

6000 DISTRIBUTIONS

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6010 DISTRIBUTIONS FROM A PARTNERSHIP-GENERAL

Partnership distributions are covered in IRC §§ 731 through 737. Auditors should consider the effects of IRC §§ 704(c)(1)(B), 707(a)(2), 736, 737, 751(b) and 311(b) when analyzing the consequences of a distribution under IRC § 731.

Distributions from a partnership are common and therefore the determination of the tax ramifications is important. Distributions are important from a compliance standpoint because generally, a distribution of cash or property is “tax free”. There are several exceptions to the general rule. Gain or loss may be recognized in the following situations:

- in a current or liquidating distribution, if money distributed exceeds the partners’ adjusted basis in their partnership interest. (See PTM 6120)
- the partnership distributes “marketable securities”. (See PTM 6400)
- in a liquidating distribution, a loss may be recognized if the distribution consists of money, unrealized receivables or inventory (or any combination of the foregoing) and the amount of money and the basis to the distributee of the unrealized receivables and inventory is less than the adjusted basis of his partnership interest prior to the distribution. (See PTM 6500)
- a partner contributes property and that property is distributed to another partner or a distribution of other property to the contributing partner. This transaction may be treated as a sale or exchange. (See PTM 4500)
- if a partner's individual liabilities are assumed by the partnership or a partner's share of partnership liabilities are reduced, the assumption or reduction is treated as a distribution of money. If the constructive distribution of money exceeds the partner's basis in his partnership interest, the partner will recognize gain.

The basis of the distributed property must be computed. If the basis is not computed correctly, there may be issues with respect to both depreciation and the subsequent sale of the property.

The character of gain or loss that results from the sale of distributed unrealized receivables or inventory is ordinary income or loss. (See PTM 6595)

A loan from a partnership to a partner may be recharacterized as a distribution from the partnership. (See PTM 6585)

6020 CALIFORNIA CONFORMITY

In general, California conforms to IRC §731- 737 with minor exceptions. The exceptions will be discussed in detail in each corresponding section, when

appropriate. The Taxpayers Relief Act of 1997 contained the following Subchapter K changes for federal purposes:

- Allocation of basis among properties distributed by partnership (§732, §751)
- Repealed requirement that inventory be substantially appreciated with respect to disposition of partnership interest.
- Extended time for taxing pre-contribution gain. (§737(b))
- Closing partnership year with respect to a deceased partner. (§706)

Most of these federal changes were effective when the federal law was passed, 8/5/97. However, California conformed to the Taxpayers Relief Act of 1997 for tax years beginning on and after 1/1/98 and transactions occurring after that date.

**6100 CURRENT DISTRIBUTIONS V. LIQUIDATING DISTRIBUTIONS—
DEFINITIONS**

Once the transaction has been categorized as a distribution, it must be determined whether it is a "current" or a "liquidating" distribution, since different sets of rules apply to each.

A distribution in liquidation of a partner's interest is defined by Regulations §1.761-1(d) to mean "the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions." This Regulation also provides that a "series" of liquidating distributions may span more than one tax year.

The distributee's entire interest must be liquidated. If a partner is both a general and limited partner, both the general and limited partnership interests must be liquidated in order for distributions to be characterized as liquidating distributions. [*Delwin G. Chase*, 92 TC 874 (1989); cf. Revenue Ruling 84-53, 1984-1 CB 159]

A current distribution is defined by exclusion as any distribution that is **not** a liquidating distribution.

- Therefore, a distribution may be pro rata or disproportionate, large or small, in-cash or in-kind, and still be a current distribution, if it does not completely terminate the distributee's interest and is not one of a series of liquidating distributions that will result in the termination of the distributee partner's interest.
- It may substantially reduce the distributee's interest, as long as the distributee retains some interest in the partnership. For example, a distribution that reduces a partner's interest from 99 percent to 1 percent is a current distribution.

PTM 6110	Current Distribution--General
PTM 6120	Taxable Current Distribution
PTM 6130	Advances or Draws versus Distribution
PTM 6140	Basis of Property in Current Distributions
PTM 6150	Partnership Terminations--General
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6110 Current Distributions-General

- Under IRC §731(b), a partnership does not recognize gain on a distribution of money or other property to a partner.
- Similarly, the distributee partner does not recognize gain upon the partnership's distribution of property other than money in excess of a partner's

adjusted basis in his partnership interest (except for a property distribution to a contributing partner and situations encompassed by IRC §§704(c)(1)(B), 707(a)(2), 731(c), 737 and 751(b). (See PTM 6441, and PTM 4500.) [IRC § 731(a)(1).]

- The fair market value of marketable securities is considered "money" for purposes of IRC §731(a)(1). [IRC § 731(c)] (For California purposes, applicable after 1/1/97)
- A distributee partner's basis in property distributed in a nonliquidating distribution is generally the lesser of the partnership's adjusted basis in the distributed property or the partner's adjusted basis in the partnership interest (reduced by any money distributed in the transaction). [IRC § 732(a)]
- A distributee partner's adjusted basis in his partnership interest is reduced by the amount of money and the basis of property distributed to him in a nonliquidating distribution. [IRC § 733]
- A loss is **never** recognized by the distributee partner or the partnership in connection with a current distribution of cash or property. [IRC § 731(a)(2)]
- Many partnership distributions will consist of partnership income that has already been taxed to the partners or returns of partnership capital, neither of which should be subject to further tax.
- When the partner ultimately sells distributed property, the carryover basis (as limited by the partner's outside basis per IRC § 732(a)(2)) will be used to calculate any gain that must be recognized.

6120 Taxable Current Distributions

The following current distributions may be taxable:

- A current money distribution in excess of a partner's basis in his partnership interest. [IRC § 731(a)(1)]
 - If a partner's share of partnership liabilities decreases, or a partnership assumes a partner's individual liability(ies), a constructive cash distribution of money occurs under IRC §752(b). (See example below)
 - If a partnership distributes marketable securities, the marketable securities are considered money. [IRC § 731(c)] (See PTM 6400)
(Applicable for California purposes for tax years beginning on or after 1/1/97)

- A partnership distributes property that had been contributed by another partner and which had built in gain at the time of the contribution. If the property is distributed within seven years of the contribution, the partnership is treated as having sold the property at the time of distribution. (See PTM 4500)

Example:

J is a 40% partner in Picture Perfect Partnership (PPP). His adjusted basis in his partnership interest on January 1, 1995 is \$20,000. On December 31, 1995, he received a \$10,000 cash distribution in partial liquidation of his interest in PPP. His interest decreased from 40% to 20%. PPP has \$100,000 in recourse liabilities, of which \$40,000 had been allocated to J. When J's interest in PPP decreased to 20%, his share of the liabilities decreased to \$20,000. J must recognize a gain of \$10,000 (\$10,000 cash distribution plus \$20,000 deemed cash distribution from decrease in liabilities less \$20,000 adjusted basis in partnership interest) on the partial liquidation.

6130 Advances or Draws versus Distributions

A partner's basis in her partnership interest is not adjusted on account of income or loss until the close of the partnership's taxable year unless there is need for a determination of the partner's basis prior to the end of the partnership's taxable year. [IRC § 706(a), Treas. Reg. § 1.705-1(a).]

With respect to current distributions, IRC § 731(a)(1) and Treas. Reg. § 1.731-1(a)(1)(i) require gain recognition if a distribution of money exceeds the distributee partner's tax basis in his partnership interest immediately before the distribution. However, Treas. Reg. § 1.731-1(a)(1)(ii) provides that advances or drawings of money or property that are made against a partner's distributive share of income are treated as distributions occurring on the last day of the partnership's taxable year. Therefore, decreases in a distributee partner's basis on account of advances and draws during the year are treated as occurring after the partner's basis is increased at the end of the taxable year for items of income under IRC § 705(a)(1). Neither the Code nor the Regulations define advances or draws. However, it appears that to be considered draws or advances the distributee must be required to return the distributions to the extent they ultimately exceed the partner's share of partnership income for the year. [See Rev. Ruling 81-241, 1981-2 C.B. 146, Tym Seay TCM 1992-254; McKee, Nelson & Whitmire: Federal Taxation of Partnerships & Partners (WG&L), ¶19.03[2]. See also Rev. Rul. 92-97, 1992-2 C.B. 124; Rev. Rul. 94-4, 1994-1 C.B. 196, treating deemed distributions as advances or draws]

To the extent that a current distribution is not considered as an advance or draw, the cash distribution is taken into account at the time the distribution was made. Gain is

determined based on the partner's basis immediately prior to the distribution. That is, the partner must determine what his tax basis in the partnership was immediately before the cash distribution as required by IRC § 705 and Treas. Reg. § 1.705-1(a)(1).

Example:

P is an equal partner in Pat's Flowers, a general partnership. P has basis in his partnership interest of \$0 at the start of the partnership's tax year. P's distributive share of partnership income for the year is \$30,000 (which is earned ratably over the year). The partnership distributes \$2,000 a month in cash to P during the year. The monthly payment is treated as a draw against P's distributive share of income for the year, thus, P would not incur any tax as a result of the distributions. See Treas. Reg. § 1.731-1(a)(1)(ii). Had the distribution not be treated as an advance or draw, P would be required to recognize \$24,000 of capital gain under IRC §731(a) since he received \$24,000 of cash distributions in excess of his \$0 basis in his interest prior to the end of the year. P will be taxable on his \$30,000 distributive share of partnership income. Treating the \$24,000 of cash distributions as draws, i.e. as though they were made on the last day of the partnership tax year, P will be allowed to first increase his basis in his partnership interest by his \$30,000 distributive share of partnership income before the distribution is taken into account. Thus, the \$24,000 in distributions will not be subject to tax under IRC §731(a) and P will only be taxed on his \$30,000 distributive share of partnership income.

6140 Basis of Property in Current Distributions

- Under the general rule, the distributee-partner's basis for property received in a current distribution is the same as the basis of the property in the hands of the partnership immediately prior to the distribution. [IRC § 732(a)(1)]
- In the case of a current distribution of marketable securities for which gain is recognized under IRC §731(c), the basis of the distributed marketable securities is the basis of the securities as determined under IRC §732 increased by the amount of gain recognized. [IRC § 731(c)(4)(A)]
- The basis increase is allocated among the distributed marketable securities in proportion to their respective amounts of unrealized appreciation (determined before the increase). [IRC § 731(c)(4)(B)]
- The general carryover basis rule of IRC §732(a)(1) does not apply if the distributee partner does not have sufficient basis in his partnership interest, as reduced by any money distributed in the same transaction, to fully absorb the partnership's basis in the distributed property.
- IRC §732(a)(2) limits the distributee's basis in the distributed property to his predistribution basis in his partnership interest, after reducing said basis by any money distributed in the same transaction.

- If a partnership distributes more than one asset in-kind and the distributee partner does not have adequate basis in his partnership interest to absorb all of the partnership's basis in the distributed assets, IRC §732(c) and 733 set forth the rules that govern the allocation of basis among the distributed assets. The rules are applied in the following manner:
 1. Money – The distributee's basis in his partnership interest is first reduced by the amount of any cash distributed. [IRC § 733; Treas. Reg. § 1.733-1.]
 2. §751 Property – If the partner's remaining basis in his partnership interest is greater than the partnership's basis in inventory and unrealized receivables, the partnership's basis in those items is carried over to the distributee and the distributee's basis in his partnership interest is accordingly reduced. If the partner's remaining basis in his partnership interest is less than the partnership's basis in distributed unrealized receivables and inventory items, a decrease in the bases of the distributed properties is required in order to have the bases of such properties equal the basis to be allocated. Under IRC § 732(c)(3) – method of allocating decrease, the decrease is first allocated proportionately to those properties that have unrealized depreciation to the extent thereof, and then, among all properties in proportion to their respective bases (after reduction for any unrealized depreciation).
 3. Other Property – Any basis remaining after the allocations in 1 & 2 above is allocated to other distributed properties by first assigning to each such other property the carryover basis, and then, reducing the carryover basis by an amount determined using the method of allocating decrease described immediately above. [§ 732(c)(1)(B)].

Example 1:

AB Partnership distributes property to C with an adjusted basis of \$100,000. C's adjusted basis in the partnership is \$50,000 prior to the distribution. C's basis in the property becomes \$50,000 [IRC § 732(a)(2)] while her basis in her partnership interest is reduced to \$0. [IRC § 733] The gain is unrecognized since IRC §731(a)(1) provides that in the case of a distribution, gain is only recognized where the amount of distributed "money" exceeds the recipient partner's outside basis. However, the gain is preserved in the basis of the distributed property and will be recognized upon subsequent sale of such property. If the general rule of IRC §732 were applicable, AB's \$100,000 basis would carry over to C and the \$50,000 gain would go unrecognized since IRC §733 prohibits a reduction in C's basis in AB Partnership below zero.

