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TAXATION ISSUES ASSOCIATED WITH THE FORMATION AND OPERATION OF LIMITED LIABILITY COMPANIES AND GENERAL AND LIMITED PARTNERSHIPS

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1. INTRODUCTION

The last few years have seen a rapid increase in the number of states that have adopted legislation authorizing the formation of limited liability companies. As recently as 1990, only three states had LLC statutes; now, almost all states do. Now Montana and other states are adopting legislation authorizing limited liability partnerships, a cousin to the LLC. LLC's and LLP's are attractive because they may be taxable as partnerships, yet offer limited liability protection like corporations. To be able to offer clients competent advice on, and operation of, a LLC or LLP, a fundamental understanding of partnership tax principles is necessary.

The emergence of the LLC and LLP as entities that can provide the benefits of limited liability and pass-through taxation gives attorneys new flexibility in designing business organizations that meet their clients' goals and objectives. A fundamental understanding of certain attributes of these entities under state law is also essential if we are to render competent advice to our clients.

One issue attorneys will need to consider, with little interpretive guidance from the courts, is the extent of the limited liability shield that is available under these new entities. The answer to that question differs significantly from state to state and from statute to statute. For example, the articulated liability shield under the Montana Uniform Partnership Act with respect to LLP's differs significantly from the articulated liability shield under the Montana Limited Liability Company Act with respect to LLC's. The statutes share, however, one common characteristic: none limit the liability of an individual for his or her own acts. This is a particularly important point with regard to closely-held LLC's and LLP's that have one or just a few owners. With lenders and substantial creditors commonly requiring personal responsibility of the owners, and the unavailability of the "corporate shield" for protection from tort liability for one's own acts, the limited liability shield of LLC's and LLP's for single-owner

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[1]This outline is an adaptation of an outline prepared by the author along with Profs. Martin J. Burke and Sally Weaver of the University of Montana School of Law and presented at the 1996 UM School of Law 46th Annual Federal Tax Institute, the title of which was "Getting Up, Getting Going and Getting Out (Formation, Operation and Sales of Partnerships and LLC's).

businesses may be more illusory than factual.

With virtually no guidance from the courts, practitioners and commentators can only speculate about whether the courts will look to the law of corporations for guidance with respect to issues such as fiduciary obligations, defective formation, piercing the "corporate" veil and undercapitalization or whether a separate body of law will develop to address these issues in the context of LLP's and LLC's. It is clear, however, that partners who have become accustomed to conducting the business of their partnership with informality should not conclude that registration as a LLP or conversion to a LLC will provide an impenetrable shield against liability if they continue to conduct their business with the same informality.

States such as Montana have flexible LLC statutes which permit the LLC to be structured either so that it is taxable as a partnership or as an association taxable as a corporation, and with the proposed check-the-box regulations [Prop. Reg. §301.7701-1, -2, and -3] the members will have even greater flexibility in choosing how the LLC will be taxed.

There is also a proposed amendment to the definition of "partnership" to include LLC's taxable as partnerships under the check-the-box regulations. For anyone who previously had any concern regarding the applicability of Subchapter K to LLC's, this proposed amendment ought to provide comfort. [Prop. Reg. §1.761-1(a)]

Montana allows formation of one-member LLC's. The proposed check-the-box regulations make clear that such a LLC will be ignored for tax purposes. §301.7701-2(c) states that for federal tax purposes, "a business entity that has a single owner and is not a corporation under paragraph (b) of this section is disregarded as an entity separate from its owner." One-member LLC's, therefore, will be taxed as sole proprietorships.

Under the proposed check-the-box regulations, therefore, LLC's can be taxed in one of three ways: (i) as partnerships; (ii) as corporations; or (iii) as sole proprietorships. This outline deals with partnership tax principles and, consequently, LLC's taxable as partnerships. LLC's taxable either as corporations or as sole proprietorships will be subject to the tax principles applicable to those forms of business organization, and to those LLC's, this outline will not apply.

