Constructive Cash Distributions in a Partnership: How and When They Occur

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Repository Citation
http://scholarship.law.wm.edu/facpubs/1396

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Constructive cash distributions in a partnership: How and when they occur

by ROBERT S. PARKER, JR., and JOHN W. LEE, III

Constructive cash distributions to partners with possible concomitant severe tax impact can occur whenever a partner's share of firm or individual liabilities is cut. This reduction of liabilities can be triggered by a variety of typical partnership transactions. Messrs. Parker and Lee analyze those transactions under which there is the danger of unforeseen taxation and urge extreme caution.

A decrease in a partner's share of partnership liabilities is treated as a distribution of money ("constructive cash distribution") to such partner by the partnership under Section 752(b). More specifically, Regs. 1.752-1(b) and (e) mandate that a reduction in the ratio in which losses are shared in the case of recourse liabilities or in ratio in which profits are shared in the case of non-recourse liabilities results in a decrease in a partner's share of partnership liabilities. Such constructive cash distributions are generally taxable to the "distributee" under Section 751(a)(1) as capital gain from the sale or exchange of his interest to the extent such cash distribution exceeds his basis in his partnership interest. But, if the partnership owns Section 751 property (unrealized receivables and inventory items) at the time of the constructive distribution, the "distributee" of the constructive cash distribution may instead have ordinary income under Section 751(b). Such ordinary income can arise even where the constructive cash distribution does not exceed his basis in his partnership interest.

Constructive cash distributions commonly occur, for example, when a partnership varies its profit and loss ratio in the admission of a new partner by capital contribution or simply in an internal change in a partner's (or classes of partners') percentage interest in profits or losses, such as a "flip-flop" (i.e., a change in the ratio of sharing profits and losses between the general and limited partners triggered by stated events such as the partnership becoming profitable or selling its assets). In addition, the mere abandonment by a partner of his partnership interest or the withdrawal from a partnership can result in a constructive cash distribution, as recently illustrated in Rev. Rul. 74-40, IRB 1974-4, 11. Presumably the constructive distribution rule obtains when a partner contributes to a charity his interest in a partnership that has become profitable.

A second major income tax problem which must be given careful consideration whenever there is a shift in the partners' share of partnership profits and losses coupled with a complementary shift of their share of partnership liabilities in a transaction which is not an actual sale or exchange (i.e., the same transactions referred to in the immediately preceding paragraph; the internal shift of the partnership profit or loss ratio, such as the admission of a new partner by way of capital contribution or a "flip-flop"; a withdrawal or the abandonment by a partner of his partnership interest; and the gift of a partnership interest) is the possibility that the shift of partnership interest from one partner to another will be treated as a step-transaction sale or exchange. If such a step-transaction sale is found to exist, the constructive cash distribution rules of Sections 752(b), 731(a)(1) and 751(b) would not apply. Rather, Section 752(d) would apply. This provision states that in "the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with the partnership." Reg. 1.752-1(d) explicates that where a partner sells his interest and at the same time transfers to the purchaser his share of partnership liabilities, the amount received by the seller includes the share of liabilities shifted to the purchaser. This is an apparent adoption of the "aggregate" approach of partnership taxation for this purpose. Thus, if a step-transaction sale is found to exist, the proceeds from the "sale" would include the share of partnership liabilities shifted to the "purchaser" and would be taxable under Sections 741 and 751(a). Such step-transaction sales could also result in a termination of the partnership under the rule of Section 708(b) (1)(B) 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.

Section 752(b) also provides that a decrease in a partner's individual liabilities will be treated as a constructive cash distribution. This rule would normally apply, for example, when property which is subject to a liability is contributed to a partnership and the distribution would be taxable under Sections 751 and 751(b). However, Reg. 1.731-1(c)(5) provides that a "distribution" to a partner will not be treated as such if such partner has, in fact, sold the property to the partnership or to other partners. Furthermore, Reg. 1.721-1(a) provides that a transfer of property by a partner to a partnership resulting in his receipt of money or other consideration (i.e., "boot") will be treated as a sale to the partnership under Section 707. Thus, the contribution to a partnership of property which property is subject to a liability, could be taxed as a step-transaction sale or part sale of that property and not as a contribution to a partnership coupled with a distribution from that partnership (the assumption of liabilities is treated as "boot" under other non-recognition provisions).