Example 2:

A is a partner in a partnership and receives a current distribution consisting of \$50,000 cash, inventory with an adjusted basis of \$70,000 to the partnership and

two pieces of real property, parcel 1 and 2, with bases to the partnership of \$60,000 and \$20,000 respectively. The fair market value of parcel 1 and 2 is \$40,000 each. A's adjusted basis in the partnership is \$150,000. The \$50,000 cash distribution reduces A's basis in his interest from \$150,000 to \$100,000. This remaining basis is first allocated to inventory, which receives a carryover basis of \$70,000 reducing A's basis in the partnership to \$30,000 (100,000 basis in partnership interest less \$70,000 basis in inventory). The remaining \$30,000 basis is allocated to parcel 1 and 2 as follows:

- i) Parcel 1 and 2 are tentatively assigned their carryover basis, \$60,000 and \$20,000, respectively;*
- ii) The aggregate carryover basis of \$80,000 must be decreased by \$50,000 in order to match the remaining outside basis to be allocated. Since parcel 1 has \$20,000 of unrealized depreciation, the first \$20,000 of the decrease is allocated to parcel 1, reducing its basis to \$40,000. The remaining \$30,000 decrease is allocated between parcel 1 and 2 in proportion to their respective adjusted bases. Therefore, \$20,000 decrease $[30,000 \times 40,000 / (40,000 + 20,000)]$ is allocated to parcel 1, reducing its basis to \$20,000. The remaining \$10,000 decrease $(30,000 \times 20,000 / (40,000 + 20,000))$ is allocated to parcel 2, reducing its basis to \$10,000. In sum, A's remaining outside basis of \$30,000 is allocated \$20,000 to parcel 1 and \$10,000 to parcel 2.*

6150 Partnership Terminations-General

IRC §708(a) provides that an existing partnership shall be considered as continuing if it is not terminated.

Termination under IRC § 708(b)(1)(A) – partnership business discontinued

When the operations of a partnership are discontinued and no part of any business, financial operation or venture of the partnership continues to be carried on, the partnership shall be terminated. [IRC § 708(b)(1)(A); Treas. Reg. § 1.708-1(b)(1).]

Termination under IRC § 708(b)(1)(B) – technical termination for sale of 50 percent or more of interests in partnership profits and capital

When a partnership technically terminates per IRC §708, the termination does not cause the partners to recognize gain as a result of a deemed distribution of the partnership's marketable securities. [Treas. Reg. § 1.731-2(g)(2)]

California tax treatment of technical terminations for tax years beginning on or after 1/1/98 and before 01/01/2019.

If a partnership terminated as a consequence of the sale or exchange of 50% or more of the total interests in partnership profits and capital during a twelve month period under IRC §708(b)(1)(B), the following is deemed to have occurred:

- The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and immediately thereafter, the terminated partnership distributes interests in the new partnership to the purchasing partner and other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminated partnership. [Treas. Reg. §1.708-1(b)(4)]

Technical terminations prior to May 10, 1997:

If a partnership terminated under IRC §708(b)(1)(B) prior to May 10, 1997 (prior to 1/1/98 for California purposes) the following is deemed to have occurred:

- The assets of the partnership are treated as having been distributed from the old, terminated partnership to the partners; and
- The assets are immediately are then treated as having been contributed by the partners to a new partnership. [Treas. Reg. § 1.708-1(b)(iv)]

6160 Current Distributions Of Special Basis Property- General

- The general rule set forth in IRC §734(a) is that the adjusted basis of partnership property is not adjusted as result of a distribution by the partnership to a partner.
- Under certain circumstances, a discrepancy may arise between the partnership's adjusted bases in its assets and the partners' adjusted bases in their partnership interests. The discrepancy may arise following a distribution in which the distributee partner recognizes a §731 gain or loss or in which the partner's adjusted basis in the distributed property is greater than or less than the partnership's adjusted basis in the property immediately preceding the distribution.
- These discrepancies create disparities in the amount and timing of income. For example, if a partner's interest is liquidated for cash, the partner will recognize gain equal to the excess of the cash received over the partner's adjusted basis in his partnership interest. The gain represents the partner's share of the appreciation in the partnership's assets. However, absent a basis adjustment, upon a subsequent sale of the assets by the partnership, the remaining partners will be subject to tax on the same gain.
- This subject is discussed in more detail in PTM 6240.

6200 LIQUIDATING DISTRIBUTIONS

PTM 6210	Liquidating Distributions--General
PTM 6220	Basis of Property Received-General Rules
PTM 6221	Distributions prior to August 5, 1997
PTM 6222	Distribution after August 5, 1997
PTM 6230	Election to Make adjustments
PTM 6240	Optional Basis Adjustments—IRC § 734
PTM 6250	Optional Basis Adjustments-IRC § 743(b)

6210 Liquidating Distributions-General

Liquidation of a partner's interest means the termination of that partner's entire interest in a partnership by means of a distribution or series of distributions to that partner from the partnership. [Treas. Reg. 1.761-1(d)]

A liquidating distribution includes a single distribution [IRC § 761(d)] or a series of distributions that result in the termination of the distributee partner's entire interest in a partnership interest. [IRC § 761(d); Treas. Reg. § 1.761-1(d)]

Each distribution in the series of liquidating distributions is considered to be a liquidating distribution although the partner's interest in the partnership whose interest is to be liquidated is not considered to be liquidated until the final distribution has been made. [Treas. Reg. § 1.761-1(d)]

Distributions in liquidation of a partner's interest in partnership property result in gain recognition to the distributee partner **only if** the amount of money distributed exceeds his adjusted basis in his partnership interest immediately before the distribution. [IRC § 731(a)(1); Treas. Reg. § 1.731-1(a)(1).] This must be coordinated with IRC §§ 736 and 751(b).

- The fair market value of marketable securities distributed is treated as "money." [IRC § 731(c), applicable for California purposes for tax years beginning on or after 1/1/97.]

A loss may be recognized by the distributee partner on the liquidation of his entire interest in a partnership if the partner's basis in his partnership interest exceeds the basis of the property distributed and the property distributed consists solely of one or more of the following: **money** (not including marketable securities), **unrealized receivables** (as defined in IRC § 751(c)), and **inventory items** (as defined in IRC § 751(d)). [IRC § 731(a)(2)]

- If a loss is recognized, it is equal to the excess of the distributee's predistribution basis less the amount of money and adjusted basis of unrealized receivables and inventory items distributed to that partner.

Any gain or loss recognized under IRC §731 is treated as gain or loss from the sale or exchange of a capital asset. [IRC §731(a); *Miller v. United States*, 331 F2d 854 (Ct. Cl. 1964); *Neil O'Brien*, 77 TC 113 (1981).]

Provided that IRC §731 controls the tax consequences of the transaction, a partnership does not recognize a gain or loss in connection with a distribution of partnership property in liquidation of a partner's interest. [IRC § 731(b); Treas. Reg. § 1.731-1(b)]

The following examples are based on the fact that IRC §731 alone controls the tax consequences of the transactions described therein.

Example 1:

A has decided to retire from AB Partners in December 1997. A's basis in AB Partners is \$100,000 prior to any distributions. AB Partners distributes \$50,000 in cash and \$20,000 of inventory in a liquidating distribution. A recognizes a capital loss in the amount of \$30,000.

Example 2:

J has an adjusted basis in his interest in partnership XYZ of \$10,000. J retires from the partnership and receives in return for his share of partnership property \$5,000 in cash and inventory with a basis to the partnership of \$3,000. J recognizes a capital loss of \$2,000.

If, in addition to the cash and inventory, J also receives real property with a value and an adjusted basis to the partnership of \$1,000, J will not be entitled to recognize a loss. In that case, since J received property other than money, unrealized receivables and inventory items, the loss may not be recognized under § 731(a)(2).

6220 Basis of Property Received-General Rules

IRC §732(b) provides that the basis of property distributed by a partnership to a partner is equal to the partner's basis in their partnership interest immediately prior to the distribution reduced by any cash received in the same transaction.

If a partnership distributes more than one asset in-kind in complete liquidation of a partner's interest and the distributee partner does not have adequate basis in his partnership interest to absorb all of the partnership's basis in the distributed assets, IRC §732(c) sets forth the rules that govern the allocation of basis among the distributed assets. The basis allocation rules for a liquidating distribution are similar to those of a current distribution. See PTM 6140

PTM 6221 Distributions before to August 5, 1997

PTM 6222 Distributions after August 5, 1997

6221 Distributions before August 5, 1997

California conformed to IRC §732(c) for tax years prior to 1/1/98. This means, prior to the federal change effective for distributions after 8/5/97, both California and federal provided that the basis be allocated as discussed below.

The basis to be allocated to the unrealized receivables and inventory that are distributed cannot exceed the partnership's predistribution basis in those assets.

- If the total basis to be allocated is less than the partnership's basis in the unrealized receivables and inventory, the distributee partner's basis is allocated entirely to the unrealized receivables and inventory in proportion to his adjusted basis in the hands of the partnership. [IRC § 732(c)]
- Any other property distributed receives a zero basis.

If the basis to be allocated among the distributed properties exceeds the partnership's basis in distributed unrealized receivables and inventory, the balance of the basis is allocated to the other properties distributed in proportion to their adjusted basis to the partnership.

The basis allocation rules for a liquidating distribution are similar to those of a current distribution with the following exception.

- If a partner receives a current distribution of partnership property, the basis of the distributed property in the hands of the distributee may not exceed the basis of the property in the hands of the partnership (or the partner's basis in his partnership interest, if less). [IRC § 732(a)(1) and (2)]
- It is possible for a partner who receives property in liquidation of his partnership interest to obtain a basis in the property in excess of the partnership's basis in the property, except in the case of unrealized receivables and inventory, because the distributee partner will take a basis in the distributed property equal to his basis in his partnership interest.

The following example is premised on the fact that IRC §731 alone controls the tax consequences of the transactions described therein and the distributions occurred prior to August 5, 1997 (prior to 1/1/98 for California purposes)

Example 1:

CALIFORNIA FRANCHISE TAX BOARD

On July 1, 1997, B has an adjusted basis in his partnership interest of \$20,000. In complete liquidation of B's partnership interest, B receives \$10,000 in cash, unrealized receivables with an adjusted basis of \$10,000, inventory with an adjusted basis of \$10,000, a piece of equipment with an adjusted basis of \$5,000 and a truck with an adjusted basis of \$10,000. B does not recognize a gain upon liquidation of his partnership interest since the cash distributed (\$10,000) does not exceed B's basis in his partnership interest (\$20,000). B will not recognize a loss since he received property other than cash, unrealized receivables and inventory. The following allocations are made:

<i>Adjusted basis of partnership interest (7/1/97)</i>	\$20,000
<i>Less: Cash distribution</i>	<u>(10,000)</u>
	10,000

Allocation of basis to property:

	<i>Partnership's</i>		<i>Allocation</i>
	<i>Adjusted</i>		<i>of</i>
	<u><i>Basis</i></u>	<u><i>Percentage</i></u>	<u><i>Remaining</i></u>
			<u><i>Basis</i></u>
<i>Unrealized Receivables</i>	\$10,000	50	\$5,000
<i>Inventory</i>	<u>10,000</u>	<u>50</u>	<u>5,000</u>
<i>Total</i>	<u>\$20,000</u>	<u>100</u>	<u>\$10,000</u>

Equipment \$0

Truck \$0

Remaining basis to allocate

6222 Distributions after August 5, 1997

Federal modified IRC §732(c) effective for distribution occurring after 8/5/97. California conformed to this change for tax years beginning on or after 1/1/98 and transactions occurring after 1/1/98. This means for distributions after 8/5/97, federal provides that the basis be allocated as discussed below. For California purposes, the discussion below applies to distributions after 12/31/97.

The general rule applies to the distribution with basis being first applied to unrealized receivables and inventory items. Any remaining basis is allocated to other property. [IRC § 732(c)(1)] See PTM 6220.

In a liquidating distribution, an increase or decrease in the bases of distributed properties may be necessary so that the sum of these bases equal the distributee partner's outside basis. And the increase or decrease is allocated among the distributed properties in the following manner:

Increase:

An increase in the basis of distributed property will only occur in a liquidating distribution and only in the case where the distributee partner receives at least one item of other property and his outside basis is greater than the basis of the distributed property. The basis in § 751 property is never increased. An increase in basis is allocated

- first, to properties with unrealized appreciation in proportion to the full extent of each property's unrealized appreciation, [IRC § 732 (c)(2)(A)] and
- to the extent of any remaining basis, it is allocated in proportion to the property's fair market value. [IRC § 732(c)(2)(B)]

Decrease:

A decrease in basis is required if the partner does not have sufficient basis to allocate the partnership's full basis in the properties. It can occur in a current or a liquidating distribution and can apply to § 751 property or to other property. See PTM 6140.

Any basis decrease is allocated as follows:

- first, to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease, [IRC § 732(c)(3)(A)] and
- to the extent the required decrease is not allocated due to unrealized depreciation, in proportion to the respective bases of the properties. [IRC § 732(c)(3)(B)]

Example 1:

A partnership distributes both its assets A & B, in liquidation of a partner whose basis in its interest is \$55. Neither asset consists of unrealized receivables or inventory. A has a basis to the partnership of \$5 and a fair market value of \$40, and B has a basis to the partnership of \$10 and a fair market value of \$10. Basis is first allocated \$5 to A and \$10 to B (their adjusted basis to the partnership). The remaining \$40 is a basis increase (the partner's \$55 basis minus the partnership's

total basis in the distributed property of \$15) which is first allocated to A in the amount of \$35, its unrealized appreciation. Since B does not have any unrealized appreciation, no allocation is made. The remaining basis adjustment of \$5 is allocated according to the assets fair market values, i.e. $\$4(\$40/50 \times 5)$ to A (for a total basis of \$44) and $\$1(10/50 \times 5)$ to B (for a total basis of \$11).