Prior to the promulgation of the proposed check-the-box regulations, in order to be taxed as a partnership, a LLC could have no more than two of the four corporate attributes: 1) limited liability; 2) perpetual duration; 3) free transferability of interests; and 4) centralized management. The default provisions in most flexible LLC statutes, including Montana, were designed

to avoid at least two of the corporate characteristics. Since limited liability was generally desirable, the drafters of these statutes generally attempted to avoid two of the remaining three characteristics. Articles of Organization and Operating Agreements that deviated from the default provisions in the statutes were also structured to avoid at least two of these characteristics. In some instances, this approach resulted in provisions dealing with duration, transferability and management that reflected the requirements of the Internal Revenue Service rather than the business goals and objectives of the client. The adoption of the check-the-box regulations affords to attorneys and their clients the flexibility to structure a LLC to achieve business goals and objectives rather than adhering to a rigid structure in order to achieve a desired tax benefit.

Many commentators and practitioners believe that the promulgation of the check-the-box regulations has the potential to decrease significantly the differences between partnerships and LLC's. In fact, Professor Larry E. Ribstein, one of the foremost experts on partnership law, has just published a new form of "chameleon" agreement that he calls a "Memnership Agreement." The parties to the Agreement are called "memners" to blur the distinction between a partner and a member. Professor Ribstein does not suggest that the "chameleon" agreement should be used as a form "as is" but rather that, in many instances, it is now appropriate to address issues in the same way, regardless of whether the entity is a partnership, particularly a limited liability partnership, or a LLC.

Finally, it is interesting to think about the myriad ways in which the joint and several liability of partners for the obligations of the partnership has influenced the development of default and mandatory provisions in variations of the Uniform Partnership Act and the Revised Uniform Partnership Act adopted by the states. Mandatory and default provisions that require equal sharing of profits and losses, equal participation in management, the right of a partner to veto the admission of a new partner and the right of a partner to cause a dissolution of the partnership derive, in large part, from the personal liability of each partner for the obligations of the partnership. Providing partners in LLP's and members in LLC's with limited liability should force attorneys to reconsider the appropriateness of these and other default provisions in the LLC and LLP statutes.

At appropriate points in these materials, we have included drafting or practice points that in some instances address important state law issues related to the general topic under discussion. In most instances, these comments will refer to the Montana Limited Liability Company Act (MLLCA) or the Montana Uniform Partnership Act (MUPA). Montana is, however, one of the few states that follows the Uniform Partnership Act (1993) so caution is in order when dealing with partnerships that have been organized under the laws of states other than Montana.

2. OVERVIEW OF SUBCHAPTER K

a. Contributions of Property

i. **§721:** No gain or loss is recognized upon contribution of property to a partnership.

(1) Either by the partner or the partnership.

(2) Distinguish contributions of services

ii. **§722:** The beginning basis in the partnership interest is equal to the basis in the property contributed.

iii. **§723:** The partnership takes the partner's basis in the property contributed.

iv. **§724:** Though the character of property is generally determined at the partnership level, some items (unrealized receivables, inventory and capital loss property) retain the character they had in the hands of the partner who contributed them.

b. Basis in Partnership Interest ("Outside Basis")

i. *Five sections determine basis of a partner's interest:*

(1) **§722:** As stated above, upon contribution of property to partnership in exchange for partnership interest, contributing partner gets basis in partnership interest equal to basis of property contributed.

(2) **§742:** A partner who buys a partnership interest takes a cost basis.

(3) **§705:** Once the beginning basis is determined (under §722 or §742), basis is adjusted for the partner's distributive share of income and expenses of the partnership. In general, increase basis for income and decrease for losses.

(4) **§733:** Decrease basis (not below zero) for nonliquidating distributions from the partnership to the partner.

(5) **§752:** Increase basis for partner's share of liabilities; decrease basis to the

extent the partner is relieved of liabilities.

ii. *Why basis is important*:

(1) Losses can be deducted only to the extent of partnership interest basis [§704].

