Termination of Partnerships and of Partnership Interests

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I. INTRODUCTION

A. Principles of Partnership Taxation

1. Partnership taxation is based on two opposing theories of partnership law: the aggregate theory and the entity theory.

   a. Under the aggregate theory, a partnership is viewed as a collection of individuals who are commonly conducting a business.

   b. Under the entity theory, a partnership is viewed as a separate body that is conducting the business and is owned by the partners.

2. The aggregate theory generally applies to the formation of a partnership, the taxation of the income generated by the partnership's activities, and the dissolution of a partnership.

3. The entity theory generally applies to transactions between a partner and the partnership other than in his capacity as a partner and to transfers of partnership interests to other partners or third parties.

4. In some situations where the entity theory normally applies, the Internal Revenue Code permits the partnership and the partners to elect to have the aggregate theory apply; for example, in connection with the sale of a partnership interest, the partnership may make an election under I.R.C. § 754 to adjust the basis of the partnership assets.

5. Partnership taxation is a difficult subject because the Internal Revenue Code does not cover every type of transaction that may arise in connection with the formation, operation, and termination of a partnership.
a. In such a case, the practitioner must decide which theory will apply; i.e., the aggregate theory or the entity theory.

b. The Code provisions and regulations have not been as carefully scrutinized by the courts as other areas, such as in the corporate tax area, because of the relatively few cases involving partnership taxation, although this phenomenon has been changing over the last ten or fifteen years as a result of litigation involving tax shelters.

6. Partnership taxation has become increasingly important, not only because of the use of limited partnerships for tax shelter vehicles, but also as a result of the Tax Reform Act of 1986.

a. The repeal of the General Utilities doctrine means that corporate earnings and any appreciation in the value of property held in the corporate form will be subject to double taxation upon dissolution unless an S election has been made and the built-in gain tax is avoided.

b. The inversion of the rates means that a corporation is now in a higher tax bracket than an individual, thereby increasing the tax benefits of using a pass-through entity such as a partnership to conduct a business.

c. Although many of the same tax benefits can be achieved through an S corporation, the S corporation is not as flexible as the partnership with respect to allocations of gain, income, losses, and deductions, and a partner's basis in the partnership includes his share of the partnership liabilities while the basis of a shareholder in an S corporation does not include any share of the corporation's liabilities.

B. Focus of Outline

1. This outline deals with issues involved in the termination of partnerships and of partnership interests, including:
a. Sales or exchanges of partnership interests, specifically I.R.C. §§ 731, 732, 733, 734, 735, 741, 742, and 743. See Parts II and V of this outline.

b. The tax consequences upon the death or retirement of a partner, specifically I.R.C. §§ 736 and 753. See Part III of this outline.

c. The termination of a partnership, specifically, I.R.C. § 708. See Part IV of this outline.

d. The optional adjustment to the basis of partnership property permitted under I.R.C. § 754. See Part V of this outline.

2. This outline does not cover:


b. The taxation of partnership operations, specifically, I.R.C. §§ 701, 702, 703, 704, 705, and 706.

c. Transactions between a partner and a partnership, specifically, I.R.C. § 707.

d. The treatment of certain assets under I.R.C. § 751 (so-called "hot assets").

e. The effect of partnership liabilities, specifically, I.R.C. § 752.


II. SALES AND EXCHANGES OF PARTNERSHIP INTERESTS

A. General Rule

1. A partner generally recognizes capital gain or loss as a result of a sale or exchange of an interest in a partnership. I.R.C. § 741.
a. Any gain attributable to a partner's interest in unrealized receivables and substantially appreciated inventory items will be treated as ordinary income. I.R.C. § 751(a).

2. The basis of the transferee is determined under the usual rules contained in Part II of Subchapter O (I.R.C. §§ 1011 and following). I.R.C. § 742. See Part V.A.3 of this outline for a more thorough discussion of the basis of a partnership interest acquired by sale or exchange, by gift, or as a result of the death of a partner.

3. The basis of the partnership in its assets is not adjusted as a result of a transfer of an interest in a partnership by sale or exchange, by gift, or on the death of a partner unless an election is made under I.R.C. § 754. I.R.C. § 743. See Part V of this outline for a discussion of I.R.C. § 754.

4. I.R.C. § 267(a) may disallow a deduction for a loss realized on a sale or exchange of a partnership interest directly or indirectly to a related person as described in I.R.C. § 267(b).

5. The amount of any gain or loss to the partner is the difference between the amount realized on the sale and the adjusted basis of the partner in the partnership interest.
   a. If less than the entire interest is sold, the basis must be apportioned between the interest sold and the interest retained.
   b. It is not clear how a partner allocates his basis where he has acquired interests in several transactions, although perhaps the same rules will apply that apply with respect to shares of stock. See Treas. Reg. § 1.1012-1(c).
   c. If a partner sells a profits interest and a capital interest, there may be no basis actually allocated to the profits interest, since the partnership itself would have no basis in the future profits of the partnership.
6. The amount realized is the sum of the amount of money and the fair market value of the property received by the selling partner, as well as the partner's share of partnership liabilities which he is relieved of in connection with the transfer of the interest.

B. The Adjusted Basis of a Partnership Interest

1. The initial basis of an interest in a partnership acquired by contribution of property, including money, is the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution, increased by the amount of any gain recognized to the contributing partner at such time. I.R.C. § 722.

2. The initial basis of an interest acquired by purchase, gift, or on account of the death of a partner, is determined under the usual basis rules and is described in more detail in Part V.A.3 of this outline.