[H Rept No. 105-148 (PL 105-34) p. 505-506]

Note:

Treas. Reg. § 1.732-1(c)(iii), added by T.D. 9833, 6/7/2018, provides: "If a partnership makes a distribution described in §1.337(d)-3(e)(1), then for purposes of this section, the basis to be allocated to properties distributed under section 732(a)(2) or (b) is allocated first to the Stock of the Corporate Partner, as defined in §1.337(d)-3(c)(2), before the distribution of any other property (other than cash). The amount allocated to the Stock of the Corporate Partner is as provided in §1.337(d)-3(e)(2)." Paragraph (c)(1)(iii) applies to distributions of Stock of the Corporate Partner, as defined in §1.337(d)-3(c)(2), that occur on or after June 12, 2015. (T.D. 9833 also amended Treas. Reg. § 1.732-3, relating to IRC § 731(f), applicable to transactions occurring on or after June 8, 2018, specifically to address Gain Elimination Transactions, as defined therein.)

6230 Election to Make Optional Adjustments to the Basis of Partnership Property for Purposes of IRC §§ 734 and 743

In order to make basis adjustments to partnership property for purposes of IRC §§ 734 and 743, the partnership must make an election in the manner provided by IRC § 754.

The election is made by a written statement that must be filed with the partnership return for the first year to which the election applies. In order for the election to be valid, the partnership return must be filed on time (including extensions). [Treas. Reg. § 1.754-1(b)] (However, for federal purposes an automatic 12-month extension to make the election is provided for under Treas. Reg. § 301.9100-2, provided the corrective action and procedural requirements are followed as provided in §301.9100-2. Additional reasonable cause relief for late elections for federal purposes is provided for under Treas. Reg. § 301.9100-3. If a federal election under 754 is proper, it will be deemed to be proper under the R&TC pursuant to R&TC § 17024.5(e).)

The written statement must:

-
- state the name and address of the partnership making the election,
 - be signed by any one of the partners, and
 - contain a declaration that the partnership elects under IRC 7§54 to apply the provision of IRC §734(b) and IRC §743(b). [Treas. Reg. § 1.754-1(b)]

Once the election is made, it applies to all current and future distributions and transfers and can be revoked only with IRS permission. [Treas. Reg. § 1.754-1(a) and (c).]

Once an election is made, it may be revoked only with the consent of the District Director for the IRS District in which the partnership files its return. [Treas. Reg. § 1.754-1(c)]

- The regulations cite the following examples of reasons why a request for a revocation may be granted:
 1. a change in the nature of the partnership's business;
 2. a substantial increase in the assets of the partnership;
 3. a change in the character of the partnership's assets; or
 4. an increased frequency of retirements or shifts of partnership interests causing an increased administrative burden on the partnership due to the IRC §754 election. [Treas. Reg. § 1.754-1(c)]
- The regulations specifically state "no application for revocation of an election shall be approved when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution." [Treas. Reg. § 1.754-1(c)]

If there is a transfer of an interest due to an unforeseen event such as death, the election does not need to be made before the death occurred. It may be made when filing the partnership return for the year in which the death took place. [Rev Ruling 57-347, 1957-2 CB 365]

If there is a transfer of a 50% or more of the profits and capital interests that results in a partnership technical termination pursuant to former IRC 708(b)(1)(B), the terminated partnership could file an election under IRC § 754 with its final return, applicable with respect to the incoming partner(s) in the "new" partnership. [See Treas. Reg. 1.708-1(b)(5), applicable for California for taxable years beginning before 01/01/2019.]

A partnership which must adjust the bases of partnership properties under section 734 shall attach a statement to the partnership return for the year of the distribution

setting forth the computation of the adjustment and the partnership properties to which the adjustment has been allocated. [Treas. Reg. § 1.734-1(d).]

A partnership that must adjust the bases of partnership properties under section 743(b) must attach a statement to the partnership return for the year of the transfer setting forth the name and taxpayer identification number of the transferee as well as the computation of the adjustment and the partnership properties to which the adjustment has been allocated. [Treas. Reg. § 1.743-1(k)(1).] In addition, a transferee that acquires an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, of the transfer within 30 days of the acquisition by sale or exchange or within one year of an acquisition by transfer from a deceased partner. [See Treas. Reg. § 1.743-1(k)(2).]

6240 Optional Basis Adjustments—IRC § 734

The general rule is that the adjusted basis of partnership property is not adjusted as a result of a distribution by the partnership to a partner unless the election, provided in § 754, is in effect with respect to that partnership or unless there is a substantial basis reduction as defined in § 734(d).

As provided in section IRC § 734(d) there is a substantial basis reduction with respect to a distribution if the sum of the following two amounts exceeds \$250,000:

- (1) the amount of the partner's recognized loss on the distribution, and
- (2) the excess of the basis of the distributed property to the distributee over the adjusted basis of the distributed property to the partnership immediately before the distribution.

For regulations to carry out this subsection, see § 743(d)(2).

The IRS on 01/16/2014 issued proposed regulations on IRC § 734 substantial basis reductions for distributions of property made after 10/22/04. (For further details see Prop. Reg. §1.734-1 & REG -144468-05)

IRC § 734(e) provides an exception to substantial basis reduction. For purposes of this section, a securitization partnership shall not be treated as having a substantial basis reduction with respect to any distribution of property to a partner. (See IRC §734 for further details)

Under the general rule, a discrepancy may arise between the partnership's adjusted bases in their partnership assets and the partners' adjusted basis in their partnership interest. [IRC § 734(a); Treas. Reg. § 1.734-1(a)]

This discrepancy may arise after a distribution in which the distributee partner:

- recognizes gain or loss under IRC §731, or
- in which the partner's adjusted basis in the distributed property, as determined under IRC §732, is greater or less than the partnership's adjusted basis in the property prior to the distribution.

The general rule of IRC §734(a) often results in double inclusion of taxable income or double deduction of losses. (See Examples 1 and 2 below)

The IRC §734(b) adjustment is designed to mitigate the discrepancies that would create a distortion in the amount and/or timing of income, provided a §754 election is in effect. (See PTM 6230) If the election is valid, the partnership's bases in its assets are adjusted upon distribution by the partnership to the partner.

IRC §734(b) adjustment applies in the following instances:

- the distributee partner recognizes gain or loss under IRC §731 (See PTM 6120 and PTM 6200); [IRC § 734(b)(1)(A), § 734(b)(2)(A)]
- the distributee partner's adjusted basis in the distributed property is less than the partnership's adjusted basis in the property immediately before the distribution (See PTM 6140 and PTM 6220); [IRC § 734(b)(1)(B)] or
- the distributee partner's adjusted basis in the distributed property is greater than the partnership's adjusted basis in the property immediately before the distribution. [IRC § 734(b)(2)(B)]

The §734(b) adjustment affects all of the remaining partners.

The amount of the §734(b) adjustment is equal to the amount of gain or loss recognized by the distributee partner and the increase or decrease in the basis of the distributed property. [IRC § 734(b)(1), § 734(b)(2)]

- Gain recognition by the distributee partner or a decrease in the basis of the distributed property result in an increase to the partnership's basis in undistributed property in the amount equal to the sum of the gain recognized and the decrease in basis. [IRC § 734(b)(1)]
- Alternately, if a distributee partner recognizes a loss on the distribution or takes an increased basis in the distributed property, the §734(b) adjustment to the partnership's basis in undistributed property is a negative adjustment equal to the

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sum of distributee's recognized loss and the increase in the basis. [IRC § 734(b)(2)]

Example 1:

On June 30, 1997, A has a 1/3 interest in partnership ABC, which has the following balance sheet:

<u>ASSET</u>	<u>BASIS</u>	<u>VALUE</u>
Cash	\$500,000	\$500,000
Land	<u>400,000</u>	<u>1,000,000</u>
	<u>\$900,000</u>	<u>\$1,500,000</u>
 <u>CAPITAL</u>		
A	\$300,000	\$ 500,000
B	300,000	500,000
C	<u>300,000</u>	<u>500,000</u>
	<u>\$900,000</u>	<u>\$1,500,000</u>

On that date, ABC distributes the \$500,000 in cash in liquidation of A's partnership interest. The land is an IRC § 1231 asset. Under IRC §731(a)(1), A is required to recognize \$200,000 of taxable gain in connection with the distribution. This \$200,000 represents A's 1/3 share of the \$600,000 of appreciation in the land. If the partnership did not have an IRC §754 election in effect at the time of the distribution, the partnership's balance sheet would appear as follows:

<u>ASSET</u>	<u>BASIS</u>	<u>VALUE</u>
Cash	\$0	\$0
Land	<u>400,000</u>	<u>1,000,000</u>
	<u>\$400,000</u>	<u>\$1,000,000</u>
 <u>CAPITAL</u>		
B	\$300,000	\$500,000
C	<u>300,000</u>	<u>500,000</u>
	<u>\$600,000</u>	<u>\$1,000,000</u>

As a result of the distribution, there is a discrepancy of \$200,000 between the partnership's adjusted basis in the property and the partners' adjusted bases in their interests. If BC has a §754 election in effect there is a \$200,000 upward § 734(b) adjustment applied to the partnership's remaining assets. [IRC §734(b)(1)(B)] The \$200,000 is allocated using the rules set forth in IRC §755.

Without a § 754 election, if the land is subsequently sold by partnership BC for its \$1,000,000 value, the full \$600,000 gain inherent in the land must be recognized by the partnership. B and C will be subject to tax on \$300,000 of gain each, even though \$200,000 of the \$600,000 gain has already been recognized by A.

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Observation: The "double taxation" described in example 1 above would be "made up" eventually even without the special basis adjustment because the gain recognized by the other 2 partners would increase their bases in their partnership interests. This basis increase would offset the earlier gain by giving the partners an equal reduction in gain (or a loss) when their partnership interests are disposed of. However, this "correction" of the double taxation might not occur for years and might not benefit the other two partners depending on their tax circumstances for the year of disposition.

Example 2:

Assume Partnership ABC has the following balance sheet as of January 1, 1996:

<u>Assets</u>	<u>Adjusted Basis</u>	<u>Fair Market Value</u>
Cash	\$50,000	\$50,000
Capital Asset #1	45,000	120,000
Capital Asset #2	<u>55,000</u>	<u>70,000</u>
Total	<u>\$150,000</u>	<u>\$240,000</u>
<u>Capital</u>		
A	\$50,000	\$80,000
B	\$50,000	\$80,000
C	<u>\$50,000</u>	<u>\$80,000</u>
Total	<u>\$150,000</u>	<u>\$240,000</u>

The partnership distributes capital asset #2 to A, as a current distribution. A will not recognize any gain on the distribution since she did not receive any money in the distribution. A's adjusted basis in the distributed asset is limited to her adjusted basis in the partnership interest which is \$50,000. If the partnership does not have an IRC § 754 election in effect, its balance sheet will appear as follows:

<u>Assets</u>	<u>Adjusted Basis</u>	<u>Fair Market Value</u>
Cash	\$50,000	\$50,000
Capital Asset #1	45,000	120,000

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<i>Total</i>	<u>\$95,000</u>	<u>\$170,000</u>
<u>Capital</u>		
<i>A B</i>	\$0	\$10,000
<i>C</i>	\$50,000	\$80,000
<i>Total</i>	<u>\$50,000</u>	<u>\$80,000</u>
	<u>\$100,000</u>	<u>\$170,000</u>

The result of the distribution is a \$5,000 discrepancy between the partnership's adjusted basis in its assets and the partners' adjusted basis in their partnership interests. If the partnership has a §754 election in effect, a §734(b) upward adjustment equal to the discrepancy is applied to increase the partnership's basis in its remaining assets. [IRC § 734(b)(1)(B)] The \$5,000 adjustment is allocated to the remaining asset in the same class as the distributed asset. [IRC § 755] Therefore, the partnership's adjusted basis in capital asset #1 is increased by \$5,000 to \$50,000.

Note: *The basis adjustment described above works both ways with respect to "double taxation." While it prevents the double taxation of gain as illustrated above, it also prevents a double tax benefit from losses that can occur. In Example 1 above, had A recognized a loss as a consequence of her liquidating distribution, and had the value of the partnership's land decline after the liquidation of her interest, absent a basis adjustment (here, a basis reduction), the partnership could incur an additional loss when it sells the land. Accordingly, a determination as to whether the partnership should file an election pursuant to IRC §754 basis adjustment must take into consideration the specific circumstances of the partnership.*

6250 Optional Basis Adjustments- IRC §743(b)

The general rule is that the adjusted basis of partnership property is not adjusted due to a sale or exchange or death of a partner unless the election provided by § 754 is in effect with respect to that partnership or unless the partnership has a substantial built-in loss immediately after the transfer. [IRC § 743(a); Prop. Reg. § 1.743-1(a)(1)]

- The transferee partner's adjusted basis in his partnership interest is generally equal to the cost of the partnership interest. [IRC § 742]
- The transferee partner's adjusted basis in his partnership interest may not equal the sum of his share of the partnership's adjusted basis in

the assets. If this is the case, the discrepancy may distort the amount and timing of a new partner's share of income.