(2) Basis is used to determine gain or loss realized on the sale of a partnership interest [§1001].

(3) Distributions in general are tax-free, but if money is distributed in excess of a partner's basis, the partner has capital gain [§731(a)].

iii. "Outside Basis"

(1) The term "outside basis" commonly is used to refer to a partner's basis in his partnership interest.

(2) In general, outside basis is the partner's share of "inside basis" (that is, the adjusted basis of the partnership in its assets net of its liabilities) plus the partner's share of liabilities.

iv. "Inside Basis" is the partnership's basis in partnership property.

c. **Income Reporting**

i. §701

(1) Partnerships are not subject to tax. Partners are liable in their separate and individual capacities.

(2) Partnerships do file income tax returns (Form 1065).

(3) Form 1065 is primarily an information return, but some tax elections must be made by the partnership, and failure to file subjects the partnership to penalties.

ii. §703: Income Reporting

(1) Partnership determines its income, then reports to each partner his share. The

partners then include their shares of income on their individual returns.

(2) The partnership determines its income in the same manner as an individual. Of course, the partnership does not get to take advantage of certain deductions, such as personal exemptions, charitable contributions, net operating losses and itemized deductions for individuals [§703(a)].

(3) The partnership makes any election affecting the computation of taxable income [§703(b)].

(4) In general, the partnership taxable income is determined by netting expenses against income and reporting to each partner his share of the net income. However, some items, specified in §702, must be separately reported to the partners.

iii. §702: Separately Reported Items

(1) Some items must be separately reported by the partnership because they could have differing impact on the partners.

(a) These include capital gains and losses, §1231 gains and losses, and charitable contributions. See §702(a) and the regulations thereunder for additional items.

(b) For example, one partner may be subject to percentage limitations on charitable contributions and another may not. If each partner's share of charitable contributions made by the partnership were not separately reported, it might not be possible for the partners to determine whether they were limited under §170 in the amount of charitable contributions they could deduct.

(2) The character of items of income, gain, loss, deduction or credit is determined at the partnership level [§702(b)].

iv. §704: Partners' Shares of Income

(1) A partner's distributive share is determined by the partnership agreement [§704(a)].

(2) A partner's distributive share is determined by the partner's interest in the partnership if:

(a) the partnership agreement is silent; or

(b) the allocation to the partner under the partnership agreement lacks substantial economic effect [§704(b)].

(3) Contributed property: Built-in gain or loss on property at the time it is contributed to the partnership by a partner must be allocated to the contributing partner [§704(c)].

(4) Losses: A partner can deduct losses only to the extent he or she has basis in his partnership interest. Nondeductible losses are merely postponed until the partner has basis in the partnership interest sufficient to deduct the loss [§704(d)].

v. §705: Basis Adjustment for Results of Operations

(1) Adjust basis in a partner's partnership interest for income or loss.

(2) Basis changes with the operations of the partnership.

d. **Distributions**

i. §731: Gain or loss on distributions

(1) In general, no gain or loss is recognized for distributions from the partnership to the partner.

(2) Exceptions:

(a) Gain recognized if money distributed exceeds basis in the partnership interest.

(b) Loss recognized if

❑ distribution is in liquidation of partnership interest; and

- ❑ the only property distributed is money, unrealized receivables and inventory (as defined by §751).

ii. §732: Basis of distributed property

(1) Nonliquidating distributions:

(a) In general, partner receiving distribution takes partnership's basis in property distributed.

(b) Limitation: Basis in the property distributed cannot exceed partner's basis in his partnership interest.

(2) Liquidating distributions: Partner receiving distribution in liquidation of his partnership interest allocated basis in partnership interest to the property distributed.

iii. §733: Basis of Distributee Partner's Interest

(1) Decrease outside basis for property distributed.

iv. §735

(1) Subsequent sale of distributed property

(2) In general, character of gain or loss is determined in the hands of the partner.