Step-transaction sales

It has been suggested that the shifting of interests in partnership profits and losses and liabilities when there is an admission of a new partner by capital contribution, a flip-flop, a withdrawal,
or a donation of a partnership interest, could be treated as a step-transaction sale or exchange of partnership interests by the partners with reduced interests to the partner or partners with increased interests. If so, two distinct potential problems arise: (1) the application of Sections 741 and 751(a) to the “selling” partner in the step-transaction sale; and (2) the possible termination of the partnership under the 50% rule of Section 708.

Consequences of step-transaction sale. In such a step-transaction sale, the selling partner’s sale proceeds would include, under Section 752(d), his share of partnership liabilities shifted to the purchasing partner. He would be entitled to capital gains treatment under Section 741 as to his gain, except to the extent that the partnership had Section 751 property. In that case, the step-transaction sale proceeds received by the selling partner for that part of his partnership interest attributable to Section 751 property would be taxed as ordinary income, to the extent in excess of basis allocable to the Section 751 property, under Section 751(a), even if the total proceeds received did not exceed his total adjusted basis in his partnership interest.

Turning to the termination question, Section 708(b)(1)(B) provides that a partnership will terminate if within a period of 12 consecutive months 50% or more of the total interest in partnership capital and profits is sold or exchanged. In this connection, Reg. 1.708-1(b)(1)(ii) specifies that a sale to another member of the partnership must be counted. Reg. 1.708-1(b)(1)(ii) notes that a contribution of property to a partnership, i.e., acquisition of a partnership interest by capital contribution, does not constitute a sale or exchange, but raises a caveat as to the potential effect of Reg. 1.751-1(c)(3). The latter in turn states that Section 751, treating partnership distributions in general as tax-free, may not apply where there is a contribution of “property” to a partnership and within a short period (1) before or after such contribution, “other property” is distributed to the contributing partner and the contributed property is retained by the partnership or (2) after such contribution the contributed property is distributed to another person. The Regulation concludes by saying that “such a transaction shall be treated as an exchange of property.”

A termination itself would be taxed as though there had been a liquidation of the old partnership and distribution of its assets and liabilities to the purchaser and other remaining partners with retribution by them of such property to a new partnership, under Reg. 1.708-1(b)(iv). There should be no adverse tax consequences from such a liquidation-retribution alone since the termination results in a wash as to partnership liabilities, following the example in Reg. 1.752-1(a)(2). On the “liquidation” the partners’ shares of old partnership liabilities would decrease, but that decrease would be offset by a corresponding increase in individual liabilities. On the “retribution” a decrease in the contributing partners’ individual liabilities would be offset by an increase in their share of the new partnership liabilities. (Under Section 752(c) a liability to which property is subject is considered a liability of the owner of the property.) The real problems with a termination are that the new partnership would probably be a second user under Reg. 1.167(a)-1(a)(6), thereby limiting the availability of accelerated depreciation, and that retroactive modifications as to the terminated partnership would probably be thereafter eliminated. Furthermore, since the basis of the new partnership in the “contributed” property will be equal to that of the contributing partners, its basis may differ from that of the old partnership (as where the purchasing partners acquire their partnership interests at a cost greater than the old partnership’s “inside” basis attributable to their interests).

Reasons supporting no-step-transaction sale in partnership shift. The authors suggest that the shifting of partnership interests occurring when there are admissions of new partners by capital contributions, flip-flops, withdrawals, or donations of partnership interests when the partnership has liabilities (non-course in the case of limited partnerships), do not constitute step-transaction sales of partnership interests by the partners with decreased interests.

Rev. Rul. 74-40, hereinafter discussed more fully, appears to have clearly held that a withdrawal does not involve a constructive sale or exchange. In addition, that Ruling gives substantial support to the view that there is no step-transaction sale upon the admission of a new partner, at the time of a flip-flop, or upon the donation of a partnership interest. Situations 2 and 3 of the Ruling involve the withdrawal from a partnership by one partner. Necessarily, his interest in the partnership profits and losses and liabilities decreases and the remaining partners’ interests in profits and losses and liabilities increase. Therefore, the withdrawal involves the same shifts in interests in profits and losses and liabilities as an admission of a new partner, a flip-flop or a donation of a partnership interest. The Ruling specifically holds in each instance, that the decrease in the withdrawing partner’s share of partnership liabilities constitutes a distribution under Section 752(b) and that his tax consequences are determined under Section 731(a). The Ruling does not so much as mention the possibility that the withdrawing partner could be regarded as having sold his interest to the continuing partners.