The IRC §743(b) adjustment is designed to mitigate these distortions by allowing adjustments to a new partner's share of the partnership's adjusted bases in its assets.

If a basis adjustment (IRC §754) election is in effect, upon a transfer of a partnership interest or the death of a partner, or if the partnership has a substantial built-in loss* immediately after such transfer. The transferee partner's basis in the partnership's property is:

- increased by any excess of the adjusted basis to the transferee partner of his partnership interest over his share of the adjusted basis of the partnership property, [IRC § 743(b)(1)] or
- decreased by any excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of his interest in the partnership. [IRC § 743(b)(2)]

*IRC § 743(a) and (b) requires a partnership to reduce the basis of partnership property on a transfer partnership interest due to a sale or exchange or the death of a partner made after October 22, 2004, if at the time of transfer the partnership has a substantial built in-loss. A partnership has a substantial built-in loss that requires an IRC § 743(b) basis adjustment to partnership assets on a transfer of a partnership interest if the partnership's adjusted basis in the partnership property exceeds by more than \$250,000 the fair market value of the property. [IRC §743(d)(1)]

Note: The Tax Cuts and Jobs Act, P.L. 115-97, amended § 743(d)(1), and thus, effective for transfers of partnership interests after 12/31/2017, a partnership would also be considered to have a substantial built-in loss if the transferee partner would be allocated a loss of more than \$250,000 if the partnership assets were sold for cash equal to their fair market value immediately after the transfer. California has not conformed to this provision of the Tax Cuts and Jobs Act.

A basis adjustment affects the basis of partnership property only with respect to the transferee partner and **not for the other partners**. This means that although the partnership makes the election and adjustment or has a substantial built-in loss, the adjustment of the partnership's basis in its assets is only made with respect to the tax treatment of the transferee or successor partner. [IRC § 743(b)]

For purposes of depreciation, depletion, gain or loss, and distributions, the transferee partner will have a special basis for partnership assets that are adjusted under IRC §743(b). The transferee partner's special basis in each of the partnership's assets to which his special basis adjustment has been allocated is equal to his proportionate share of the common partnership basis for that asset (i.e., basis computed without regard to any special basis adjustments) plus or minus his special basis adjustments with respect to that asset. The Regulations require that the transferee partner's special basis adjustment be separated from his proportionate share of the basis in each of the partnership's assets. [See Treas. Reg. §1.743-1(b)]

Example:

R pays \$50,000 for P's 40% interest in a partnership that has a basis in its assets of \$60,000. Since a 40% interest in the basis of partnership assets is only \$24,000, R has paid an excess of \$26,000 over his share of the partnership's basis in its assets. If the partnership has an election in effect under IRC §754 or has a substantial built-in loss, R will be entitled to add a special basis adjustment of \$26,000 to the basis of certain partnership properties (as determined under IRC §755) for purposes of calculating depreciation or gain or loss on the sale of those properties.

IRC §743(e) provides alternative rules for electing investment partnerships having a substantial built-in loss with respect to any transfer. For purposes of this section, an electing investment partnership shall not be treated as having a substantial built-in loss with respect to any transfer occurring while the election under (e)(5)(A) is in effect. (See IRC § 743 for further guidance) Subsection (e) is applied without regard to any termination of a partnership under Former IRC §708(b)(1)(B). (See former IRC § 743 (e)(4), repealed by the Tax Cuts and Jobs Act of 2017, but with which California has not conformed.)

IRC §743(f) provides an exception to mandatory basis adjustments for a partnership with a substantial built-in loss. For purposes of this section, a securitization partnership, as defined in IRC §743(f)(2), shall not be treated as having a substantial built-in loss with respect to any transfer. (See IRC §743 for further guidance)

6300 CURRENT DISTRIBUTIONS

- PTM 6310 Special Basis Property Distributed to Transferee
PTM 6320 Special Basis Property Distributed to NonTransferee
PTM 6330 Liquidating Distribution to a Transferee Partner

6310 Special Basis Property Distributed to Transferee

If a partnership distributes special basis property (property subject to a §743(b) adjustment) to the partner to whom the adjustment affects, the basis adjustment is taken into account in determining the partnership's adjusted basis in the property for purposes of calculating the distributee partner's basis in the property. [Treas. Reg. § 1.743-1(g)(1)(i), §1.732-2(b)]

Example:

T & C are equal partners in partnership TC Tacos. The partnership owns several assets, one of which is a depreciable asset with a common partnership basis of \$20,000 and a special basis adjustment to C of \$5,000. If the partnership makes a current distribution of this asset to C, the partnership's adjusted basis in the asset with respect to C is \$25,000. Therefore, for purposes of IRC § 732(a)(1), the adjusted basis in the distributed asset to C immediately before its distribution is \$25,000. Thus, IRC § 732(a)(2) limitation does not apply to C.

6320 Special Basis Property Distributed to Non-Transferee

If a partnership distributes special basis property (property subject to a §743(b) adjustment) to a partner to whom the §743(b) adjustment does not apply, the distributee partner does not take the adjustment into account for purposes of determining the partnership's adjusted basis in the property. [Treas. Reg. § 1.743-1(g)(2)(i)]

The partner to whom the §743(b) adjustment applies reallocates it in accordance with the rules in §755 to remaining partnership property or distributed property (if a distribution occurred). [Treas. Reg. § 1.743-1(g)(2)(ii)]

Example:

L and M are equal partners in L M Partnership. The partnership owns several assets, two of which are depreciable assets. Depreciable asset #1 has a common basis to the partnership of \$8,000 and a special basis adjustment to M

of \$2,000. Depreciable asset #2 has a common basis of \$10,000 and a special basis adjustment to M of \$3,000. The partnership makes a current distribution of asset #1 to L and asset #2 to M. The partnership's adjusted basis in asset #1 with respect to L is \$8,000. Therefore, assuming the limitation of IRC §732(a)(2) does not apply, L's basis in the distributed property is \$8,000. The partnership's adjusted basis in asset #2 with respect to M is \$15,000 (10,000 common basis plus \$3,000 basis adjustment allocated to asset # 2 plus \$2,000 basis adjustment originally allocated to asset #1 and reallocated to asset #2). Assuming the limitation of IRC §732(a)(2) does not apply, M's adjusted basis in asset #2 is \$15,000. [Treas. Reg. § 1.743-1(g)(5)(iv)]

If M had not received a distribution of property, the \$2,000 basis adjustment originally allocated to asset #1 would still have been reallocated to asset #2 (assuming it was the partnership's sole asset).

6330 Liquidating Distribution to a Transferee Partner

If a transferee receives a distribution of property (whether or not the transferee has a basis adjustment in such property) in liquidation of its interest in the partnership, the adjusted basis to the partnership of the distributed property immediately before the distribution includes the transferee's basis adjustment for the property in which the transferee relinquished an interest (either because it remained in the partnership or was distributed to another partner). Any basis adjustment for property in which the transferee is deemed to relinquish its interest is reallocated among the properties distributed to the transferee under Treas. Reg. § 1.755-1(c). [Treas. Reg. § 1.743-1(g)(3)] For an example see Treas. Reg. §1.743-1(g)(5)(v).

6400 DISTRIBUTION OF MARKETABLE SECURITIES

- PTM 6410 General
- PTM 6420 Definition of Marketable Securities
- PTM 6430 Limitation on Gain Recognized
- PTM 6440 Exceptions to Gains Recognition Rules
- PTM 6441 Marketable Securities Distributed to Contributor
- PTM 6442 Securities not Marketable When Acquired by
Partnership
- PTM 6443 Securities Acquired in a Non-recognition
Transaction
- PTM 6450 Distributions by Investment Partnerships

PTM 6460 Basis of Marketable Securities Distributed

6410 General

- For Federal purposes, IRC §731(c) generally applies to distributions after December 8, 1994, the date of its enactment. **California does not conform to this Code Section until 1/1/97, applicable for distributions occurring on or after 1/1/97.**
- IRC §731(c) was enacted due to a concern that under the prior law, a partner was able to exchange, tax free, his share of appreciated partnership assets for an increased share of the partnership's marketable securities without gain recognition. [H. R. No. 826, 103d Congress, 2nd Session 187]
- For purposes of gain recognition, when a partner receives a distribution of money in excess of his basis, a distribution of marketable securities is treated as a distribution of money. [IRC § 731(c)(1)(A)]
- The marketable securities are treated as money in an amount equal to their fair market value as of the date of distribution. [IRC § 731(c)(1)(B)]
- Where a deemed partnership termination occurs as a result of a transfer of a 50% or greater partnership interest, the termination does not cause the partners to recognize gain as a result of a deemed distribution of the partnership's marketable securities. [Treas. Reg. § 1.731-2(g)(2)]
- Generally, the distributee partner will recognize gain to the extent he receives a distribution of marketable securities whose fair market value (reduced by the distributee's share of net gain in those securities per IRC § 731(c)(3)(B)) exceeds the basis of his partnership interest immediately before the distribution. [H. R. No. 826, 103d Congress, 2nd Session 189] In computing the amount of gain that the distributee partner must recognize, it should be noted that the amount of his gain will be computed by aggregating the amount of other money distributed to him in the same transaction along with the fair market value of the marketable securities.

Example:

Nancy and Rich form N & R Partners as equal partners. Nancy contributes property with a fair market value of \$2,000 and an adjusted basis of \$500 to the

partnership and Rich contributes \$2,000 of cash. The partnership subsequently purchases Stock in X Co, a marketable security within the meaning of IRC § 731(c) (See PTM 6420) for \$1,000 and immediately distributes the stock to Nancy in a current distribution. The basis of Nancy's interest at the time of distribution is \$500 (the adjusted basis of the property contributed). The distribution of Stock X is treated as a distribution of money in an amount equal to the fair market value of Security X on the date of distribution (\$1,000). The amount of the distribution that is treated as money is not reduced under IRC §731(c)(3)(B) because if Stock X had been sold immediately before the distribution, there would have been no gain recognized by N & R and Nancy's distributive share of gain would be \$0. As a result, Nancy recognizes \$500 of gain under §731(a)(1) on the distribution (\$1,000 distribution of money less \$500 adjusted basis in Nancy's partnership interest).

Note: Although this transaction does not trigger any adverse effects under IRC §731(c), the facts should be further analyzed to determine if other provisions of the Code may cause taxable consequences, e.g. IRC §§707(a)(2)(B), 704(c)(1)(B), 737 and 751(b).

6420 Definition of Marketable Securities

Marketable securities is defined as financial instruments and foreign currencies which are actively traded on the date of distribution. [IRC § 731(c)(2)(A)]

Marketable Securities include [IRC § 731(c)(2)(C)]:

- Stocks and other equity interests;
- options;
- evidences of indebtedness;
- forward or futures contracts;
- notional principal contracts;
- derivatives;
- an interest in a common trust fund, [IRC § 731(c)(2)(B)(i)(I)] or in a regulated investment company; [IRC § 731(c)(2)(B)(i)(II)]
- any interest readily convertible into or exchanged for money or marketable securities, pursuant to its terms or any other arrangements; [IRC § 731(c)(2)(B)(ii)]
- any financial instrument whose value is determined substantially by reference to marketable securities; [IRC § 731(c)(2)(B)(iii)]

- any interest in precious metal which is actively traded, unless the metal was produced, used or held in the active conduct of a trade or business by the partnership; [IRC § 731(c)(2)(B)(iv)]
- any interest in an entity if substantially all of the assets (90% or more) of that entity consist directly or indirectly, of marketable securities, money or both; [IRC § 731(c)(2)(B)(v) and Treas. Reg. §1.731-2(c)(3)(i)]
- any interest in any entity to the extent that the value of the interest is attributable to marketable securities, money or both if more than 20%, but less than 90%, of the entity's assets (measured by value) consist of marketable securities and money. [IRC § 731(c)(2)(B)(vi) and Treas. Reg. §1.731-2(c)(3)(ii)]

Commodities (other than precious metals) are not considered marketable securities. [H. R. No. 826, 103d Congress, 2nd Session 189]

Actively traded options, futures and forward contracts are treated as marketable securities, whether or not they relate to commodities.