(3) Exceptions: Unrealized receivables and inventory (as defined in §751) will be "tainted" with their character in the hands of the partnership. That is, their disposition by the distributee partner will result in ordinary income to the partner, even if they otherwise would not have been ordinary income assets in the partner's hands.

(a) 5 year limit on "taint" as to inventory [§735(a)(1)].

(b) No time limit on "taint" as to unrealized receivables [§735(a)(2)].

(4) Tack holding period: The distributee partner can include the period the partnership held the property when determining the holding period of the property in the hands of the partner [§735(b)].

e. **Sale of a Partnership Interest**

i. §741: General Rule

(1) In general, sale of a partnership interest results in capital gain or loss.

(2) Exception for §751 assets.

ii. §751: Exception for Hot Assets

(1) Partner who sells a partnership interest recognizes ordinary income to the extent sales price is attributable to unrealized receivables of the partnership or inventory items of the partnership which have substantially appreciated.

(2) "Inventory" is broadly defined.

(a) Not limited to §1221 type inventory (that is, stock in trade of a business, etc.). Includes all property that is not capital asset or §1231 property.

(b) But must be "substantially appreciated."

❑ 120% test used to determine this.

(3) "Unrealized receivables" also are broadly defined. Can include almost any right to receive ordinary income, even if it would not be classified as a receivable for accounting purposes. *Ledoux v. Comm'r,* 77 T.C. 293, aff'd *per curiam* 695 F.2d 1320 (11th Cir. 1983).

iii. §742: Basis to Purchasing Partner

(1) The buying partner takes a cost basis in the partnership interest.

iv. §743: Optional Inside Basis Adjustment

(1) Optional adjustment to basis of partnership property.

(2) Because the basis of partnership assets does not change upon sale of a partnership interest, it may be necessary to make a special adjustment to the basis of partner-

ship assets as to the purchasing partner to avoid taxing that partner when the partnership recognizes the income for which the purchasing partner has already paid.

v. §752: Impact of Debt

(1) The amount realized by a partner on the sale of a partnership interest includes in the amount of any amount of debt of which the partner is relieved.

f. **Retirement of a Partner**

i. Available Treatments

(1) A partner who wants to retire can either sell his partnership interest to the other partners (or to a new partner) or the partnership can liquidate his interest.

(2) The sale of a partnership interest is governed by §741.

(3) The liquidation of a partnership interest is governed by §736.

(a) Exception: If all the partners are liquidating--in other words, the partnership is terminating--§736 does not apply.

(b) §761(d) defines "liquidation of a partner's interest" as the termination of a partner's entire interest in the partnership by means of a distribution, or a series of distributions, to the partner by the partnership.

ii. Allocation of §736 Payments

(1) Payments must be allocated between §736(b) payments and §736(a) payments.

(2) §736(b) payments are made for the interest of a retiring partner in partnership property, except that payments made for the partner's interest in unrealized receivables and unstated goodwill will be governed by §736(a).

(a) §736(b) payments are treated as a distributions. Thus, the rules discussed under 2.d above apply. Any income recognized by the retiring partner will be treated as capital gain (except to the extent §751 overrides).

(b) §736(b) payments do not affect the tax liability of the other partners.

(3) §736(a) payments are treated as a distributive share of partnership income (if determined by partnership income) or as a guaranteed payment (if not determined by partnership income).

(a) Either way, the retiring partner will have ordinary income and the other partners will have a deduction.

(b) The partnership will have to recognize gain <loss> if a §736(a) payment is satisfied with appreciated <depreciated> property.

(4) §736(a) overrides §751.

g. **Death of a Partner**

i. Application of §736

(1) §736 applies to payments made in liquidation of the interest of a deceased partner.

ii. Termination of the Partnership

(1) The death of a partner generally does not cause a termination of the partnership [§708].

(2) Nor does it in general cause the tax year of the partnership to close with respect to a deceased partner [§706(c)].

