basis adjustment. Reg. § 1.704-4(e)(3).

Redemption of Entire Interest – Property Distribution and Mixing Bowls

- Dan has “net pre-contribution gain” with respect to his interest in the partnership of \$200.
- “Net pre-contribution gain” is the net gain that would be recognized by a partner under section 704(c)(1)(B) if all property contributed by the partner and held by the partnership immediately before a distribution to such partner were distributed to another partner.
- Under section 737, Dan recognizes \$200 of gain; that is, the fair market value of the property distributed (\$200) over his basis in his partnership interest (\$0), limited by the amount of his net pre-contribution gain.

Redemption of Entire Interest – Property Distribution and Mixing Bowls

- For purposes of determining the basis of distributed property, Dan will increase the basis of his partnership interest by \$200. Reg. § 1.737-3(a) and (b)(1).
- PRS will increase the basis of “eligible property” to take into account the gain recognized by Dan under section 737. Reg. § 1.737-3(c).

Redemption of Entire Interest – Property Distribution and Mixing Bowls

■ End result for Donovan

- Recognition of \$200 capital loss.
- Basis in partnership interest of \$200.

■ End result for Dan

- Recognition of \$200 capital gain.
- Basis of distributed property is \$200.

■ End result for PRS

- No basis adjustment under section 734(b).
- However, basis of Property 3 (i.e., eligible property) is increased under section 737 by \$200.

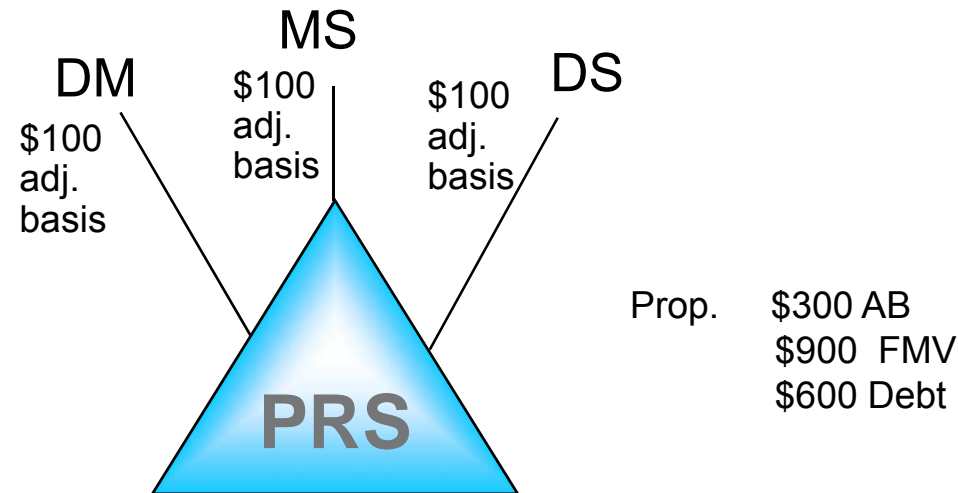
Redemption for Property-Distribution of Marketable Securities

- **Back to the original example (p. 8): PRS has \$300 in cash and property worth \$300.**
- **Donovan and Mike wish to redeem Dan, who has a 25% interest with a value of \$150 and basis of \$100.**
- **PRS has cash to redeem Dan, but Dan would recognize \$50 gain (ignoring section 751(b)).**

Redemption for Property-Distribution of Marketable Securities

- Can PRS acquire portfolio stock and distribute that to Dan instead, thus allowing Dan to avoid recognizing gain in connection with a property distribution, while still giving Dan liquid assets?
- Section 731(c) generally treats marketable securities as cash, so Dan would recognize gain.
- Are there similar cash-like assets that are not treated as a marketable security? See *Countryside LP v. Commissioner*, 95 TCM 1006; see generally P. Gall and D. Franklin, *Partnership Distributions of Marketable Securities*, 2007 Tax Notes Today 220-38.

Redemption for Property – Negative Tax Capital Account



- Donovan, Mike, and Dan each own a 1/3 interest in PRS, which owns a single parcel of property.
- The property has a value of \$900, basis of \$300, and is subject to debt of \$600.
- Each partner has a \$200 share of the debt.

Redemption for Property – Negative Tax Capital Account

- Mike and Dan would like to redeem Donovan's interest.
- Donovan does not want to recognize gain in connection with the redemption, so he asks that the partnership acquire another parcel of property and distribute that to him in redemption of his interest.
- Unless Donovan takes the distributed property subject to debt of at least \$100, Donovan will recognize gain.
- Donovan has \$100 basis in his partnership interest. If he takes the property subject to at least \$100 of debt, he will ensure that the deemed distribution under 752(b) will not exceed his basis. Compare Countryside LP v. Commissioner, 95 TCM 1006, with CCA 200650014.

Getting Out for Nothing

- **Abandonment of partnership interests.**

Abandonment of Partnership Interest

- **To abandon a partnership interest, a partner must show:**
 - An intention to abandon the interest, and
 - An affirmative act of abandonment.
 - (See Citron v. Commissioner, 97 T.C. 200 (1991))
- **The determination of whether the loss from abandonment or worthlessness of a partnership interest is capital or ordinary is dependent on whether the loss results from the sale or exchange of a capital asset.**

Abandonment of Partnership Interest

- The IRS takes the position that any actual or deemed (under section 752(b)) distribution in connection with the abandonment of a partnership interest will invoke the distribution rule under section 731. Accordingly, except to the extent that section 751(b) applies, the loss will be capital. See Rev. Rul. 93-80, 1993-2 C.B. 239.
- If no distribution or other consideration is received in connection with the abandonment, the loss should be ordinary. But cf. §1234A.

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