6430 Limitation on Gain Recognized

The amount of marketable securities taken into account is reduced (but not below zero) by the excess (if any) of:

1. the partner's distributive share of net gain that would be recognized if all marketable securities of the same class and issuer as the distributed securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value, [IRC § 731(c)(3)(B)(i)]

over

2. the partner's distributive share of net gain that is attributable to the marketable securities of the same class and issue as the distributed securities held by the partnership immediately after the transaction, determined using the fair market value. [IRC § 731(c)(3)(B)(ii)]

A partner's distributive share of net gain is determined:

- by taking into account any basis adjustments under IRC §743(b) with respect to that partner, i.e., adjustments resulting from a sale or exchange or a death of a partner, [Treas. Reg. § 1.731-2(b)(3)(i)]

- without taking into account any special allocation if the principal purpose of the allocation was to avoid or minimize the effect of IRC §731(c), [Treas. Reg. § 1.731-2(b)(3)(ii)] and
- without taking into account any gain or loss attributable to a distribution of a security if one of the following exceptions apply:
 1. The security was contributed to the partnership by the recipient partner;
 2. The security was acquired by the partnership in a nonrecognition transaction, subject to certain other conditions prescribed by the Regulations, or
 3. The security was not a marketable security on the date it was acquired by the partnership, subject to certain other conditions prescribed by the Regulations. [Treas. Reg. § 1.731-2(b)(3)(iii)]

Example 1:

Partnership ABC holds 300 shares of X Corporation common stock (a marketable security) and other assets. A owns a 1/3 interest in ABC. The stock has a basis of \$10 a share and a value of \$100 a share. A has a \$5,000 basis in his partnership interest. ABC distributes all of the stock in X to A in liquidation of his partnership interest. Under the rule treating marketable securities as a cash distribution, A is treated as receiving \$30,000 in cash (300 shares x \$100 per share). Under the above rule, the amount is reduced by \$9,000, the amount that A would have to recognize if the partnership had sold the securities ((\$30,000 fair market value less \$3,000 adjusted basis) divided by his 1/3 interest which equals \$9,000). Therefore, A is treated as receiving a cash distribution of \$21,000 (\$30,000 less \$9,000). The end result is that A would recognize a gain of \$16,000 on this transaction (\$21,000 distribution less \$5,000 adjusted basis in partnership interest). [H. R. 826, 103d Congress, 2nd Session 192]

Note: This example is used to show the effect of IRC § 731(c). However, the facts should be further analyzed to determine if other provisions of the Code may cause taxable consequences, e.g. IRC §§ 707(a)(2)(B), 704(c)(1)(B), 737, 736 and 751(b).

Example 2:

J is a 50% partner in a partnership. The partnership distributes Security X to J in a current distribution. Immediately before the distribution, the partnership held securities with the following adjusted bases, fair market values and unrecognized gains or losses:

	<u>Value</u>	<u>Basis</u>	<u>Gain/Loss</u>
Security X	\$100	\$70	\$30
Security Y	\$100	\$80	\$20
Security Z	\$100	\$110	(\$10)

If the partnership had sold the securities for their fair market value immediately before the distribution to J, the partnership would have recognized \$40 of net gain (\$30 gain on Security X plus \$20 gain on Security Y less \$10 loss on Security Z). J's gain would be \$20 (one half of \$40 net gain). If the partnership distributes Security X to J and sells the remaining securities immediately after the distribution, the partnership would have \$10 of net gain (\$20 of gain on Security Y less \$10 loss on Security Z). J's distributive share of this gain would have been \$5 (one half of \$10 net gain). As a result, the distribution resulted in a decrease of \$15 in J's distributive share of the net gain in the partnership's securities (\$20 net gain before the distribution less \$5 net gain after distribution). The amount of the distribution of Security X that is treated as a cash distribution is reduced by \$15, with the result that the distribution of Security X is treated as an \$85 cash distribution to J (\$100 fair market value of Security X less \$15 reduction). [Treas. Reg. § 1.731-2(j), Example 2]

Note: For more examples, see Treas. Reg. §1.731-2(j)

6440 Exceptions to Gain Recognition Rules

There are several exceptions to the general rule that gain is recognized upon a partnership distribution of marketable securities. The exceptions include:

- Marketable securities contributed by distributee partner, (See PTM 6441)
- Securities not marketable when acquired by partnership, (See PTM 6442)
- Securities acquired in a nonrecognition transaction. (See PTM 6443)

6441 Marketable Securities Distributed to Contributor

A partner does not recognize gain if a distribution is made to him of marketable securities that he contributed to the partnership.

Under IRC §731(c)(3)(A)(i), a marketable security is not treated as money if it was contributed by the partner to whom it is distributed. [Treas. Reg. § 1.731-2(d)(1)]

6442 Securities not Marketable when Acquired by Partnership

The distribution of marketable securities is not treated as a distribution of money if:

- The security was not a marketable security on the date acquired by the partnership and the entity that issued the marketable security had no outstanding marketable securities on that date;
- The security was held by the partnership for at least six months before the date the security became marketable; and
- The partnership distributed the security within five years from the date the security became marketable.

[IRC § 731(c)(3)(A)(ii) and Treas. Reg. § 1.731-2(d)(1)(iii)]

6443 Securities Acquired in a Nonrecognition Transaction

A distribution of a marketable security is not treated as a distribution of money to the extent that:

- The security was acquired by the partnership in a nonrecognition transaction in exchange for property other than marketable securities or cash;
- The value of any marketable securities and money exchanged by the partnership in the nonrecognition transaction is less than 20% of the value of all the assets exchanged by the partnership in the nonrecognition transaction; and
- The partnership distributes the security five years from the later of
 - 1) the date the security was acquired by the partnership, or
 - 2) the date the security became marketable.[Treas. Reg. § 1.731-2(d)(1)(ii)]

6450 Distributions by Investment Partnerships

Marketable securities will not be treated as money for the purpose of IRC §§ 731(a)(1) and 737 if the partnership making the distribution is an "investment

partnership" and the partner that receives the distribution of marketable securities is an eligible member of the partnership. [IRC § 731(c)(3)(A)(iii)]

- An eligible partner is defined as any partner, who before the date of the distribution, did not contribute any property to the partnership other than assets described below. [IRC § 731(c)(3)(C)(iii)(I)]

An investment partnership is defined as any partnership that has never engaged in a trade or business and substantially all of its assets (by value) have consisted of the following:

- cash, [IRC § 731(c)(3)(C)(i)(I)]
- stock in a corporation, [IRC § 731(c)(3)(C)(i)(II)]
- notes, bonds, debentures or other evidence of indebtedness, [IRC § 731(c)(3)(C)(i)(III)]
- interest rate, currency or equity notional principal contracts, [IRC § 731(c)(3)(C)(i)(IV)]
- foreign currencies, [IRC § 731(c)(3)(C)(i)(V)]
- interests in or derivative financial instruments (options, forwards, future contracts, shorts positions) relating to any asset described above. [IRC § 731(c)(3)(C)(i)(VI)]

For a further discussion of investment partnerships, see PTM 4550.

6460 Basis of Marketable Securities Distributed

If a distributee partner recognizes gain because marketable securities distributed to the partner are treated as cash, the basis of the marketable securities is their basis determined under the normal distribution rules (See PTM 6140 for current distributions or PTM 6220 for liquidating distributions) increased by the gain recognized by the partner. [IRC § 731(c)(4)(A)]

Note: The following examples assume that the partnership does not have any other securities or that IRC § 731(c)(3)(B) does not come into play.

Example 1:

N is a partner in partnership NB and her interest in the partnership is \$100. Partnership NB distributes Security X, with a basis of \$90 and a fair market value of \$105 to N. Under the rules described above, the distribution of Security X is treated as a \$105 cash distribution. The result is that N must recognize \$5 of gain on the distribution. N's adjusted basis in Security X is \$95 (\$90 adjusted basis of Security X plus \$5 of gain recognized by N). [Treas. Reg. § 1.731-2(j),

*Example 5]***Example 2:**

*N is a partner in NB and has a \$10 basis in her partnership interest. NB distributes to N in a **current distribution** 1) Security X with a fair market value and adjusted basis of \$40 and 2) Property Z with an adjusted basis and fair market value of \$40. Under the rules described above, the distribution is treated as a \$40 cash distribution, with the result that N recognizes \$30 of gain on the distribution. N's adjusted basis in Security X is \$35 (\$5 adjusted basis under rules described in PTM 6140 plus \$30 of gain recognized). N's adjusted basis in Property Z is \$5 under the rules described in PTM 6140. [Treas. Reg. § 1.731-2(j), Example 6]*

The increase in basis is allocated to the distributed marketable securities in proportion to their respective amounts of unrealized appreciation before the basis increase. [IRC § 731(c)(4)(b)]

6500 DISTRIBUTION OF INVENTORY AND ACCOUNTS RECEIVABLE

- PTM 6510 Distributions of Inventory and Accounts Receivable
General
- PTM 6520 Effects of a Distribution of Inventory and Receivables
- PTM 6525 Effects of a Distribution of Other Property
- PTM 6530 Definition of Inventory
- PTM 6540 Definition of Unrealized Receivables
- PTM 6550 Exceptions to the General Rule of § 751
- PTM 6560 Distribution of Partner Debt
- PTM 6561 Direct Loan
- PTM 6562 Partner Debt Acquired from Third Parties
- PTM 6563 Partner Debt Contributed in Exchange for Partnership
Interest
- PTM 6564 Transfer of Property in Exchange for Deferred Payments
- PTM 6570 Distribution to Corporate Partner of it's Own Stock
- PTM 6575 Deemed Redemptions of Corporate Partner's stocks
- PTM 6580 Distributions of Property Subject to Liabilities
- PTM 6585 Loans vs. Distributions
- PTM 6590 Guaranteed Payments
- PTM 6595 Character of Gains Recognized

6510 Distribution of Inventory and Accounts Receivable-(§751)

If a partnership distributes unrealized receivables or substantially appreciated inventory, the gain associated with the disposition may be treated as ordinary income or loss. [IRC § 735(a)]

Certain distributions of unrealized receivables or substantially appreciated partnership inventory (§751 property) will result in gain recognition to the partner, partnership or both. Not all distributions of §751 property result in recognition of gain (loss is never recognized), only **uneven distributions** (non-prorata distributions).

Gain recognition can result to the extent that the distribution is re-characterized as a sale of a portion of the partner's share of §751 property. [IRC § 751(b)(1)]
In order for this rules to apply:

- the partner must receive more than his share of unrealized receivables or substantially appreciated inventory items in a partnership

distribution in exchange for less than his share of partnership's other assets, i.e., assets other than unrealized receivables or substantially appreciated inventory (non §751 property); or

- the partner must receive less than his share of unrealized receivables or substantially appreciated inventory items in a partnership distribution in exchange for more than his share of the partnership's non- §751 property.

It is not necessary that a partner receive a pro rata portion of each item of §751 property of the partnership in order for the distribution to be proportionate. The partner must receive §751 property with a value equal to that partner's interest in the total value of §751 property owned by the partnership in order for the nonrecognition rules to apply. In addition, the partner receiving the distribution of §751 property must not surrender any portion of his interest in the non-§751 property of the partnership as a consequence of the distribution.

Gain from the distribution of §751 property may result from both current and liquidating distributions.

If the distribution is a liquidating distribution, it must be determined whether all or a portion of the distribution is a payment received for partnership property. (See PTM 6600) If the payments are not received for partnership property, they are considered §736(a) payments and are exempt from recognition provisions of IRC §751(b). [IRC § 751(b)(2)(B)]

For further information regarding disproportionate distributions, see McKee, Nelson & Whitmire: *Federal Taxation of Partnerships and Partners*, Fourth Edition ¶ 21.04

6520 Effects of a Distribution of Inventory and Receivables

To the extent that a partner receives §751 property in a distribution that is in exchange for part of his interest in non-§751 property, the transaction will be treated as a sale or exchange of property between the distributee partner and the partnership. [Treas. Reg. § 1.751-1(b)(2)(i)] The portion of the distribution that is not treated as a "sale or exchange" will be governed by the general rules relating to distributions, i.e., §§731 through 736.

Ordinary income or loss is recognized by the partnership to the extent of the difference between the fair market value and the partnership's adjusted basis of

the receivables and inventory that the partnership is deemed to have sold as a consequence of the distribution. The income or loss is allocated to the nondistributee partners and is shown separately on the partnership return. [Treas. Reg. § 1.751-1(b)(2)(ii)]

The partnership's basis in the non-§751 property that it is deemed to have purchased from the distributee partner is equal to its fair market value i.e., its cost as determined under IRC §1012.

Gain or loss is also recognized by the distributee partner to the extent of the difference between the adjusted basis of the non-§751 property that he gave up and the fair market value of the §751 property that he was deemed to have received in the fictional exchange. [Treas. Reg. § 1.751-1(b)(2)(iii)]

- The partner's basis in the non-§751 property relinquished is the basis the property would have had if the distributee partner had received that property in a current distribution immediately before the actual distribution which is treated as a sale or exchange.
- The gain or loss is either capital or ordinary depending on the character of the property given up.

The distributee partner's basis in the §751 property that he is deemed to have purchased from the partnership is equal to its fair market value, i.e., its cost as determined under IRC §1012, while his basis in the §751 property that he is deemed to have received as a distribution from the partnership is determined under the rules applicable to distributions. [Treas. Reg. § 1.732-1(e)]

Section 751(b) applies only to the extent that a partner either receives section 751 property in exchange for his relinquishing any part of his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in section 751 property. Thus, section 751(b) does not apply to the extent that a distribution consists of the distributee partner's share of section 751 property or his share of other property. Similarly, section 751(b) does not apply to current draws or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital. In determining whether a partner has received only his share of either section 751 property or of other property, his interest in such property remaining in the partnership immediately after a distribution must be taken into account. [Treas. Reg. § 1.751-1(b)(1)(i) & (ii)]

Example:

A partnership's §751 property has a value of \$200,000. A 30% partner's interest in the §751 property is \$60,000. If he receives \$40,000 of this type of property and continues to have a 30% interest in the remaining §751 property, he is considered to have received \$12,000 as his share of these assets i.e., \$60,000 less \$48,000 (30% of \$160,000 remaining §751 property). The remaining \$28,000 represents a distribution in excess of his share of §751 property.