It is clear from its context that Reg.Appearances of Arosnow Partnership and Income Taxa 128 (1957 ed.); Ferguson, Freeland and Stephens, Federal Income Taxation of Estates and Beneficiaries 230-31, 240-41 (1970); Milroy, “Tax Aspects of Partnership Distributions and Transfers,” in Partnership Interests,” 41 Indiana J., 636, 649 (1966). This holding also appears flawed by the fact that the court determined the amount realized in the Section 751(a) transaction under Sections 742 (basis) and 1001 (amount realized) and not under Reg. 1.751-1(a) (2), which provides special rules for both basis (constructive pre-sale distribution) and amount realized, as is required. The amount of the step up is a separate question (zero if attributable to “IRD” under the aggregate approach). See Quick Trust, 444 F. Supp. 90 (CA-8, 1971).
1.731-1(c)(3) was intended to apply to the contributing partner in the case of a contribution of property which, coupled with an appropriate distribution, constitutes an effective sale of part or all of that contributed property. Viewed in this light, the Regulations in no way suggest that a non-contributing partner has sold anything, much less a partnership interest. Furthermore, it seems that every shift of interest in partnership profits and losses and liabilities, by admission of a new partner or in a flip-flop, for example, would constitute a sale of a partnership interest by the partners with decreased interests if the step-transaction theory were generally applicable. This result seems hardly sensible in the general partnership context. Certainly, if the drafters of the Regulations had intended that a shift in partnership profits and losses and liabilities would be treated as a sale or exchange of a partnership interest, would not the Regulations have been more specific? In addition, it is submitted that the step-transaction doctrine is inapplicable because (1) the shift in liabilities (the “sale” proceeds) is not made in order to effect an exchange of property between two or more partners but is a mechanical result of the partnership rules; and (2) a decrease in liabilities for the partners with reduced interests is not the desired end-result of admission of a new partner to a tax-shelter syndicate, but an unwanted by-product since its effect is a reduction in the old partners’ bases against which they can offset losses under Section 704(d). Furthermore, old limited partners do not even realize any direct economic benefit from the reduction of their share of non-recourse liabilities since they can never be called upon to pay them anyway.

The legislative history of Section 708 is not conclusive, but appears to support the view that there is no constructive sale resulting from the admission of a new partner, a flip-flop, a withdrawal or the donation of a partnership interest. S. Rept. No. 1622, 88th Cong., 2d Sess. 91 (1954), states that “Both versions of the bill also provide that the taxable year of a partnership is not to close as a result of the admission of a new partner, the liquidation of a partner’s interest by means of a distribution, or a sale or exchange of a partner’s interest in the partnership. Thus, it will not be possible for any of these events in themselves to terminate the partnership taxable year and commence a new partnership year. However, the partnership year does close if there is a termination of the partnership. A termination is defined for this purpose as a discontinuance of the business activities carried on by the partnership, or the sale of an interest of more than 50% in the partnership capital or profits to persons not members of the partnership.” An inference may be drawn from this juxtaposition of (1) admission of a new partner, (2) liquidation of a partner’s interest and (3) sale or exchange of a partner’s interest with the definition of termination by a sale of a 50% interest in profits and capital, that only an actual sale or exchange of such an interest terminates the partnership. Certainly, there is no specific suggestion that an admission, flip-flop, withdrawal or donation can be treated as a sale for this purpose.

Interestingly, the Committee on Partnerships of the ABA Section of Taxation has recommended to the Service that Section 708 be amended to provide that a contribution to a partnership by a person who has not been a partner for 12 months in exchange for a partnership interest will be counted as a sale of a partnership interest for purposes of the 50% partnership termination rule. Unfortunately, the Report made by the Committee in February, 1974, does not specifically decide whether a contribution could be treated as a sale under present law in that it provides: “Under present law neither the liquidation of a partnership interest nor the contribution of property to a partnership [constitutes] a sale or exchange for purposes of Section 708. Reg. 1.708-1(b)(1)(ii). See, however, paragraph (c)(3) of Reg. 1.731-1.”