3. The initial adjusted basis of a partner's interest in a partnership is increased by:
   a. The taxable income of the partnership;
   b. The income of the partnership exempt from tax;
   c. The excess of the deductions for depletion over the basis of the property subject to depletion;
   d. Any additional contributions of money;
   e. The adjusted basis of any property subsequently contributed less any liabilities to which the property is subject at the time of the contribution or which the partnership assumes in connection with the transfer of the property; and
   f. Any increase in the partner's share of partnership liabilities.

4. A partner's initial adjusted basis in a partnership is decreased by:
a. Losses of the partnership;

b. Expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account;

c. The amount of the partner's deduction for depletion for any partnership oil or gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such partner under I.R.C. § 613A(c)(7)(D);

d. Any money distributed;

e. The adjusted basis of any property distributed less any liabilities to which the property is subject to or which the distributee assumes in connection with the transfer of the property; and

f. Any reduction in the partner's share of liabilities.

5. Liabilities of a partnership are generally shared as follows:

a. A general partner shares recourse liabilities in proportion to his share of losses. Treas. Reg. § 1.752-1(e).

b. A limited partner shares recourse liabilities only to the extent he is obligated to make additional contributions. Treas. Reg. § 1.752-1(e).

c. General and limited partners share nonrecourse liabilities according to their share of partnership profits. Treas. Reg. § 1.752-1(e).

6. Regulations under I.R.C. § 705(b) permit the partners to use an alternative method for determining the adjusted basis of a partner's interest.

a. Under the alternate method, the adjusted basis of the partner's interest in the partnership
is equal to the partner's proportionate share of the partnership's adjusted basis for the properties which the partner would be entitled to receive if the partnership were to terminate.

b. The alternative method may be used only if the circumstances are such that the partner cannot practically apply the general rule for determining basis or if he demonstrates to the Internal Revenue Service that the result produced by the use of the alternative method will not vary substantially from the result obtainable under the general rule.

7. A partner who has both a general partnership interest and a limited partnership interest has a unified basis for both types of partnership interests. See Rev. Rul. 84-53, 1984-1 C.B. 159.

C. Other Tax Consequences of a Sale or Exchange of a Partnership Interest

1. The partner may recapture investment tax credit in the event of a disposition of more than one-third of his original interest in the general partnership profits. Treas. Reg. § 1.47-6(a)(2)(ii).

2. Any losses suspended under I.R.C. § 704(d) are lost if the partner sells his interest.

3. Suspended losses under the at risk rules are deductible to the extent the transferor recognizes gain. Prop. Regs. §§ 1.465-66(a) and 1.465-12.

4. Losses suspended as a result of the passive activity loss limitations with respect to passive activities of the partnership will offset any gain on the sale or exchange of the partnership interest provided that it is a disposition of the partner's entire interest in the partnership; any suspended losses in excess of the gain may offset any other passive income recognized in the year of sale, and to the extent not so used, can offset active income and portfolio income in the year of sale.
III. DEATH OR RETIREMENT OF A PARTNER

A. Alternatives Upon the Death or Retirement of a Partner.

1. There are five possible ways of disposing of a deceased or retiring partner's interest in a partnership:
   a. The partnership may be liquidated.
   b. The partner's interest may be liquidated.
   c. The interest may be sold to other partners.
   d. The interest may be sold to a third party.
   e. The deceased partner's successor in interest may continue as a partner.

2. Alternatives b and c (the liquidation of the partner's interest and a sale to the other partners) are economically the same but have substantially different tax consequences to the withdrawing partner, the partnership, and the other partners.

3. Alternatives c and d, the sale of the withdrawing partner's interest to another partner or a third party, has no tax consequences to the partnership itself unless an I.R.C. § 754 election is in effect.

4. Alternative a is discussed in Part IV of this outline.

5. Alternatives c and d are discussed in Part II of this outline.

6. Alternative b is discussed in this Part III.

B. Application of I.R.C. § 736.

1. I.R.C. § 736 applies to payments made to a retired partner or a deceased partner's successor in interest (referred to in the rest of this discussion as the "withdrawing partner") in liquidation of such partner's interest. Treas. Reg. § 1.736-1(a)(1)(1).
a. I.R.C. § 736 only applies if the entire interest of the withdrawing partner is being liquidated. Treas. Reg. § 1.736-1(a)(1)(i).

b. The withdrawing partner must have ceased to be a partner under state law at the time of the payment. Treas. Reg. § 1.736-1(a)(1)(ii).

c. I.R.C. § 736 does not apply to the sale by a partner of his partnership interest to another partner. Treas. Reg. § 1.736-1(a)(1)(i).

d. It is not clear whether I.R.C. § 736 applies to in kind distributions.

e. I.R.C. § 736 may apply to a withdrawing partner who is relieved of partnership liabilities as a result of the operation of I.R.C. § 752, even though the withdrawing partner does not receive any cash or other property.

2. Payments are classified under I.R.C. § 736 into three categories:

a. As a payment for the withdrawing partner's interest in the partnership property;

b. As an allocation of a distributive share of the partnership's income if the amount of the payment is determined with regard to the income of the partnership; and

c. As a guaranteed payment described in I.R.C. § 707(c) if the amount of the payment is determined without regard to the income of the partnership.

3. The classification of a payment under I.R.C. § 736 will determine:

a. Whether the withdrawing partner recognizes capital gain or loss, or ordinary income with respect to such payments;

b. The timing of the gain or loss on income recognized by the withdrawing partner;
c. Whether the partnership is entitled to a deduction with respect to such payments;
d. Whether the partners are entitled to an exclusion from their own share of partnership income with respect to such payments; and
e. Whether the payments to a successor in interest constitute income in respect of a decedent under I.R.C. §§ 691 and 753.