[Treas. Reg. § 1.751-1(b)(1)(ii)]

6525 Effects of a Distribution of Other Property

To the extent a partner receives more than his share of non-§751 property (including money) in return for his interest in §751 property, the partnership is considered to have sold the excess non-§751 property to the recipient partner for an amount equal to the fair market value of the excess §751 property retained by the partnership. [Treas. Reg. § 1.751-1(b)(3)(i)]

The partnership's gain or loss is equal to the difference between the fair market value of the non-§751 property and its adjusted basis in the hands of the partnership. [Treas. Reg. § 1.751-1(b)(3)(ii)]

- The gain is either capital or ordinary depending on the character of the property sold.
- The gain or loss is allocated to the nondistributee partners and is shown separately on the tax return. [Treas. Reg. § 1.751-1(b)(3)(ii)]

The partnership's basis in the unrealized receivables and substantially appreciated inventory that it is deemed to have acquired from the distributee partner is equal to the fair market value of the other property at the time of the deemed "sale or exchange".

The distributee partner recognizes ordinary income or loss to the extent of the difference between the fair market value of non-§751 property that he received, and the adjusted basis of the IRC §751 property that he relinquished, in the fictional sale or exchange. [Treas. Reg. § 1.751-1(b)(3)(iii)]

- The partner's adjusted basis in the §751 property that he is deemed to have sold in the fictional sale or exchange is the basis the assets would have had if the property had been received by the distributee partner in a current distribution immediately before the actual distribution. [Treas. Regs. §§ 1.732-1(e), 1.751-1(b)(3)(iii).]

The distributee partner's basis in the non-§751 property that he is deemed to have purchased from the partnership is equal to its fair market value, i.e., its cost as determined under IRC §1012, while his basis in the non-§751 property that he is deemed to have received as a distribution from the partnership is determined under the rules applicable to distributions i.e., IRC §§731 through 736. [Treas. Reg. § 1.751-1(b)(1)]

6530 Definition of Inventory

Inventory must be "substantially appreciated" in order to be considered §751 property.

- For Federal purposes after April 30, 1993 and California purposes after 1/1/97, inventory is considered substantially appreciated if its fair market value exceeds 120% of its adjusted basis. [IRC § 751(b)(3)(A)]
- For California purposes (prior to 1/1/97), inventory is considered substantially appreciated if :
 1. the fair market value of the property exceeds 120% of its adjusted basis, and
 2. the fair market value of the property exceeds 10% of the fair market value of all partnership property other than money.
- The 120% test applies to the total appreciation of the inventory items of a partnership. If the 120% test is met, all of the partnership's inventory items (whether or not appreciated) are treated as §751 property. [Treas. Reg. §1.751-1(d)(1).]

"Inventory" includes stock in trade and property held primarily for sale to customers in the ordinary course of a trade or business. (as defined in IRC §1221(a)(1)). [IRC § 751(d)(1)]

Inventory also includes any partnership property other than capital assets or IRC §1231 property and any other partnership property, if held by the selling or distributee partner, would be considered property other than capital assets or IRC §1231 property. [IRC § 751(d)(2) & (3)] In determining whether property meets these definitions of inventory, the property is evaluated from both the partnership's and the distributee partner's point of view. [IRC §§ 751(d)(2) and 751(d)(3)] For example, if property would be classified as inventory in the hands of the distributee partner, it will be deemed to be inventory in the hands of the partnership for purposes of IRC §751(b) purposes.

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An item of inventory property is excluded from the calculation of the 120% test if a principal purpose for acquiring it was to avoid having the partnership's inventory treated as substantially appreciated inventory. [IRC § 751(b)(3)(B)]

Example:

ABC Partnership has the following balance sheet:

<i>Assets:</i>	<u><i>Adjusted Basis</i></u>	<u><i>Fair Market Value</i></u>
<i>Cash</i>	\$300	\$300
<i>Inventory:</i>		
<i>X</i>	0	100
<i>Y</i>	0	100
<i>Z</i>	<u>150</u>	<u>100</u>
	<u>\$450</u>	<u>\$600</u>
 <i>Total assets</i>		
<i>Capital:</i>		
<i>A</i>	\$150	\$200
<i>B</i>	150	200
<i>C</i>	<u>150</u>	<u>200</u>
<i>Total capital</i>	<u>\$450</u>	<u>\$600</u>

*All of ABC's inventory items are "**substantially appreciated**" under § 751(d)(1), since their aggregate fair market value (\$300) exceeds 120% of their aggregate basis (Basis \$150 x 120% = \$180). [IRC § 751(b)(3)]*

*A's share of the **value** of partnership §751 property is \$100 (1/3 of \$300 fair market value), and A's share of the **unrealized ordinary income** inherent in the §751 property is \$50 (1/3 of the excess of \$300 fair market value of the inventory less the \$150 adjusted basis of the inventory). If partner A withdraws from the partnership and receives a cash distribution of \$100 plus any one of the inventory items, the distribution does not trigger §751(b), since A receives §751 property with a market value (\$100) equal to his predistribution share of partnership §751 property. However, any such distribution will distort the amount of ordinary income realized by A. For example, if A receives a distribution of either inventory item X or Y (both of which have \$0 basis), his basis in the item*

will be zero [IRC § 732(c)(1)], and he will realize ordinary income of \$100 if he then sells the inventory item for its fair market value. [IRC § 735(a)(2)] The BC partnership will have only \$50 of gain inherent in the remaining inventory items after the distribution; if they are both sold, B and C will each have \$25 of ordinary income. Therefore, after A withdraws from the partnership and receives the distributions described above, the \$150 of ordinary income inherent in partnership inventory prior to the distribution would thus be subsequently realized (i.e., when sold) in the amounts of \$100 by A and \$25 each by B and C.

6540 Definition of Unrealized Receivables

Rights to payment for goods or services that the partner has not yet included in income are categorized as unrealized receivables.

- An unrealized receivable can also be one of many other assets that are capable of producing ordinary income to a partnership.
- Any of the following items will be categorized as an unrealized receivable:
 - o mining property,
 - o §1245 property,
 - o stock in a DISC or certain other foreign corporation (not applicable for California purposes),
 - o §1250 property,
 - o farm land,
 - o franchises, trademarks or trade names,
 - o certain oil and gas property (not applicable for California purposes),
 - o market discount bonds, and short-term obligations.

The distinguishing feature of all of these items is that they are capable of producing ordinary income. [IRC § 751(c)]

6550 Exceptions to the General Rule of §751

The general rule of §751(b) does not apply to the distribution of property to a partner who contributed the property. This type of transaction is governed by the general distribution rules covered under §731 through § 736. [Treas. Reg. § 1.751-1(b)(4)(i)]

Payments made to a retiring partner or a deceased partner's successor in interest are not subject to IRC §751(b) if such payments are considered a

distributive share of partnership income or guaranteed payments (§736(a) payments). [Treas. Reg. § 1.751-1(b)(4)(ii)] (See PTM 6600)

- Payments which are considered as made in exchange for an interest in partnership property (§736 (b) payments) are subject to §751(b) if the distribution involves an exchange of substantially appreciated inventory. [Treas. Reg. § 1.751-1(b)(4)(ii)]

6560 Distribution of Partner Debt

A partner can become indebted to a partnership in several ways. If a partnership distributes a partner's debt to the debtor, the tax consequences vary. Some of the types of debt that can be canceled in this manner are:

- A direct loan from a partnership to a partner (See PTM 6561)
- Partner debt purchased by a partnership from a third party (See PTM 6562)
- Debt of a partner contributed to a partnership as part of a partner's capital contribution (See PTM 6563)
- Debt from a transfer of property to a partner from a partnership in exchange for deferred payments (See PTM 6564)

6561 Direct Loan

- If a partnership loans money to a partner and the loan is subsequently cancelled, the partner whose debt was cancelled will be deemed to have received a distribution of money or property at the time of cancellation. [Treas. Reg. § 1.731-1(c)(2)]
- The partnership will not recognize any gain or loss under IRC §731(b) when it distributes money or property to a partner(s). A partner who receives a distribution from a partnership will not recognize gain or loss under IRC §731(a)(1) unless the amount of money (including debt relief) received in the distribution exceeds the basis of his partnership interest.
- The regulations do not specify the amount of the deemed distribution of money when a partner's debt is canceled by a partnership. Commentators have said that the amount should be equal to the fair market value of the debt at the time it is cancelled, rather than its face amount. (See McKee, Nelson & Whitmire: *Federal Taxation of Partnerships and Partners*, Fourth Edition ¶ 19.02[5][a]; Willis, Postlewaite & Alexander: *Partnership Taxation*, ¶ 13.02[1][a][iii].)

- If the distributee partner recognizes a gain or loss and the partnership has a §754 election in effect or has a substantial basis reduction, the basis of the partnership assets may be increased or decreased in accordance with IRC §734(b).

6562 Partner Debt Acquired from Third Parties

Revenue Ruling 93-7, provides that a distribution of a partner's debt that has been acquired by a partnership from a third party is considered a property distribution. [Revenue Ruling 93-7, 1993-1 CB 125]

Since it is a property distribution, no gain or loss is recognized by the partnership. [IRC § 731]

The ruling divides the transaction as to the debtor-partner into two parts:

- First, the debt is considered property, and not money. The partnership is deemed to distribute the debt to the debtor partner, who acquires a basis in the distributed debt pursuant to the rules of IRC §732.
- Second, after the debtor-partner receives the distributed debt, the Ruling views the debt as being cancelled for an amount equal to its fair market value (FMV). Under the Ruling, the partner is treated as having satisfied the debt for its fair market value. The partner will recognize capital gain or loss to the extent the fair market value of the deb differs from the basis of the debt determined under IRC § 732, and may recognize COD income under IRC § 61(a)(12) if the adjusted issue price, e.g., face amount, exceeds the debt's fair market value.

6563 Partner Debt Contributed in Exchange for Partnership Interest

In many instances, a partner will contribute a promissory note and money in exchange for a partnership interest. This type of note does not increase a partner's interest in his partnership interest unless payments are made to the partnership. (See PTM 5460)

When a partnership distributes this type of note to a partner, it is considered a non-event for tax purposes unless it causes a reduction in the partner's share of partnership liabilities that may cause a deemed cash distribution in accordance with IRC §752(b).

6564 Transfer of Property in Exchange for Deferred Payments

If a partner enters into a deferred payment obligation to pay a partnership for property purchased from the partnership and the obligation is cancelled, the obligor partner will be considered to have received a distribution of money. [S. Report No-1622, 93d Congress, 2nd Session. 30 (1954)]

Regulation §1.731-1(c)(2) that treats the cancellation as being tantamount to the distribution of money controls this type of transaction.

6570 Distribution to Corporate Partner of its Own Stock

Nonrecognition of gain or loss under IRC §731(a) is not available in certain circumstances when a corporate partner receives a partnership distribution of its own stock. [Notice 89-37, 1989-1 CB 679] The purpose of the recognition of gain on this transaction is to prevent corporate taxpayers from using a partnership to circumvent gain required to be recognized under IRC § 311(b) or IRC § 336(a). Proposed regulations under IRC § 337(d) were issued in 1992. [PS-91-90, REG-208989-90, 1993-1 CB 919, in the Federal Register (57 FR 59324) addressing partnership transactions involving stock of a corporate partner. The 1992 proposed regulations adopted two rules to protect the repeal of the General Utilities doctrine: the deemed redemption rule (the 1992 deemed redemption rule) and the distribution rule (the 1992 distribution rule). [See T.D. 9722, 06/12/2015.] The 1992 proposed regulations also provided de minimis and inadvertence exceptions to these two rules.

For transactions occurring before 06/12/2015, a distribution to a corporate partner of its own stock (or stock of an affiliate) is treated as a redemption of the partner's stock in exchange for all or a portion of the partner's partnership interest. [Notice 89-37, 1989-1 CB 679]

The IRS disregards the partnership and treats the corporation as if **redeemed** its stock directly from the other partners in exchange for property equal in value to the redeemed stock.

The IRS treats the corporation as if it exchanged its interest in the partnership for the stock. The value of the partnership interest reflects the value of property that the corporation has contributed to the partnership.

The transaction is taxed as a corporate distribution of appreciated property to the other partners. [IRC § 311(b)] The corporation recognizes gain equal to the difference between the partner's basis in the portion of the partnership interest considered transferred and the fair market value of that interest (equal to the value of the stock distributed).

The special rule for distributions of a corporation's own stock is designed to close a loophole that had been used by corporations to achieve tax-free redemptions of stock for property, in violation of the spirit of IRC §311(b).

Different rules apply for determining gain on distributions after 06/12/15 of stock of a corporate partner to the corporate partner. The 1992 proposed regulations were withdrawn, and final federal regulations were issued under IRC § 337(d) applicable to transactions occurring on or after 06/12/2015. [Treas. Reg. §§ 1.337(d)-3, and 1.731-1, (T.D. 9833, 6/7/2018.) Under Treas. Reg. § 1.337(d)-3, a Corporate Partner, as defined, is required to recognize gain when a transaction (Section 337(d) transaction, as defined) has the effect of the Corporate Partner acquiring or increasing an interest in its own stock in exchange for appreciated property in a manner that uses a partnership to circumvent gain required to be recognized under IRC § 311(b) or IRC § 336(a). Under the final regulations, a distribution of the stock of the corporate partner to the corporate partner by the partnership is one of five types of transactions that may qualify as a Section 337(d) transaction. [Treas. Reg. §§ 1.337(d)-3(c)(3).] The final regulations remove the 1992 distribution rule and apply the deemed redemption rule to partnership distributions of Stock of the Corporate Partner to the Corporate Partner as though the partnership amended its agreement, immediately before the distribution, to allocate 100 percent of the distributed stock to the Corporate Partner. [See T.D. 9833. See also, McKee, Nelson & Whitmire: Federal Taxation of Partnerships & Partners ¶ 9.03[1][a][ii].]