Constructive cash distributions

If neither the admission of a new partner by capital contribution, a flip-flop, a withdrawal nor a donation of a partnership interest constitutes a constructive sale, material income tax consequences will nevertheless occur as a result of the constructive cash distribution rules.

Operation of Section 731. Even if Section 731(b) is not applicable, a partner will recognize gain under Section 731(a) (1) to the extent that the constructive cash distribution to him, resulting from the admission of a new partner or from a flip-flop, exceeds the adjusted basis of his partnership interest. Of course, a partner’s adjusted basis in his partnership interest includes, by virtue of Sections 752(a) and 722, his share of the partnership liabilities. Thus, in the case of admission of new partners, Section 731(a) should not be so troublesome to the old partners in the usual case (an exception would exist when the limited partners have had tax write-offs in excess of their actual contributions to the partnership and the new partner is admitted to a substantial interest). Furthermore, in any partnership where the old partners first acquire a withdrawing partner’s interest and then admit a new partner by capital contribution to substantially the same interest as that of the withdrawn partner, Section 731(a) will not normally cause a problem because the constructive cash distribution to the continuing old partners upon the admission of the new partner will in the aggregate be offset by the constructive cash contributions and increases in basis that arose under Sections 742, 1012, 752(a) and 722 from the old partners’ acquisition of the withdrawing partner’s interest. In a “flip-flop,” where the profit or loss ratio shifts (for example, from 95% to the limited partners as a class and 5% to the general partner to “50-50”) upon the partnership’s crossing-over, upon the sale of the partnership property or upon a refinancing of the partnership liabilities, Section 731(a) is apt to apply since the constructive cash distributions to the limited partners are much more likely to exceed their bases in the partnership interests. Such treatment of a flip-flop assumes that, until the flip-flop, the limited partners are in fact entitled to that portion of the profits specified in the agreement and that they may include that same percentage of the non-recourse partnership liabilities in their bases. (Continuing the above example, if cash flow is shared on a 50-50 basis, it is possible that
the limited partners are in fact entitled to only 50% of the partnership tax profits and losses and could never properly include 95% of the liabilities in basis, in which case their bases would be lower, but there would be no change in interests, and no constructive cash distribution at the time of the nominal change in interests.\(^8\)

The cash distribution rule of Sections 752 and 751(a) should also apply where a person disposes of a partnership interest by withdrawal or donation because such withdrawing partner still has a decrease in his share of partnership liabilities. Rev. Rul. 74-40 provides an example (situation 3) in which limited partner L withdraws from a partnership at a time when his proportionate share of nonrecourse liabilities is $15,000 but the adjusted basis of his partnership interest is zero (including the $15,000 in liabilities). The Ruling concludes that L is considered to have received a distribution of money ($15,000) from the partnership and realizes a gain of $15,000 determined under Section 751(a). Commentators have suggested that the tax-bite of disposing of a partnership interest in a partnership that has crossed over can be avoided by making a gift of the interest to a tax-exempt organization.\(^8\) It would appear, however, that under the implicit reasoning of Rev. Rul. 74-40, the donor-partner's withdrawal from the partnership will trigger a constructive cash distribution, taxable to the extent in excess of his basis. The counter-argument that Section 752 should not serve to create income which would not be recognized in a similar non-partnership transaction provides cold comfort: the recent trend is to treat a gift of encumbered property to a tax-exempt organization made subject to the debt as a transfer of property in part a sale and in part a gift, with the amount of such debt constituting the amount realized by the transferee on the sale part of the transaction.\(^9\) Moreover, the Sixth Circuit very recently in Johnson, Jr., 751(a)(3) (1974), while disposing of a part-gift, part-sale analysis in a similar transfer of encumbered (non-recourse) stock to a family trust, held that the grantor realized income from the "shredding" of the nonrecourse liability under Crane, 331 U.S. 1 (1947). The amount of capital gain recognized was the excess of the liability over the grantor's basis, which comports with the tax result under Section 751(a). This approach may result in less taxable income than a bargain sale to a tax-exempt organization.