(3) If there is a buy-sell agreement requiring a sale of the partner's interest upon death, the partnership tax year will close with respect to the deceased partner [§706(c)(2)(A)(i)] and, if the partner had a 50% or greater interest in the partnership, the partnership will terminate, as well [§708(b)].

(4) Thus, in general, the distributive share of income or loss for that partnership interest will be taxed on the estate income tax return, not on the decedent's final income tax return.

iii. Outside Basis

(1) The partnership interest takes a basis equal to fair market value as of the date of death (or as of the alternate valuation date) under §1014.

(2) Exception: To the extent the value of the partnership interest is attributable to income in respect of a decedent, no basis will be allowed.

3. CREATION OF A PARTNERSHIP OR LIMITED LIABILITY COMPANY

a. Nonrecognition Regime of Subchapter K

i. Gain / Loss

(1) Taxpayers can transfer property to a partnership or LLC **either at the time of forming the partnership or LLC or during the existence of the partnership** or LLC without triggering gain or loss.

(2) **§721**: No gain or loss shall be recognized **to a partnership or to any of its partners** in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

(3) Contrast **§351**, the corporate nonrecognition rule, which requires that the contributing party obtain or have "control" immediately after the exchange.

ii. Examples

(1) **Appreciated property**: X transfers land worth $100,000 with an adjusted basis of $40,000. Neither X nor the partnership will recognize any gain.

(2) **Loss property**: X transfers land worth $40,000 with an adjusted basis of $100,000. Neither X nor the partnership will recognize any loss.

(3) **Depreciable property:** X transfers machinery worth $50,000 and having an adjusted basis of $10,000. X has claimed $80,000 of depreciation on the property during the time that X held it. Neither X nor the partnership will recognize any gain. **§721 nonrecognition rules override §1245 recapture.** §1245(b)(3).

(4) **Accounts receivable and other unrealized receivables:** X, a cash method taxpayer, transfers the accounts receivable of X's sole proprietorship to a partnership. The accounts have a fair market value of $10,000 and an adjusted basis of $0. Neither X nor the partnership will recognize any gain. As will be noted later in Professor McMahon's discussion, X has not effectively assigned income to other partners. At the same time, §721 prevents any immediate recognition by X of the income inherent in the accounts. Rev. Rul. 84-115, 1984-2 C.B. 118. See, e.g., *Stafford v. U.S.,* 611 F.2d 990, 995-997 (5th Cir. 1980).

(5) **Installment notes:** X transfers installment notes in the face amount of $100,000 and with an adjusted basis of $20,000. Neither X nor the partnership will recognize the gain upon this transfer. Despite the general rule of §453B requiring immediate recognition of gain upon the disposition of installment obligations, the §721 nonrecognition rule applies. Reg. §§1.721-1(a) and 1.453-9(c)(2).

b. **Exceptions to Nonrecognition Regime**

i. Contributions of Property Subject to Liabilities in Excess of Basis

As discussed *infra*, contribution of property with liabilities in excess of basis may trigger gain recognition, although that is generally not the case.

ii. Disguised Sales

If the transfer of property to a partnership does not really represent a contribution to the partnership but rather is given in exchange for property held by the partnership or some other partner, gain or loss may be recognized. §707(a)(2) (A) and (B).

iii. **Practice Pointer: Treatment of the Service Partner**

(1) A "service partner" is still treated as a second class citizen under virtually every partnership statute. The presumption is that the service partner renders services in return for the receipt of an interest in the partnership and, absent a provision to the contrary in the partnership agreement, a partner is generally not entitled to remuneration for services performed for the partnership.