The final federal regulations include a de minimis provision that would exempt corporations from the distribution rule if the corporation has only a small investment in the partnership. [Treas. Reg. §1.337(d)-3(f)]

A distribution would be exempt if:

- the corporate partner and related parties own in the aggregate not more than five percent of the partnership;
- the partnership holds stock of the corporate partner with a value of less than two percent of the partnership's gross assets, including the corporate partner's stock; and

- the partnership has never held in the aggregate: (1) stock of the corporate partner with a fair market value greater than \$1,000,000 or (2) two percent of the value of any class of stock of the corporate partner.

Additionally, an exemption for inadvertent transfers would provide an exemption if the partnership disposes of the stock in the same year it was acquired, and the stock was never distributed to the corporate partner or affiliate.

Note: for examples, see Treas. Reg. § 1.337(d)-3(h)

6575 Deemed Redemptions of Corporate Partner's Stock

In addition to actual distributions of a corporate partner's own stock, "indirect" distributions of a corporate partner's own stock will also be taxed as a sale or exchange.

- An indirect distribution is a transaction in which no distribution occurs and the corporation never regains possession of the stock, but which produces the same economic result as if the corporation traded appreciated property for its own stock. [Notice 89-37, 1989-1 CB 679]
- A deemed redemption is not an actual distribution of stock, but it is deemed to have the economic effect of a surrender by the partner of a portion of its interest in the partnership (i.e., a share in the appreciated property owned by the partnership).

The deemed redemption rule applies to any transaction or series of transactions, which has the economic effect of an exchange of appreciated property for the partner's stock (i.e., a stock redemption).

Under the final regulation section 1.337(d)-3, circumstances which might cause this economic effect include when a corporate partner contributes property to a partnership which owns stock of the corporate partner; or when a partnership acquires stock of the corporate partner; or a partnership that owns stock of the corporate partner distributes appreciated property to a partner other than the corporate partner; or when a partnership distributes stock of the corporate partner to the corporate partner; or when a partnership agreement is amended to provide different sharing ratios of partnership items. [Treas. Reg. §1.337(d)-3(c)(3)]

Example:

Able Corp, a corporation, and A, an individual who is also a shareholder of Able Corp, form equal partnership A & A. Able Corp contributes appreciated property to A & A. The basis of the property is \$0, and the fair market value of the contributed property is \$100 at the time of contribution. A contributes Able Corp stock to partnership A & A with a basis and fair market value of \$100. Under the deemed redemption rule, at the time the appreciated property is contributed to A & A, Able Corp is considered to have relinquished 50% of its interest in the appreciated property in exchange for 50% of the partnership's Able Corp stock. The property deemed exchanged has a basis of \$0 and a fair market value of \$50 (representing A's 50% interest in the partnership). Able Corp will recognize \$50 gain as a result of the transaction and will increase its basis in the partnership interest by \$50. [See Treas. Reg. §1.337(d)-3(h), Example 1]

6580 Distributions of Property Subject to Liabilities

A distribution of property subject to a liability is treated as two separate transactions:

- first, a transaction in which the partner assumes a partnership liability, plus
- second, a distribution of partnership property.

A distribution of encumbered property can result in gain to the partner receiving the distribution, if the net reduction in the partner's liabilities as a result of the transaction exceeds the partner's basis in the partnership immediately before the distribution, or to any other partner whose share of partnership liabilities is reduced as a result of the distribution. [IRC § 731(a), IRC § 752(b)]

A partner's assumption of a partnership liability is treated as a constructive contribution of money to the partnership. [IRC § 752(a)]

A decrease in a partner's share of partnership liabilities is treated as a distribution of money to the partner from the partnership. [IRC § 752(b)]

When partnership property subject to a liability is distributed to a partner, the transferee partner is treated as having assumed the liability. [Treas. Reg. §1.752-1(e)]

- This would decrease the remaining partners' shares of the liability to the extent that they had been liable for it prior to the distribution. The amount of the decrease is treated as a money distribution.

When encumbered property is distributed, the decrease in liabilities is treated as a constructive distribution of cash, and will reduce a partner's basis in the same manner as an actual cash distribution. [IRC § 752(b)]

- Any partner who included a share of the liability in the basis of his partnership interest, including the partner receiving the distribution of the encumbered property, will be treated as receiving a constructive distribution of money when the property is distributed. [IRC § 752(b)]

Increases and decreases in a partner's share of partnership liabilities can both occur when property subject to a liability is distributed. When this happens, the increases and decreases in liabilities are netted in order to determine whether a partner will be treated, overall, as having made a contribution or as having received a distribution as a result of the transaction. [Treas. Reg. §1.752-1(f)]

If more than one encumbered property is distributed as part of a single transaction, the increases and decreases in liabilities resulting from all of the distributions will be offset in determining the overall result for the partners. [Rev. Ruling 79-205]

If the constructive cash distribution exceeds the partner's basis in his partnership interest, the partner will recognize gain in the same manner as a partner receiving an actual cash distribution. [IRC § 731(a)(1)]

Adjustments to a partner's basis caused by an increase or decrease in the partner's share of partnership liabilities are made before the property distribution is taken into account. [IRC §§ 732(a)(2) and 732(b)]

- If the partner's net decrease in liabilities exceeds his basis in the partnership immediately before the property was distributed, the partner will recognize gain in the amount of the excess; and the partner's basis in the distributed property in that event will be the basis in his partnership interest, rather than the partnership's basis in the property—i.e., zero.

Example 1:

G and T are equal partners in GTA. G has a basis of \$1,000 in his partnership interest. GTA distributes property to G (other than § 751 property). The property has a basis to GTA of \$2,000, and is subject to a liability of \$1,600. As a result of the distribution, G's basis in his partnership interest is increased by \$1,600 to reflect his assumption of the liability. At the same time, his basis is also

decreased by \$800 to reflect the reduction in G's share of partnership liabilities (50% of the \$1,600 liability). The net result of these adjustments is an increase of \$800 to G's partnership basis (\$1,000 original basis plus (\$1,600 liability less \$800 G's share of liability) = \$1,800). G's basis in the distributed property is \$1,800, the lesser of the partnership's basis (\$2,000) and G's basis in his partnership interest immediately before the distribution (\$1,800). G does not recognize gain as a result of the distribution.

Example 2:

In the previous example, assume that T's basis in his partnership is \$600. As a result of the distribution to G, T's share of partnership liabilities is reduced by \$800 (50% of the \$1,600 liability). The reduction in liabilities is treated as a constructive cash distribution to T, and will produce gain of \$200 to T under IRC §731(a) (the extent to which the \$800 constructive distribution exceed T's \$600 basis in his partnership interest). T's basis in his partnership interest following the distribution is zero.

6585 Loans vs. Distributions

A loan is a transfer of money or property to a partner who is under an obligation to repay or return the transferred amount to the partnership.

A loan is not taxed as a current distribution and will not result in gain recognition to the partner. Instead, a loan is treated as a transaction between the partnership and a partner not acting in the capacity of a partner. [IRC § 707(a); Treas. Reg. §1.731-1(c)(2)]

A payment to a partner is **not** considered a loan unless the partner is under an unconditional and legally enforceable obligation to repay a specific sum at a determinable date. [Rev. Ruling 73-301, 1973-2 CB 215; Edward P. Knoll, et ux. v. Commissioner, TC Memo 2003-277]

- The obligation to repay must be created at the time the funds are disbursed. Bookkeeping entries alone are insufficient to establish the existence of a loan. The fact that the payment creates a deficit in the partner's account which the partner is under an obligation to restore upon liquidation is also not enough to create an obligation to repay a loan.

See Rev. Rul. 57-318, 1957-2 CB 362; Rev. Rul.73-301, 1973-2 CB 215.

6590 Guaranteed Payments

When a partner performs services for, or advances capital to, his partnership within his capacity as a partner and his payment for such is determined without regard to partnership income, the payments are guaranteed payments. [IRC § 707(c); Michael P. Cahill, TC Memo 2013-220.]

A partnership is considered as an entity separate from the partners whenever a partner engages in a transaction with a partnership other than in his capacity as a member of the partnership. Therefore, when a partner engages in a transaction with the partnership and the transaction is not in his capacity as a partner, the transaction is treated as if it occurred between the partnership and a nonpartner. [IRC § 707(a)]

- Where management services are rendered to a partnership by a partner pursuant to partnership agreement (as opposed to a separate management agreement) and based on the gross income of the partnership, there has been some confusion as to how they should be characterized. The Tax Court held that such payments should be classified as a distributive share of partnership income. [*Pratt v. Commissioner*, 64 T.C. 202 (1975)] The IRS then ruled that the payments in such situations (with respect to gross profits) should be governed by IRC §707(c). [Rev. Ruling 81-300, 1981-2 C.B. 143] However, the legislative history of the Deficit Reduction Act of 1984 states that the payments in such situations should be governed under IRC §707(a), and not IRC §707(c). [Senate Comm. On Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, S.Rpt. No. 169, at 229, 230. See Preamble to Prop. Reg. 07/23/2015, Fed. Reg. Vol. 80, No. 141, p. 43652, Disguised Payments for Services §§1.707-0, 1.707-1, 1.707-2, 1.707-9, 1.736-1, which obsoletes Rev. Rul. 81-300 and adopts view that IRC § 707(a) governs such payments.]

A guaranteed payment is deductible by the partnership (unless it must be capitalized) and is taxable as ordinary income to the partner. [Treas. Reg. §1.707-1(c)]

Example 1:

C & F Partnership has gross income of \$5,000, business expenses of \$3,000 and pays \$1,000 to partner C. If the payment is a current distribution (rather than as a guaranteed payment), the payment will be treated as a tax-free distribution to C that is not deductible by the partnership. The partnership would have income of

\$2,000 (\$5,000 gross income less \$3,000 business expenses), allocable \$1,000 to C and \$1,000 to F.

If the payment is treated as payment to C in his capacity as a partner as payment for services or as use of capital, it will be treated as a business expense by the partnership and is includible in C's income as compensation for services. In that case, the partnership would have taxable income of \$1,000 (\$5,000 gross income less \$3,000 business expenses less \$1,000 guaranteed payment) and both C and F's share of the income is \$500.

Example 2:

The partnership agreement of CDE Partnership provides that C is to receive an annual payment of \$25,000 for services rendered. The payment qualifies as a guaranteed payment. However, if the agreement provided that C is to receive 20% of partnership income, with no minimum guaranteed amount, the payment would not qualify as a guaranteed payment. [Treas. Reg. §1.707-1(c), Example 3]

For a further discussion on guaranteed payments under IRC §§ 707(a) and (c), See McKee, Nelson & Whitmire: Federal Taxation of Partnerships and Partners, Fourth Edition, ¶ 14.01[1]-[2], ¶ 14.02, and ¶ 14.03.

6595 Character of Gain Recognized

Any gain or loss recognized on a distribution from a partnership is considered to be gain or loss from the sale or exchange of the distributee partner's partnership interest. [Treas. Reg. §1.731-1(a)(3)]

- That gain is capital gain or loss except as otherwise provided in the rules relating to unrealized receivables and inventory. [Treas. Reg. §1.731-1(a)(3) and IRC §741(a)]

If a partnership distributes unrealized receivables or inventory (does not have to be substantially appreciated inventory), the gain realized by the recipient partner upon the subsequent disposition of that property may be treated as ordinary income or loss. [IRC §735(a)] This is not a distribution subject to IRC §751(b). Any gain or loss on the subsequent disposition of unrealized receivables by the distributee partner will result in ordinary income or loss treatment. Any gain or loss realized by a partner from the sale or exchange of distributed inventory that was sold by him **within five years** from the date of distribution will also be treated as ordinary income or loss. [IRC §735(a)]

- After the five-year time period has elapsed, the character of the distributed property is based on its character in the hands of the distributee at the time of the sale. [Treas. Reg. § 1.735-1(a)(2)]

If a partner receives only a reduction of partnership liabilities upon his withdrawal from the partnership, the reduction is deemed to be a cash distribution to the partner from the partnership. Accordingly, the partner is treated as receiving a distribution in exchange for his partnership interest, causing the transaction to be treated as a distribution that results in capital gain or loss. [*Stilwell, Andrew*, (1966) 46 TC 247]

Example:

J receives a distribution of partnership inventory in liquidation of his partnership interest. The inventory after distribution assumes J's basis in his partnership interest which is \$50,000. IRC §732(b) limits the adjusted basis of the distributed inventory in the hands of the partner to the partner's basis in his partnership interest, provided that IRC §§734 and 751(b) does not come into play. Within 5 years of the distribution, J sells the inventory to a dealer for \$80,000. The \$30,000 gain will be taxed as ordinary income. If J had waited to sell the property until after the required five years, he would treat the gain as capital gain if he is not a dealer at the time of disposition.