C. Payments for a Partner's Interest in Partnership Property.

1. Payments for a withdrawing partner's interest in partnership property are not classified as distributive shares or guaranteed payments (referred to in the rest of this discussion as 736(a) payments) unless the payment is for:
   a. Unrealized receivables as described in I.R.C. § 751(c) (except in the unusual case in which the partnership has a basis in such receivables); and
   b. Goodwill, except to the extent that the partnership agreement provides for payments for goodwill or the partnership has a basis in the goodwill.

2. Generally the Internal Revenue Service will respect a valuation of the partner's interest in partnership property. Treas. Reg. § 1.736-1(b)(1).
   a. Before the elimination of the long-term capital gain deduction by the Tax Reform Act of 1986 (TRA 86), the remaining partners and withdrawing partner usually had adverse interests with respect to the valuation of the withdrawing partner's interest.

      (1) 736(a) payments are either deductible to the partnership or reduce the remaining partners' distributive shares of partnership income, and are ordinary income to the withdrawing partner.
(2) 736(b) payments (payments for the partner's interest in partnership property) are treated as received in a sale or exchange subject to capital gain treatment except to the extent attributable to I.R.C. § 751 assets, and are not deductible to the remaining partners.

b. Even before TRA 86, an agreement between related parties was subject to closer scrutiny.

c. With the elimination (perhaps only temporary) of the long-term capital gain deduction, the Internal Revenue Service may be more likely to apply allocation principles similar to those under I.R.C. § 1060 to the liquidation of a partner's interest.

d. If this were to become the practice of the Internal Revenue Service, the flexibility provided by I.R.C. § 736 would be restricted to payments for goodwill.

(1) As will be discussed later, payments for goodwill in excess of basis are treated as 736(a) payments unless the partnership agreement provides for payments for goodwill, in which case the payments are 736(b) payments.

3. In valuing the withdrawing partner's interest in partnership property, there should be no reduction because of liabilities of the partnership. Treas. Reg. § 1.736-1(b)(1).

a. The withdrawing partner's basis (which will include his share of partnership liabilities) will be reduced by the share of partnership liabilities he is relieved of as a result of withdrawing from the partnership.

4. I.R.C. § 731(a) will determine whether the withdrawing partner recognizes gain or loss with respect to payments for his interest in partnership property.
a. Except as provided under I.R.C. § 751 in connection with amounts attributable to substantially appreciated inventory, such payments will be treated as received in a sale or exchange under I.R.C. § 741. Treas. Reg. § 1.736-1(b)(4).

(1) Inventory is considered to have appreciated substantially if:

(a) The fair market value of all inventory of the partnership exceeds 120 percent of the partnership's adjusted basis in the inventory; and

(b) The value of the inventory exceeds 10 percent of the fair market value of all partnership property other than money.

I.R.C. § 751(d)(1).

(2) Inventory includes:

(a) Property of the partnership of the kind described in I.R.C. § 1221(1);

(b) Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in I.R.C. § 1231;

(c) Any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under I.R.C. § 1246(a) (relating to gain on foreign investment company stock); and

(d) Any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in the previous three items.
b. The partnership recognizes no gain or loss in connection with a payment in cash for a withdrawing partner's interest in the partnership property, but may be required to adjust the basis of its assets because of I.R.C. § 751 or because an I.R.C. § 754 election is in effect.

5. If the payments are made over a period of more than one year, the withdrawing partner recovers his basis before recognizing any income and will not recognize any loss until the last payment, unless the partner elects to recognize gain or loss ratably over the payments, which is only permitted if the total amount of payments is fixed. Treas. Reg. § 1.736-1(b)(6).

a. If such an election is made, the recipient making the election must attach a statement to his tax return for the first taxable year for which he receives such payments, indicating the election and showing the computation.

b. A recipient will want to make the election in the case of a loss or to spread gain over several years to keep the payments taxable in lower brackets.

c. Any gain or loss attributable to substantially appreciated inventory will be recognized immediately, regardless of whether an election is made.

D. Payments Other Than for Interest in Partnership Property.

1. I.R.C. § 736(a) payments are any payments made to a withdrawing partner that are not in exchange for his interest in partnership property and also include:

a. Payments for goodwill not provided for in the partnership agreement, in excess of the basis of the partnership in goodwill; and
b. Unrealized receivables in excess of the partnership's basis.

2. I.R.C. § 736(a) payments are divided into two categories:
   a. Payments that are determined with regard to partnership income and are treated as a distributive share of partnership income, which are referred to as 736(a)(1) payments; and
   b. Payments that are not determined with respect to partnership income and are treated as guaranteed payments under I.R.C. § 707(c), which are referred to as 736(a)(2) payments.

3. Usually determining the appropriate category is not difficult, but if the payments are dependent upon the partnership's gross receipts or gross income, there is authority that the payments may be treated as distributive shares of partnership income rather than guaranteed payments. See Pratt v. Commissioner, 64 T.C. 203, aff'd, 550 F.2d 1023 (5th Cir. 1977); and Rev. Rul. 81-300, 1981-2 C.B. 143.

4. If the payment is considered a distributive share, then:
   a. The payment is included in the partner's income under I.R.C. § 702;
   b. The remaining partners' distributive shares are reduced accordingly;
   c. The character of the withdrawing partner's share of partnership income depends upon the character of the partnership's income, e.g., capital gain, ordinary income, tax-exempt income; and
   d. Although not free from doubt, the recipient includes the distributive share in his gross income for his taxable year within or with which ends the partnership's taxable year for which the payment is a distributive share rather than the year in which the payment is actually made.
5. If the payment is a guaranteed payment, then:
   
a. The payment is deductible by the partnership notwithstanding I.R.C. § 263;

b. The payment is ordinary income to the recipient; and

c. The payment is includible in the recipient's gross income for the recipient's taxable year within or with which ends the partnership's taxable year in which the partnership deducted the payments as paid or accrued under its accounting method.