Applicability of Section 751(b). Section 751(b) provides in pertinent part that to the extent a partner receives a distribution of partnership property (including money but not Section 751 property) in exchange for all or part of his interest in Section 751 property, such transaction is to be considered as a taxable sale or exchange between the distributee partner and the partnership. In pertinent part, Reg. 1.751-1(b)(1) provides that "... section 751(b) applies only to the extent that a partner... receives other property in exchange for his relinquishing part of his interest in section 751 property." Reg. 1.751-1(b)(1) and 1.1245-4(a) (4); Johnson, Jr., 56 TC 193, 888 (1973), aff'd. on other grounds (CA-4, 1974); Rev. Rul. 76-626. On the other hand, basis with respect to a "bargain sale" to a charitable organization is allocated to the sale and gift portions under Section 1011(b) (applicable to sales and exchanges made after 12/19/69), thereby resulting in greater gain. This provision applies where property is transferred to a foundation, a charitable organization, or an organization that is subject to an indebtedness. Reg. 1.1011-2(a) (3). The Regulations do not attempt to resolve the conflict between basis treatment of part-gift, part-sales in general and of identical transactions with charitable organizations. A similar problem of basis allocation would appear to be presented by a Section 721 contribution to a partnership coupled with a "boot" distribution (including a substitution of liabilities). Following the analysis of Johnson, Jr., CA-4, 4/7/74, no allocation would be called for, however. The "shredding of debt" analysis in Johnson, Jr., discussed in the text, infra, may cast doubt upon the validity of Wiles, 53 TC 259 (1970), aff'd. CA-3, 3/28/74 where the Tax Court ruled that a trust's payments on a liability on transferred property (for which the grantor continued to be personally liable) resulted in income to the grantor under Section 671.\(^\text{10}\)

\(^8\) Independently of this question, it has been argued that if the ratio for sharing proceeds on a sale of the project is 50-50, the basis allocations of Reg. 1.752-1(e) should follow the ratio of sharing sale proceeds and not the operating income or loss ratio. The reasoning is as follows: Reg. 1.752-1(e) allocates non-recourse partnership liabilities based on "profits," but does not indicate whether profits from operating activities are the governing standard. Since the Regulations are conceptually based upon the Crane rule (331 U.S. 1, 1947) \(^\text{11}\) which arose in the context of a sale of mortgaged property and which serves principally as a rule for determining gain on disposition, "it seems more appropriate for the provisions governing sale of property to determine the original basis allocation than for provisions designed to allocate income and deductions resulting from retention of the property." 2 Surrey, Warren, McDaniel and Ault, Federal Income Taxation 128 (1973). Another leading commentator disagrees with the above analysis to the extent that the mortgage is scheduled for amortization prior to the flip-flop. He suggests, for example, that if the limited partners have a 90% interest in profits and losses prior to the flip-flop, they will usually bear 90% of the responsibility for satisfying the mortgage liability. In the usual situation, only part of the mortgage liability will be paid prior to the flip-flop. Thus, for example, if only half the debt will be amortized prior to the flip-flop, then half of the mortgage liability should be allocated 90-10 and the other half perhaps 50-50, if that is the ratio in which the sales proceeds will be shared. Thus while he disagrees with the Surrey, Warren, McDaniel and Ault analysis, he too expresses concern the theoretical correctness of allocating 90% of the liability to the limited partners prior to the flip-flop in the usual case. He indicates that, under present Regulations, the Service is not likely to recognize any allocation other than 90-10, however. See Cowan, Unpublished Manuscript on Section 752.

\(^9\) See Scheff, "Recasting and Terminating the Shelter: Getting Out Gracefully, Economically and Alive," N.Y.U. 29th Inst. on Fed. Tax. 1651, 1652-62 (1971). Where the five-year "look-back" exception of Section 514(e)(2) (B) (for gifts of property subject to encumbrances) is not available, a tax-exempt organization may be hesitant to accept such a debt from the debt-financed property and unrelated business income provisions. See Sections 512(b) (3), (4) and 512(c).