6600 DISTRIBUTION TO RETIRING PARTNER

- PTM 6610 General
- PTM 6620 Definition of a Retiring Partner
- PTM 6630 Timing of Recognition of Income

6610 General

The characterization of payments from a partnership to a withdrawing partner is significant because it determines:

- whether the withdrawing partner recognizes capital gain or loss or ordinary income with respect to the payments;
- the timing of the gain, loss or income recognition by the withdrawing partner;
- whether the partnership is entitled to a deduction with respect to the payments; and
- whether the remaining partners are entitled to an exclusion from their own share of partnership income with respect to the payments.

The general rules of IRC §731 regarding the recognition of gain or loss on partnership distributions may not apply if payments are made to a retiring partner or a deceased partner's successor in interest. [IRC § 731(d)] In those instances, IRC §736 is applicable.

IRC §736 attempts to allocate amounts received by withdrawing partners either as income payments (referred to as §736(a) payments) or as payments for property (referred to as §736(b) payments).

IRC §736 generally classifies payments from a partnership to a withdrawing partner into one of three categories. Payments in liquidation of his partnership interest may be classified as:

- payments in consideration for the withdrawing partner's interest in partnership assets; [IRC § 736(b)]
- a distributive share of partnership income; [IRC § 736(a)(1)] or
- a guaranteed payment. [IRC § 736(a)(2)]

Under §752(b), a partner is treated as receiving a distribution of money to the extent of any reduction in his share of partnership liabilities. Therefore, in addition to actual distributions of money and property, the § 736 distributions to a

retired partner include any deemed distributions to him under § 752(b). [Treas. Reg. § 1.736-1(a)(2)]

§736(a) payments are payments made to a retiring partner or to a deceased partner's successor in interest that are **not** in exchange for his interest in partnership property. They are either treated as a distributive share of partnership income [IRC § 736(a)(1)] or as a guaranteed payment. [IRC § 736(a)(2)]

- If the payments are determined with regard to the partnership's income, they are treated as a distributive share of partnership income. [Treas. Reg. § 1.736-1(a)(4)]
- If the payments are made without regard to partnership income, they are treated as guaranteed payments. [IRC § 707(c)] They are taxed as ordinary income to the partners and deductible by the partnership.

Payments treated as a distributive share of partnership income or guaranteed payments reduce the remaining partners' taxable share of partnership income either because the payments to the retiring partner reduce the distributive share of the partnership income which would otherwise be taxable to the remaining partners, or because the payments are treated as guaranteed payments that are deductible by the partnership. [Treas. Reg. § 1.736-1(a)(4)]

Generally, §736(b) payments include all payments for a retired partner's interest in partnership property. There are two exceptions to what constitutes partnership "property" for §736(b) purposes.

1. Payments in exchange for an interest in partnership property does not include amounts paid for unrealized receivables of the partnership as described in §751(c). [IRC § 736(b)(2)(A)], or
2. Payments in exchange for an interest in partnership property does not include amounts paid for goodwill of the partnership, unless the partnership agreement provides for a payment for goodwill. [IRC § 736(b)(2)(B)]

There is a limitation to the application of the exceptions under IRC § 736(b)(2)(A) and (B). IRC 736(b) applies (and the exceptions do not apply) if:

- capital is not a material income-producing factor for the partnership, and
- the retiring partner was a general partner in the partnership.

The term "liquidation of a partner's interest" means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership. [IRC § 761(d)]

- This includes a series of distributions whether they are made in one year or in more than one year as long as the partner's entire interest is ultimately to be terminated. [Treas. Reg. § 1.761-1(d)]

Partnership distributions in partial liquidation of a partner's interest are potentially subject to IRC §707(a)(2)(B), 704(c)(2), 731, 737, or 751(b) (See PTM 6110) rather than IRC §736, which deals with a complete liquidation of a partner's interest. [Treas. Reg. § 1.761-1(d)]

The partnership cannot deduct §736(b) payments made to a withdrawing partner.

Generally, the valuation placed by the partners upon a partner's interest in partnership property in an arm's length agreement will be regarded as correct. [Treas. Reg. § 1.736-1(b)(1); see *Elwood R. Milliken*, 72 TC 256 (1979), aff'd unpub. opinion (1st Circuit 1980)]

6620 Definition of a Retiring Partner

Payments made in liquidation of the interest of a withdrawing partner refers to all liquidating distributions from a partnership, which are attributable to a partner's withdrawal, regardless of the reason.

A partner may not be considered a partner under local law, but nevertheless will be treated as a partner for purposes of subchapter K until his interest in the partnership is completely liquidated. [Treas. Reg. § 1.736-1(a)(1)(ii); see *Elwood R. Milliken*, 72 TC 256 (1979), aff'd unpub. opinion (1st Circuit 1980)]

A partner who retires from a partnership for state law purposes is still considered to be a partner for income tax purposes if he is entitled to receive any distributions from the partnership after the date of retirement. [Treas. Reg. § 1.736-1(a)(1)(ii)] However, a series of payments that will ultimately result in the liquidation of a partner's entire interest in the partnership will be considered as payments in retirement of the partner's interest and will be characterized under IRC §736, rather other sections of the Internal Revenue Code. [Treas. Reg. § 1.731-1(c)(1)(i), § 1.761-1(d)]

6630 Timing of Recognition of Income

A retiring partner's interest in partnership §736(b) property may be liquidated through a series of payments spanning several years.

The timing of the recognition of gain or loss with respect to such payments is determined under §731, [Treas. Reg. § 1.736-1(b)(6)] which generally defers the reporting of gain until the distributee's entire basis has been recovered [Treas. Reg. § 1.731-1(a)(1)] and defers the recognition of loss at least until all distributions have been made. [IRC § 731(a)(2)]

There are two exceptions to this rule.

1. Payments which are subject to IRC §751(b). In this case, the retired partner's interest in the §751 property is treated as distributed to him and then sold back to the partnership. Therefore, the gain or loss attributable to these payments is reported as a gain or loss on the sale or exchange of property.
2. If the total amount of the §736(b) payment is fixed, a retired partner may elect to apportion a part of the total gain or loss among the installment payments by allocating a portion of the basis to the total amount payable under §736(b). The election must be made on the retiring partner's tax return for the first taxable year in which he receives a §736(b) payment. [Treas. Reg. § 1.736-1(b)(6)]

Thus, the general rule is that §736(b) payments are reported according to a cash-basis, cost-recovery method of accounting, regardless of the method of accounting of the partnership or of the partner receiving the payments. (See Example)

Example:

A retired partner is to receive \$500 in five annual installments of \$100 each in liquidation of his interest in §736(b) property, none of which is §751 property. The partner's basis in his partnership interest is \$200. Under the general cost recovery rule, the retired partner would recover his entire basis after the second \$100 installment, and the remaining three installments would constitute taxable gain in their entirety. If, on the other hand, he elected to apportion the gain among the installments, \$40 of each liquidating installment would be treated as basis recovery, computed as follows: \$200 the adjusted basis in his partnership interest divided by the number of payments i.e. five. The \$60 balance of each

installment would be taxable gain, computed as follows: \$100 (the amount of each installment) less \$40 allocable portion to his basis.

6700 HOLDING PERIOD OF DISTRIBUTED ASSETS

Generally, a distributee-partner is allowed to include the partnership's holding period in computing his holding period for property received in a distribution from a partnership. [IRC § 735(b)] This rule applies whether the property is received in a current distribution (See PTM 6110) or a liquidating distribution (See PTM 6210).

If the partnership acquired the distributed property by contribution from a partner, the distributee is entitled to include the period the property was held by the contributing partner under IRC §1223. [Treas. Reg. § 1.735-1(b)]

Tacking on the partnership's holding period is not allowed with respect to partnership property that a partner is viewed as acquiring by purchase rather than in a distribution. [*Edwin E. McCauslen*, 45 TC 588 (1966); Revenue Ruling 67-65, 1967]

If a partner receives inventory as part of a distribution, the five-year period during which distributed inventory items have an ordinary income taint starts with the date of the distribution, and no credit is given for the partnership's holding period for the distributed property. [Treas. Reg. § 1.735-1(b)]

6800 CASE LAW

- PTM 6810 Holding Period
- PTM 6820 Guaranteed Payments
- PTM 6830 Payments to a Retiring Partner
- PTM 6840 Gain or Loss on Partner Liquidation

6810 Holding Period

One partner in a two-person partnership purchased the partnership interest of his deceased partner, thereby terminating the partnership. The Tax Court refused to permit the purchaser to tack the partnership's holding period under §735(b) with respect to the one-half interest in partnership property attributable to his deceased partner, reasoning that because the purchase of the interest and the termination of the partnership occurred simultaneously, the purchasing partner

should be viewed as having acquired one half of the partnership's assets by purchase rather than by distribution. Edwin E. McCauslen, 45 TC 588 (1966)

Cora-Texas involves a liquidating distribution of preferred stock from a partnership to the partner who was the issuer of the preferred stock. The distributee-partner argued that it should not be prevented from recognizing a loss on the liquidation of its partnership interest under the pre-1954 equivalent of §731(a)(2), pointing out that because the preferred stock it received in the distribution was canceled, it would not have any subsequent opportunity to realize the loss. Although indicating agreement with the taxpayer's argument that a partner who receives shares of its own stock as part of a liquidating distribution should not be prevented from recognizing a loss by reason of such receipt, the district court found that no loss had actually occurred in the transaction at hand. Cora-Texas Manufacturing Co. v. United States, 222 F. Supp. 527 (ED La. 1963), aff'd per curiam, 341 F2d 579 (5th Cir. 1965)

6820 Guaranteed Payments

Regardless of whether the payment is properly classified as a "guaranteed payment", a partnership can only deduct payments made to a partner for services if they represent deductible expenses of the partnership. Cagle, Jackson Jr., (1974) 63 TC 86, aff'd on other issue (1976, CA5) 38 AFTR 2d 76-5834, 539 F2d 409, 76-2 USTC

A management fee of 5% of gross rental income paid to a general partner in a partnership engaged in real estate development was held to be unrelated to the partnership income and therefore, a guaranteed payment. Although the Tax Court held that "income" included "gross income for purposes of IRC §707(c)", the IRS interpreted the term "income" for purposes of the statute to mean the "taxable income" of the partnership. Cf. Pratt v. Commissioner, 64 T.C. 202, (1975) with Revenue Ruling 80-300

6830 Payments to Retiring Partner

The taxpayer withdrew from a two-person partnership and received nothing for his partnership interest in connection with the withdrawal. The other partner agreed to pay all debts of the partnership and further agreed to indemnify the taxpayer in connection with any partnership indebtedness. The taxpayer argued that he was entitled to an ordinary loss in connection with the withdrawal measured by his basis in his partnership interest. The Tax Court disagreed and held that the loss was capital in nature, reasoning that the taxpayer received a

deemed distribution of cash pursuant to IRC §752 due to the relief from partnership indebtedness. The deemed payment was subject to IRC §736 and, pursuant to IRC §§736(b) and 731, the loss resulting from the withdrawal was capital in nature. Thus, the Tax Court held that relief of a partner's share of liabilities with no distribution of either cash or property constitutes a §736 payment.

Stilwell v. Comr., T.C. 247 (1966)

A partner withdrew from an engineering partnership. At the time of the partner's withdrawal, there was no withdrawal agreement signed because of a dispute regarding the fair market value of the partner's interest. However, the withdrawing partner received payments from the partnership (based on a valuation of his interest by the partnership's accounting firm) and was relieved of his share of the partnership's liabilities. The court held that the cash distributions and the relief of liabilities were taxable to the withdrawing partner to the extent the payments were treated as being for the partnership's unrealized receivables. The partner argued that the payments were not fixed payments since (1) there was no specific time when the payment had to be made, and (2) the total amount to be received was not fixed since it was possible that he would receive additional payments because of his dispute with the remaining partners over the valuation of his partnership interest. The Tax Court affirmed by the Sixth Circuit, held that the regulations do not require that the time of the payments be fixed and that the amount that he was entitled to receive based on the accountant's valuation be a fixed amount. The Tax Court also rejected the taxpayer's argument that he was not a retiring partner because he remained a partner under state law until his state court action was resolved, holding that under state law he was not a partner, but only had a right to receive payments. Accordingly, the amount distributed was treated under prior law as a guaranteed payment to the extent of the portion attributable to the unrealized receivables and the remainder was treated as a return of the withdrawing partner's basis and capital gain to the extent of any excess over his basis.

Quirk, Thomas P. Est., (1988) TC Memo 1988-286, (affirmed) 67 AFTR 2d 91-782, 928 F2d 751, 91-1 USTC

6840 Gain or loss on Partner Liquidation

In spite of the dissolution of the operation of a partnership during the tax year, a partner was not relieved of partnership liability since he continued to be liable on his personal guarantee of a bank's participation loan. Therefore, he did not realize short-term capital gain when he forfeited his interest to the partnership. The taxpayer remained liable on his personal guarantee of the partnership loan

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since there was no agreement between the taxpayer and the remaining partners relieving him of liability. Also, the bank did not expressly release the taxpayer from his personal guarantee. R.B. Weiss, CA-11, 92-1 USTC ¶150,168, 956 F2d 242; see discussion in McKee, Nelson & Whitmire: Federal Taxation of Partnerships & Partners (WG&L), 16.05[1][c]