(1) For example, if a partnership on an accrual basis, having a calendar year for its taxable year, pays and deducts a payment to a withdrawing partner in 1988, but actually makes the payment in 1989, the withdrawing partner must include the payment in his 1988 gross income.

E. Allocation of Payments Between I.R.C. § 736(a) and I.R.C. § 736(b).

1. The regulations set forth rules for allocating payments made during a year between I.R.C. § 736(a) and (b). Treas. Reg. § 1.736-1(b)(5).

   a. If the payments are fixed in amount and are payable over a fixed number of years, then a portion of the total amount of agreed payments made in each year will be treated as a 736(b) payment.

      (1) The portion is a fraction of the total amount of payments that are to be made each year, the numerator of which is the total amount of 736(b) payments to be made under the agreement and the denominator of which is the total of all payments to be made under the agreement.

      (2) If contingent payments are made in excess of the fixed amount, the contingent payments will be 736(a) payments.
(3) If the amount of payments in a year are less than the amount of 736(b) payments that were to be made in the year as determined above, the deficit is carried over to succeeding years, so that a payment in a future year will be treated as 736(b) payments to the extent of the portion determined above plus any carryovers from prior years.

b. If the amount of payments are not fixed, then the payments are treated first as 736(b) payments to the full extent of the value of the withdrawing partner's interest in partnership property, and the remaining payments are treated as 736(a) payments.

c. If the payments are both fixed and contingent, and the total amount of fixed payments exceeds the value of the withdrawing partner's interest in partnership property, the fixed payments will be allocated as described above, and the contingent payments will all be 736(a) payments.

d. If the amount of the fixed payments is less than the value of the withdrawing partner's interest in partnership property, all the fixed payments will be treated as 736(b) payments, and the contingent payments will also be treated as 736(b) payments until the amount of the contingent payments received, plus the amount of all fixed payments either already received or to be made, equal the value of the withdrawing partner's interest in partnership property.

2. The partners may agree to use another method for allocating the payments between 736(a) payments and 736(b) payments, as long as the amount allocated to 736(b) payments does not exceed the fair market value of the withdrawing partner's interest in partnership property. Treas. Reg. § 1.736-1(b)(5)(iii).

3. The treatment of payments for goodwill depends upon the partnership agreement.
a. Any payments attributable to the partnership's basis in goodwill will be a 736(b) payment. Treas. Reg. § 1.736-1(b)(3).

b. If the partnership agreement provides for payments for goodwill, such payments will also be 736(b) payments. Treas. Reg. § 1.736-1(b)(3).

c. All other payments for goodwill are 736(a) payments. Treas. Reg. § 1.736-1(b)(3).

4. The provision concerning goodwill may be:

a. Contained in the original partnership agreement;

b. Agreed to at the time of a partner's withdrawal; or

c. Contained in an amendment to the partnership agreement before the due date for the partnership's return for the year in which the partner withdrew (but not including extensions). I.R.C. § 761(c).

(1) While the amendment may be oral or written, it should be written to avoid problems of proof.

5. The tax consequences involved when the distribution to a withdrawing partner consists partly of property are not certain. For a discussion of the issues involved, see McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners, Warren, Gorham & Lamont, 1977, pages 22-28 through 22-36, and Kemp, 236 T.M. Death or Retirement of a Partner; Termination of a Partnership, pages A-32 through A-34.

F. Examples.

1. The following examples, taken directly from Treas. Reg. § 1.736-1(b)(7), illustrate the operation of I.R.C. § 736.

Example (1). Partnership ABC is a personal service partnership and its balance sheet is as follows:
Partner A retires from the partnership in accordance with an agreement whereby his share of liabilities ($1,000) is assumed. In addition he is to receive $9,000 in the year of retirement plus $10,000 in each of the two succeeding years. Thus, the total that A receives for his partnership interest is $30,000 ($29,000 in cash and $1,000 in liabilities assumed). Under the agreement terminating A's interest, the value of A's interest in § 736(b) partnership property is $12,000 (one-third of $36,000, the sum of $13,000 cash and $23,000, the fair market value of capital and § 1231 assets). A's share in unrealized receivables is not included in his interest in partnership property described in § 736(b). Since the basis of A's interest is $11,000 ($10,000 plus $1,000, his share of partnership liabilities), he will realize a capital gain of $1,000 ($12,000 minus $11,000) from the disposition of his interest in partnership property. The remaining $18,000 ($30,000 minus $12,000) will constitute payments under § 736(a)(2) which are taxable to A as guaranteed payments under § 707(c). The payment for the first year is $10,000, consisting of $9,000 in cash, plus $1,000 in liability assumed (§ 752(b)). Thus, unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, each annual payment of $10,000 will be allocated as follows: $6,000 (18,000/30,000 of $10,000) is a § 736(a)(2) payment and $4,000 (12,000/30,000 of $10,000) is a payment for an interest in § 736(b) partnership property. (The partnership may deduct the

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$6,000 guaranteed payment made to A in each of the 3 years.) The gain on the payments for partnership property will be determined under § 731, as provided in subparagraph (6) of this paragraph. A will treat only $4,000 of each payment as a distribution in a series in liquidation of his entire interest and, under § 731, will have a capital gain of $1,000 when the last payment is made. However, if A so elects, as provided in subparagraph (6) of this paragraph, he may treat such gain as follows: Of each $4,000 payment attributable to A's interest in partnership property, $333 is capital gain (one-third of the total capital gain of $1,000), and $3,667 is a return of capital.