\(^10\) Rev. Rul. 70-626, 1970-2 CB 158; cf. Malone, 325 F.Supp. 106 (DC Misc., 1971), aff'd. per cur., 455 F.2d 502 (CA-5, 1972). Under a part-gift, part-sale analysis, the donor-seller's entire basis is allocated to the sale portion. Regs. 1.1001-1(e) (1) and 1.1245-4(a) (4); Johnson, Jr., 56 TC 193, 888 (1973), aff'd. on other grounds (CA-4, 1974); Rev. Rul. 76-626. On the other hand, basis with respect to a "bargain sale" to a charitable organization is allocated to the sale and gift portions under Section 1011(b) (applicable to sales and exchanges made after 12/19/69), thereby resulting in greater gain. This provision applies where property is transferred to a foundation, a charitable organization, or an organization that is subject to an indebtedness. Reg. 1.1011-2(a) (3). The Regulations do not attempt to resolve the conflict between basis treatment of part-gift, part-sales in general and of identical transactions with charitable organizations. A similar problem of basis allocation would appear to be presented by a Section 721 contribution to a partnership coupled with a "boot" distribution (including a substitution of liabilities). Following the analysis of Johnson, Jr., CA-4, 4/7/74, no allocation would be called for, however. The "shredding of debt" analysis in Johnson, Jr., discussed in the text, infra, may cast doubt upon the validity of Wiles, 53 TC 259 (1970), aff'd. CA-3, 3/28/74 where the Tax Court ruled that a trust's payments on a liability on transferred property (for which the grantor continued to be personally liable) resulted in income to the grantor under Section 671.\(^\text{10}\) Compare the basis computations in a Section 751(a) transaction outlined in note 7, supra.
distribution (in a transaction which is not treated as a step-transaction sale or exchange of a partner's interest), there should be little question but that Section 751(b) is fully applicable. This should be true when a new partner is admitted, when there is a flip-flop or when a partner gives away or abandons his share of partnership income and his share of partnership liabilities to be subject to ordinary income treatment. In addition, there is no apparent reason for distinguishing between actual and constructive cash distributions. In a transaction where there has been an exchange of a partner's interest in the partnership property with potential income from Section 751(b) to liquidating constructive distributions.

The most difficult question is whether Section 751(b) should or does apply to non-liquidating constructive distributions. For example, if it does apply, senior partners in a cash basis law or accounting partnership may realize ordinary income whenever a junior partner receives an increased share of the profits or a new partner is admitted and at the same time the partnership has both liabilities and uncollected fees (i.e., "unrealized receivables" or Section 751 property). The reduction in the senior or old partner's profit or loss ratio may result in a reduction in his share of partnership liabilities and, thereby, in a constructive cash distribution to him. If his share of unrealized receivables is also reduced, he would have ordinary income if Section 751(b) were applicable. In some cash basis partnerships, the incoming partner is not given an interest in receivables. In that case, the old partners would not have given up (actually or constructively) any interest in such receivables. It is difficult to see how Section 751(b) could possibly apply with respect to that portion of the receivables—there would simply be no "relinquishing" of any part of the old partners' interest in such receivables as required by the Regulations. (Of course, even under an arrangement such as this, there may be a problem if the new partner shares in income from services performed, but not billed, prior to his admission.)

A commentator has pointed out that where a partner's interest in profits or losses and capital is reduced, for example, from 50% to 25% in a partnership with $12,000 in unrealized receivables and $2,000 in losses, such a partner's interest in Section 751 property is reduced from $6,000 to $3,000 and under Section 752 he receives a constructive cash distribution of $500 (25% of the $2,000 liability). He suggested that in view of the fact that (1), absent the reduction, the partner would have been taxed on his 50% distributive share of the partnership income (i.e., 50% of $2,000 or $1,000) used to pay the $2,000 (non-deductible) partnership liability without receipt of cash, and (2), with the reduction to 25% of his share of partnership income, he will only be taxed on the $500 of partnership income used to pay the same liability, the reduced partner could properly be viewed as realizing under Section 751(b) the $500 constructive cash distribution as in "anticipation of that portion of the receivables that will be used to satisfy part of his [former 50%] share of the liability."15

Contributions of property

Reg. 1.1245-4(c)(4), Example 3, considers a contribution of encumbered Section 1245 property with potential depreciation recapture to a partnership in a transaction to which Section 751(b) might seemingly apply, but the example clearly does not apply Section 751(b). It involves the transfer by an individual (Smith) of Section 1245 property with a fair market value of $10,000, recompute basis of $8,000, and adjusted basis of $4,000 which is subject to a $9,000 mortgage to a new partnership in which he has a one-half interest. The example concludes that:

"Since under Section 752(b) (relating to decrease in partner's liabilities) Smith is treated as receiving a distribution in money of $4,500 (one-half of liability assumed by partnership), and since the basis of Smith's partnership interest is $4,000 (the adjusted basis of the contributed property), the $4,500 distribution results in his realizing $500 gain under Section 731(a) (relating to distributions by a partnership), determined without regard to Section 1245. Accordingly, the application of Section 1245(b)(3) limits the gain taken into account by Smith under Section 1245(a)(1) to $500."

Section 752(b) provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, is considered as a distribution of money to the partner by the partnership. Reg. 1.752-1(b)(2) specifies that "Where a partnership assumes the separate liabilities of a partner or a liability to which property owned by such partner is sub-
subject . . . , the amount of the decrease . . . is treated as a distribution of money . . . ." In addition, the Regulation provides that it is immaterial whether the partnership actually assumes the mortgage, by reference to Section 752(c) which, in turn, states that, for purposes of Section 752, a liability to which property is subject shall, to the extent of the fair market value of the property, be considered as a liability of the owner of the property. The example contained in Reg. 1.752-1(c) leaves no doubt that property taken subject to a mortgage results in a constructive cash distribution under Section 752(b).

On the surface, there is no reason to distinguish a constructive cash distribution resulting from a transfer of encumbered property to a partnership from a constructive cash distribution resulting from the reduction in a partner's share of partnership liabilities. In the "Smith" example it could be argued that, because Smith relinquished 50% of the $4,000 potential Section 1245 recapture upon transfer of the property to the partnership and there was a constructive cash distribution of at least $4,500 paid to Smith, Section 751(b) should apply. Under Section 751(b), if applicable, the ordinary income would be $2,000 (50% of $4,000 Section 1245 recapture) and not $500. Apparently the exception in Section 751(b) (2) (that Section 751(b) does not apply to a distribution of property which the distributee partner has contributed to the partnership) would not be available because the constructive distribution is of cash, which under Reg. 1.751-1(c) Smith would not have contributed to the partnership. The failure of Reg. 1.1245-4(c) (4), Example 3, to refer to Section 751(b) could be explained on one of four possible arguments.

1. Section 751(b) is inapplicable to non-liquidating distributions.

2. Section 1245(b)(3) provides that the amount of ordinary income recaptured under Section 1245 in an otherwise tax-free transfer, for example under Sections 721 or 731, does not exceed "the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this Section)." By removing Section 1245 from the computation of the gain, Section 1245 (b)(3) also removes it for purposes of determining whether partnership has Section 751(c) property so that the distribution to Smith comes within Section 731(a) rather than Section 751(b). In short, "without regard" to Section 1245 the constructive cash distribution to Smith is not received in exchange for Section 751 property (the potential Section 1245 recapture).

3. As suggested by Arthur Willis, the entire transaction in substance constitutes a contribution of the value of Smith's equity interest in the property and does not involve a reduction in his interest in the partnership's Section 751 property. This would mean that a constructive cash distribution resulting from a reduction in individual liabilities (by virtue of contributing encumbered property to the partnership) is distinguishable, for purposes of Section 751(b), from a constructive cash distribution resulting from a reduction in a partner's share of partnership liabilities.

4. The drafters of the Regulations overlooked Section 751(b).

Although the latter may well have been the reason that Example 3 does not refer to Section 751(b), it is submitted that reasons two and three, above, may constitute very real reasons why Section 751(b) should not apply.

It should also be noted that the possibility of constructive sale treatment under Reg. 1.721-1(a) and Section 707 and the attendant questions concerning the proper treatment of such a sale, whenever there is a contribution of encumbered property to a partnership, present quite serious problems. Liabilities from which the transferor is relieved constitute "boot" in some other non-recognition transactions (such as Section 1031) and, under Reg. 1.721-1(a)(4), "boot" received at the time of contribution of property to a partnership is clearly treated as received in a Section 707 sale to the partnership. Reg. 1.1245-4(c)(4), Example 3, may be misleading in that it does not even suggest the possibility of a constructive sale of the contributed property by the contributing partner.

Interplay between 751(a) and 731(a)(1)

It might appear that Section 751(a) is applicable to constructive cash distributions notwithstanding that there is no step-transaction sale or exchange of a partnership interest under the Section 721 and 731 Regulations. The reasoning is that Section 731(a) states that gain from a cash distribution (actual or constructive) in excess of basis "shall be considered as gain . . . from the sale or exchange of the partnership interest of the distributee partner." Section 731 does not describe the tax treatment to be accorded such gain. Thus, it may be argued that it is necessary to look at Section 741 which provides that gain from the sale or exchange of a partnership interest shall be considered as gain or loss from the sale of capital asset, except as otherwise provided in Section 751.