Example (2). Assume the same facts as in example (1) of this subparagraph except that the agreement between the partners provides for payments to A for three years of a percentage of annual income instead of a fixed amount. Unless the partners agree otherwise under subparagraph (5)(iii) of this paragraph, all payments received by A up to $12,000 shall be treated under § 736(b) as payments for A's interest in partnership property. His gain of $1,000 will be taxed only after he has received his full basis under § 731. Since the payments are not fixed in amount, the election provided in subparagraph (6) of this paragraph is not available. Any payments in excess of $12,000 shall be treated as a distributive share of partnership income to A under § 736(a)(1).

Example (3). Assume the same facts as in example (1) of this subparagraph except that the partnership agreement provides that the payment for A's interest in partnership property shall include payment for his interest in the good will of the partnership. At the time of A's retirement, the partners determine the value of partnership good will to be $9,000. The value of A's interest in partnership property described in § 736(b) is thus $15,000 (one-third of $45,000, the sum of $13,000 cash, plus $23,000, the value of capital and § 1231 assets, plus $9,000 good will). From the disposition of his interest in partnership property, A will realize a capital gain of $4,000 ($15,000 minus $11,000, the basis of his interest). The remaining $15,000 ($30,000 minus $15,000) will constitute payments under § 736(a)(2) which are taxable to A as guaranteed payments under § 707(c).
Example (4). Assume the same facts as in example (1) of this subparagraph except that the capital and § 1231 assets consist of an item of § 1245 property (as defined in § 1245(a)(3)). Assume further that under paragraph (c)(4) of § 1.751-1 the § 1245 property is an unrealized receivable to the extent of $2,000. Therefore, the value of A's interest in § 736(b) partnership property is only $11,333 (one-third of $34,000, the sum of $13,000 cash and $21,000, the fair market value of § 1245 property to the extent not an unrealized receivable). From the disposition of his interest in partnership property, A will realize a capital gain of $333 ($11,333 minus $11,000, the basis of his interest). The remaining $18,667 ($30,000 minus $11,333) will constitute payments under § 736(a)(2) which are taxable to A as guaranteed payments under § 707(c).

IV. TERMINATION OF A PARTNERSHIP

A. General Rule.

1. An existing partnership is considered as continuing if it is not deemed to be terminated under I.R.C. § 708(b).

2. A partnership is considered to be terminated if:

a. No part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership; or

b. Within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in the partnership capital or profits.

Example (1): On November 20, 1988, A and B, each of whom owns a 20 percent interest in partnership ABC, sell their interests to C, who owns a 60 percent interest. The partnership is terminated on November 20, 1988. Even though the business is carried on, it is not carried on by any of its partners in a partnership.

Example (2): On April 30, 1988, partners D, E, and F agree to dissolve their partnership, but the business is not wound up until September 30, 1988, when all remain-
A partnership is terminated on September 30, 1988.

3. Upon the death of one partner in a two-member partnership, the partnership is not terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership.

4. A retiring partner or a deceased partner's successor in interest receiving payments under I.R.C. § 736 is regarded as a partner until the entire interest of the retiring or deceased partner is liquidated.

5. The partnership taxable year closes with respect to all partners on the date on which the partnership terminates, which is either:
   a. The date on which the winding up of its partnership affairs is completed; or
   b. The date of the sale or exchange of a partnership interest which, when aggregated with sales or exchanges in the preceding 12-month period, transfers an interest of 50 percent or more in both partnership capital and profits.

B. Partnership Termination through Sales and Exchanges.

1. There must be a sale or exchange of 50 percent or more of the total interest in partnership capital and 50 percent or more of the total interest in partnership profits within a period of 12 consecutive months.
   a. A sale or exchange includes a sale or exchange to or with another partner.
   b. A disposition by gift (including assignment to a successor in interest), bequest, or inheritance, or a liquidation of a partnership interest, is not a sale or exchange.
   c. A contribution of property does not constitute a sale or exchange unless the contribution is characterized as a sale or exchange between the contributing partner and another partner.
2. The 50-percent requirement means that 50 percent or more of the total interest in partnership capital plus 50 percent or more of the total interest in the profits must be sold or exchanged during the 12-month period.

   a. A sale of a 30-percent interest in partnership capital and a 60-percent interest in partnership profits will not cause a termination.

   b. Sales and exchanges by one or more partners are aggregated, as well as sales and exchanges during a consecutive 12-month period.

   c. The partnership is terminated (and the partnership's taxable year closes) on the date of the sale or exchange of a partnership interest in capital or profits which, when aggregated with all other sales or exchanges of partnership interests during the preceding 12 months, equals or exceeds 50 percent of both the capital interest and the profits interest of the partnership.

Example (3): With respect to ABC partnership, A sells a 30-percent interest in capital and profits to D on May 12, 1988, and B sells a 30-percent interest in capital and profits to E on March 27, 1989. The partnership is terminated on March 27, 1989.

Example (4): Assume the same facts as in Example (3), except D, instead of B, sells his 30-percent interest to E on March 27, 1989. The partnership is not terminated on that date since only one 30-percent interest has been sold or exchanged during a 12-month period.

3. If a partnership is terminated because of a sale or exchange of an interest, the following occurs or is deemed to occur:

   a. The partnership's taxable year closes as of the date of the sale or exchange causing the termination;

   b. The partnership distributes its properties to the purchaser and the remaining partners in
proportion to their respective interests in the partnership properties; and

c. Immediately thereafter the purchaser and the other remaining partners contribute the properties to a new partnership, either for the continuation of the business or for its dissolution and winding up, causing another termination under I.R.C. § 708(b)(1)(B).