Section 751(a) in turn mandates that the amount of money received by a transferor partner in exchange for all or part of his interest in the partnership attributable to Section 751 property shall be considered as an amount realized from the sale or exchange of property other than a capital asset. It seems, however, that Congress merely intended to accord capital treatment to a gain or loss recognized under Section 731(a) and not to incorporate Section 751(a) through 741. S. Rep't. No. 1622 stated that "[g]ain or loss recognized under subsection [731(a)] will be treated as gain or loss from the sale or exchange of the distributee's partnership interest, that is capital gain or loss." This statement is echoed in Reg. 1.731-1(a)(2). Similarly, H. Rep't. No. 1357, 83rd Cong. 2d Sess. (1954), flatly declares that distributions in excess of basis "will be taxed as capital gain to the distributee." The Senate limited this only by restricting such recognition of gain to money distributions. Furthermore, the statement in Section 731(c) that Section 731 is inapplicable to the extent otherwise provided in Section 751 appears to refer to Section 751(b)" since the Senate Report, in noting Section 731(c), added that "[i]t will be observed that Section

23 Aronson, "Admission of a New Partner for Cash, Property or Services," 23 Tax Lawyer 325, 337, Ex. 1(b) (1970); accord, Bloom, "Making the Deal and Creating the Partnership," 35 (FILJA) 2488 (1973). Cf. Willis, Partnership Taxation 105 (1971). But see Anderson and Coffee, supra note 12, at 528-30 (in view of events preceding 1954 Code and silence of legislative history, Regulations incorrectly apply Section 761(b) to non-liquidating distributions). Bloom, supra at 39-40, raises the possibility that the Section 751(b) problem in the context of admission of additional partners might be avoided "by restating value of partnership assets immediately prior to admission of new partners and by specially allocating gain on such assets at time of restatement to old partners in accordance with old profit ratio."
24 Although Reg. 1.731-1(a)(2) dictates that basis of Section 751 property in such a sale is in effect the partnership's transferred basis, such basis cannot exceed the partner's basis in his partnership interest. Section 732(a)(2).
25 Cowan, Unpublished Manuscript on Section 752.
26 Willis, Partnership Taxation 105 (1971).
amended. In Rev. Rul. 74-320, IRB 1974-27 (also issued as TIR 1295, 6/11/74), the Service held that the amendment conformed the California Act to the Uniform Limited Partnership Act. Accordingly, it held that limited partnerships formed under the amended act and those formed before the amendment which elect to be governed by the amendment will not have continuity of life as long as the amendment is effective. At present, the amendment is effective only through 1975.

Ruling restrictions

In Rev. Proc. 74-17, IRB 1974-22, 17 (also issued as TIR 1290, 5/3/74), the Service held that the following conditions must exist before a ruling will be issued that a limited partnership is not an association taxable as a corporation.

1. The total interests of all general partners in each material item of partnership income, gain, loss, deduction, or credit must be 1% of each item at all times during the existence of the partnership. If the general partner also owns an interest as a limited partnership, the latter interest is excluded in applying this test. Thus, the required interest must be owned as a general partner.

2. The total deductions for the partners' shares of the losses of the partnership for the first two years of operation cannot exceed the amount of equity capital invested in the partnership.

3. A creditor who makes a non-recourse loan may not obtain any interest, direct or indirect, in the profits, capital, or property of the limited partnership as a result of the loan, other than as a secured creditor.

This Procedure is in addition to Rev. Proc. 72-13, 1972-1 CB 755, which set guidelines for a favorable ruling when the sole general partner of a limited partnership was a corporation. That Procedure set minimum requirements for the net worth of such a corporation and restricted the ownership of the stock of such a corporation by the limited partners if a favorable ruling was to be obtained.

For a full analysis of Rev. Proc. 72-13, see Weiler, Limited partnerships with corporate general partners: Beyond Rev. Proc. 72-13, 36 JTAX 306 (May, 1972)).

In Rev. Proc. 74-17, the Service states that "ordinarily" the above operating rules must be complied with or a favorable ruling will not be issued. As indicated above, previous pronouncements, such as Rev. Proc. 72-13 remain in effect and must be considered by practitioners.