4. I.R.C. §§ 731 and 732 will apply to determine the basis of the property in the partners' hands and any gain or loss recognized by the partners on the deemed distribution.

5. I.R.C. §§ 721, 722 and 723 will apply to determine the income tax treatment, the partners' bases in the new partnership, and the new partnership's basis in the contributed assets.

6. I.R.C. § 752 will apply to determine the effect of any decrease in a partner's share of liabilities.

7. The purchaser may elect under I.R.C. § 732(d) to adjust his basis in the property deemed to be distributed to him, even though an I.R.C. § 754 election is not in effect with respect to the partnership itself.

C. Mergers and Consolidations of Partnerships.

1. If two or more partnerships merge or consolidate into one partnership, the resulting partnership will be considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50 percent in the capital or profits of the resulting partnership.

a. If more than one of the merging or consolidating partnerships has members who own an interest of more than 50 percent in the capital or profits of the resulting partnership, the resulting partnership will be considered the continuation of the partnership which is credited with the contribution of the greatest dollar value of assets to the resulting partnership, unless the Internal Revenue Service permits otherwise.
b. The other merging or consolidating partnerships will be considered as terminated on the date of the merger or consolidation.

c. A partnership that terminates as a result of a merger is treated as contributing its assets to the resulting partnership and then distributing interests in the continuing partnership to its partners in liquidation. Rev. Rul. 68-289, 1968-1 C.B. 314.

(1) This treatment differs from the treatment in the case of a termination of a partnership as the result of a sale or exchange of a more-than-50-percent interest in capital and profits within a 12-month period, since in that case the assets of the terminated partnership are deemed to be distributed to the partners and then recontributed to the new partnership.

(2) The bases of the assets in the resulting partnership are not recomputed under I.R.C. § 732(b) and 732(c), but remain the same as in the hands of the merging or consolidating partnerships.

(3) Since no cash or receivables are treated as being distributed, there is less likelihood of any gain or loss being recognized, except to the extent that there is a constructive distribution under I.R.C. § 752(b). See McKee, Nelson & Whitmire, Federal Taxation of Partnership and Partners, Warren, Gorham & Lamont, 1977, page 12-19.

2. If the members of none of the merging or consolidating partnerships have an interest of more than 50 percent in the capital or interest of the resulting partnership, all the merged and consolidating partnerships will be deemed to have terminated and a new partnership results.

3. Returns.
a. The merging or consolidating partnerships that are considered terminated must file their returns for the taxable year ending on the date of the merger or consolidation.

b. The resulting partnership must file a return for the taxable year of the merging or consolidating partnership that is considered as continuing, with the following information:

(1) A statement that it is the continuation of the merging or consolidating partnership;

(2) The names and addresses of the merged or consolidated partnerships; and

(3) The respective distributive shares of the partners for the periods before and after the date of the merger or consolidation.

Example (5): Partnership AB has two 50 percent partners, A and B, and Partnership CD has two 50 percent partners, C and D. Partners A, B, C, and D and partnership AB are on a calendar year, and partnership CD has a June 30 year end. AB and CD are merged into ABCD, with partners A and B each owning 30 percent of the capital and profits and C and D each owning 20 percent of the capital and profits. Consequently, since A and B own more than 50 percent of the interest in capital and profits of partnership ABCD, partnership ABCD is treated as the continuation of partnership AB and must file a return for the year January 1, 1988 to December 31, 1988. Partnership CD is terminated on September 30, 1988 and must file a return for the short year July 1, 1988 through September 30, 1988.

D. Division of a Partnership.

1. Upon the division of a partnership into two or more partnerships, any resulting partnership or partnerships are considered continuations of the prior partnership if its members had an interest of more than 50 percent in the capital and profits of the prior partnership.

2. Any other resulting partnership will be considered a new partnership.
3. If the members of none of the resulting partnerships owned an interest of more than 50 percent in the capital and profits of the divided partnership, the divided partnership is also terminated.

4. Members of the divided partnership who do not become members of a resulting partnership that is considered to be a continuation of the divided partnership will be considered to have liquidated their interests as of the date of division.

5. Any resulting partnership treated as continuing must file a return for the taxable year of the divided partnership with the following information:

   a. A statement that it is a continuation of the divided partnership; and

   b. The respective shares of the partners for the periods before and after the date of division.

Example (6): Partnership ABCD has four partners. A who owns 40 percent in the profits and capital of the partnership, and B, C, and D, each of whom owns 20 percent of the profits and capital of the partnership. The partnership conducts two businesses, an insurance business and a real estate business. The partnership is divided on November 1, 1988 into AB partnership and CD partnership, with partners A and B owning 50 percent each of partnership AB, and partners C and D owning 50 percent each of partnership CD. AB is treated as a continuation of partnership ABCD, since its partners owned more than 50 percent of the divided partnership, and partnership AB must file a return for the taxable year beginning January 1, 1988 and ending on December 31, 1988. CD is treated as a new partnership and must file a return for the taxable year it adopts under I.R.C. § 706(b).

V. BASIS ADJUSTMENTS UNDER I.R.C. § 754.

A. In General.

1. Generally, the basis of partnership property (inside basis) is not adjusted as a result of a distribution of property to a partner unless an elec-
tion under I.R.C. § 754 is in effect. I.R.C. § 734(a).

a. In the case of a distribution by a partnership to a partner other than in liquidation of his interest, the basis of his interest in the partnership is reduced (but not below zero) by:

(1) The amount of money distributed to him, and

(2) His basis in distributed property other than money. I.R.C. § 733.

b. A partner's basis in distributed property other than money, in a distribution other than in liquidation of the partner's interest, is the basis of the property to the partnership immediately before the distribution, after reducing his basis by any money distributed in the same transaction. I.R.C. § 732(a)(1).

(1) However, the basis of the partner in the distributed property cannot exceed his basis in the partnership. I.R.C. § 732(a)(2).

Example (1): A's basis in the partnership before the distribution to him is $1,000. The partnership, in a nonliquidating distribution, distributes Blackacre to A having a basis to the partnership of $800, plus cash of $100. A's basis in Blackacre is $800, and his basis in the partnership is reduced to $100. If Blackacre had a basis to the partnership of $1,100, A's basis in Blackacre would be $900, and his basis in the partnership would be reduced to zero.

c. If the distribution completely liquidates the partner's interest, his basis in the distributed property is equal to his basis in the partnership, after reducing his basis by any money distributed in the same transaction. I.R.C. § 732(b).

d. The basis of any distributed property is allocated first to unrealized receivables and
inventory items (as defined in I.R.C. § 751(d)(1) and (2)) in proportion to the bases of such properties to the partnership and then is allocated to other distributed property, again in proportion to their bases to the partnership. I.R.C. § 732(c).

e. A partner who acquired all or a part of his interest by a transfer with respect to which a section 754 election was not in effect, and to whom a distribution of property (other than money) is made with respect to the transferred interest within two years after the transfer, may elect to treat as the partnership basis of such property the basis that the property would have had if the adjustment under § 743(b) were in effect with respect to the partnership property. I.R.C. § 732(d).

f. Under I.R.C. § 732(d) and Treas. Reg. § 1.732-1(d)(4), a partner receiving a distribution may be required to make the special adjustment to basis, whether or not the property was distributed to him within two years after the acquisition of his interest, if the following conditions existed when the partner acquired his interest in the partnership:

(1) The fair market value of all partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership;

(2) An allocation of basis under I.R.C. § 732(c) upon a liquidation of his interest immediately after the transfer of the interest would have resulted in a shift of basis from property not subject to an allowance for depreciation, depletion, or amortization, to property subject to such allowance; and

(3) A special basis adjustment under I.R.C. § 743(b) would change the basis to the transferee partner of the property actually distributed.
g. These rules with respect to basis do not apply in the case of a deemed sale or exchange of substantially appreciated inventory and unrealized receivables under I.R.C. § 751(b). I.R.C. § 732(e).

2. Generally, neither the partners nor the partnership recognize gain or loss with respect to distributions. I.R.C. § 731.

a. A partner recognizes gain in the case of a distribution by a partnership to him of cash if the amount of cash exceeds his basis in the partnership. I.R.C. § 731(a)(1).

(1) The gain is the excess of the amount of cash over his basis.

b. In a nonliquidating distribution, no loss is recognized by the partner. I.R.C. § 731(a)(2).

c. In a complete liquidation, a partner recognizes loss only if the only property distributed is cash and unrealized receivables and inventory, and the amount of the loss is the excess of the adjusted basis of the partner's interest in the partnership over the amount of cash and the basis to the partnership of the receivables and inventory distributed. I.R.C. § 731(a)(2).

d. The partnership does not recognize gain or loss in a distribution to a partner of property, including cash. I.R.C. § 731(b).

e. I.R.C. § 736 (relating to payments to a retiring partner) and § 751 (relating to unrealized receivables and inventory items) override these rules. I.R.C. § 731(c).

3. Generally, the basis of partnership property (inside basis) is not adjusted as a result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless an election under I.R.C. § 754 is in effect. I.R.C. § 743(a).
a. The basis of a partnership interest (outside basis) acquired by purchase or exchange is the amount of cash paid, plus the basis of any property transferred to the selling partner, plus the purchasing partner's share of the liabilities of the partnership, if any. I.R.C. §§ 742 and 752.

(1) A general partner's share of recourse liabilities is equal to his share of losses. Treas. Reg. § 1.752-1(e).

(2) A limited partner's share of recourse liabilities is limited to any additional contributions he is obligated to make. Treas. Reg § 1.752-1(e).

(3) General and limited partners share non-recourse liabilities according to their shares of partnership profits. Treas. Reg. § 1.752-1(e).

b. The basis of a partnership interest (outside basis) acquired by a gift is equal to the basis of the donor plus any gift tax paid with respect to the gift, unless the fair market value is less than such amount. In such event, for loss purposes, the basis is equal to the fair market value of the interest at the time of the gift. I.R.C. § 1015.

c. The basis of a partnership interest (outside basis) acquired from a decedent will be its value as reported on the federal estate tax return, which is the fair market value at either the date of death or at the alternate valuation date (the earlier of the date of disposition by the estate or six months after the date of death) increased by the successor's share of liabilities and decreased by items of income in respect of a decedent (IRD) under I.R.C. § 691. I.R.C. § 1014.

4. An I.R.C. § 754 election permits a partnership to adjust the basis of partnership property (inside basis) in cases in which property is distributed to a partner or a partnership interest is transferred.
a. The election applies with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which the election is filed and all subsequent years. I.R.C. § 754.

(1) The election must be made in a written statement filed with the partnership return for the taxable year during which the distribution is made. Treas. Reg. § 1.754-1(b)(1).

(2) The return must be filed in a timely manner (including extensions).

(3) If an election has been made for a preceding year, a new election is not required.

(4) The statement must be signed by any one of the partners and must contain the following information:

(a) The name and address of the partnership making the election; and

(b) A declaration that the partnership elects under I.R.C. § 754 to apply the provisions of I.R.C. §§ 734(b) and 743(b).

b. The election may be revoked only with the approval of the district director for the internal revenue district in which the partnership return is required to be filed. I.R.C. § 754.

(1) The application to revoke the election must be filed within 30 days after the close of the partnership taxable year with respect to which the election is intended to take effect. Treas. Reg. § 1.754-1(c).

(2) Reasons for approving the revocation include a change in the nature of the partnership business, a substantial
increase in the assets of the partnership, a change in the character of the partnership assets, or an increased frequency of retirements or shifts of partnership interests, so that an increased burden would result to the partnership from the election. Treas. Reg. § 1.754-1(c).

(3) A revocation will not be approved if the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution. Treas. Reg. § 1.754-1(c).

B. Effect of an I.R.C. § 754 Election.

1. In the case of a distribution of property to a partner when a 754 election is in effect, the partnership must:

a. Increase the basis of partnership property by:

(1) The amount of any gain recognized to the distributee partner as a result of the distribution; and

(2) The excess of the basis of the distributed property to the partnership over the basis of the distributed property to the partner (which will only occur if his basis in the partnership (after reducing it by the amount of any cash received) is less than the basis of the distributed property immediately before the distribution); or

b. Decrease the basis by:

(1) The amount of any loss recognized to the distributee partner as a result of the distribution (only possible in a complete liquidation); and

(2) The excess of the basis of the distributed property to the distributee over the basis of the distributed property to the partnership immediately before
the distribution (which will only occur if the distributee's basis in the partnership (after reducing it by the amount of any cash received) is greater than the basis of the distributed property immediately before distribution; again, only possible in a complete liquidation).

I.R.C. § 734(b).

2. In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner when a 754 election is in effect, the partnership must:

a. Increase the basis of the partnership property, with respect to the transferee partner only, by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the basis of the partnership property, determined in accordance with his interest in the partnership capital (including any required allocation under I.R.C. § 704(c) with respect to contributed property); and

b. Decrease the basis of the partnership property, with respect to the transferee partner only, by the excess of the transferee partner's proportionate share of the basis of the partnership property over the basis of his interest in the property.

I.R.C. § 743(b).

3. Any increase or decrease in the adjusted basis of the partnership property under I.R.C. § 734(b) or 743(b) must be allocated according to I.R.C. § 755 and the regulations thereunder as follows:

a. The amount of the increase or decrease is first divided between the capital assets and section 1231 assets (property used in a trade or business) and any other property (ordinary income property). Treas. Reg. § 1.755-1(a)-(1)(i).
(1) In the case of a distribution in which the distributee's basis in the distributed property is different from the adjusted basis of the partnership in the property immediately before the distribution, the adjustment must be allocated to the remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Treas. Reg. § 1.755-1(b)(1)(i).

(2) If the distribution results in the distributee recognizing gain or loss, the adjustment must be allocated only to capital assets or section 1231 property. Treas. Reg. § 1.755-1(b)(1)(ii).

(3) In the case of a transfer, the adjustment is allocated between the two classes of property in proportion to the difference between the fair market value and the basis of the assets in each class. Treas. Reg. § 1.755-1(b)(2).

(4) If the amount of decrease exceeds the basis of the property of the required character, the balance of the decrease will be made when the partnership subsequently acquires property of a like character. Treas. Reg. § 1.755-1(b)(3).

(5) Likewise, if an adjustment cannot be made because the partnership does not have property of the character required to be adjusted, the adjustment will be made when the partnership acquires such property. Treas. Reg. § 1.755-1(b)(4).

b. The portion of the increase or decrease allocated to each class is then allocated to the bases of the property within the class in a manner which will reduce the difference in the fair market value and the basis of the partnership properties, or in any other manner approved by the district director. Treas. Reg. § 1.755-1(a)(1)(i).
(1) If there is an increase in basis to be allocated, the increase must be allocated only to those assets whose values exceed their bases and in proportion to the difference between the value and the basis of each such asset. Treas. Reg. § 1.755-1(a)(1)(ii).

(2) If there is a decrease in basis to be allocated, the decrease must be allocated only to those assets whose values are less than their bases and in proportion to the difference between the value and the basis of each such asset. Treas. Reg. § 1.755-1(a)(1)(iii).

(3) No adjustment may increase the basis of any asset above its fair market value nor decrease the basis of any asset below its fair market value. Treas. Reg. § 1.755-1(a)(1)(ii) and (iii).

(4) A portion of any adjustment must be allocated to goodwill to the extent goodwill exists and is reflected in the value of the property distributed to the partner, the price at which the partnership interest is sold, or the basis of the partnership interest determined under I.R.C. § 1014. Treas. Reg. § 1.755-1(a)(1)(iv).

c. A partnership or partner electing under I.R.C. § 732(d) may request approval of an alternate manner of allocating the adjustment to basis. Treas. Reg. § 1.755-1(a)(2).

(1) The application for permission to use another method must be filed with the district director no later than 30 days after the close of the partnership taxable year in which the proposed adjustment is to be made.

(2) The regulations indicate that the manner of allocation may permit the adjustment to be made to the basis of assets without regard to whether the assets have ap-
preciated in value or depreciated in value, so as to reflect more accurately the increase or decrease in the fair market value of the various assets of the partnership in relation to the basis of such assets.

(3) The regulations do not indicate whether it is possible to allocate the adjustment to all of the assets of the partnership, or whether such adjustment can only be made within a class of assets, that is, capital assets and section 1231 property, or other property (ordinary income property).