(2) If your clients have a different intention, be sure that intention is clearly

reflected in the partnership agreement.

c. **Basis, Holding Period, and Character Considerations**

i. Basis

(1) Gain and loss not recognized as a result of §721 are preserved both in the basis which the partnership takes in the contributed property (§723)[hereinafter referred to as ***"inside basis"***] and in the basis which the contributing partner takes in her partnership interest (§722) [hereinafter referred to as ***"outside basis."***]

(2) **§723**: *"The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution..."*

(3) **§722:** *"The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution..."*

ii. Holding Period

(1) In the case of partnership interests, the holding period of the transferor will be determined with reference to the nature of the assets contributed.

(2) §1223(1) provides for tacking of holding period if the properties contributed were either capital assets or §1231 property in the transferor's hands.

iii. Character

(1) The characterization of an asset transferred to the partnership as either an asset which will produce ordinary income/loss or capital gain/loss is generally determined at the partnership level.

(2) However, §724 provides some special rules which ensure that:

(a) **unrealized receivables and inventory** will continue to have an ordinary

income taint to them [forever in the case of unrealized receivables and for 5 years in the case of inventory.]

(b) **capital loss property** will retain the capital loss taint so that if the property is sold within a 5 year period, the partnership will report a capital loss rather than an ordinary loss. §724 places a limit, however, on the amount of the capital loss taint. *See* Sec. 1211 which limits capital losses.

d. **Impact of Liabilities**

i. Allocation of Liabilities for Purposes of Outside Basis [§752]

(1) Under the general rules of **§752**, Subchapter K allocates liabilities among the partners.

(2) If the application of the rules of §752 result in an increase in a partner's share of liabilities, the partner is treated under §752(a) as having made an additional cash contribution to the partnership.

(3) By contrast, if a partner's share of liabilities is deemed to have decreased, the partner is treated under §752(b) as receiving a cash distribution.

(4) **Example:** A and B are equal partners and the partnership borrows $100,000 to construct a new warehouse. Regardless of whether the $100,000 loan is recourse or nonrecourse, A and B will each be treated as making an additional contribution of $50,000 in cash to the partnership. As a result, their bases will increase by that amount. If the corporation repays the $100,000 the following year, A and B will be treated as having received a distribution of $50,000 in cash and their bases will be decreased by $50,000 each.

ii. Recourse Liabilities

(1) If a partner contributes property encumbered by recourse debt and the partnership assumes the liability, then each partner, including the contributing partner, will be deemed to have made a cash contribution to the partnership equal to their allocable share of the partnership liability.

(2) The contributing partner will be deemed to have received a cash distribution

equal to the amount of the liability assumed by the partnership.

(3) Compare the following examples:

(a) **Example A:** B and C form a general partnership in which they will share all profits and losses equally. B contributes land valued at $100,000 which is encumbered by a recourse liability in the amount of $30,000. C contributes $70,000 in cash. The BC partnership assumes the liability encumbering B's property. Under §752 and the regulations interpreting that provision, B and C will be treated as each having a $15,000 share of the recourse liability, i.e., they will be treated as having made a cash contribution of $15,000 each to the partnership. B will also be treated as receiving a cash distribution of $30,000 from the partnership reflecting the fact that the BC partnership assumed B's liability. B thus has a net reduction in liability of $15,000 and this net amount is treated as a cash distribution to B. Assume that B's basis in the land was $10,000. Under §731, B would recognize a $5,000 gain since the cash deemed received ($15,000) exceeded his basis in the partnership ($10,000). B's basis in the partnership interest is, of course, now $0. Meanwhile, C's basis in her partnership interest would increase from $70,000 to $85,000 as a result of the increase in her share of partnership liabilities.

(b) **Example B:** Assume the same facts as in the previous example except that the partnership did not assume the $30,000 recourse liability; B remained liable for the debt. Under these circumstances, the §752 regulations will treat the BC partnership as having assumed the liability thus meaning that B's individual liabilities have decreased by $30,000. At the same time, since B continues to bear the economic risk of loss for the entire amount of the liability, B's liabilities have also increased by $30,000. Netting these numbers, there is no increase or decrease in liabilities and therefore B has no concern about gain recognition. B's basis in her partnership interest is $10,000. C's basis is $70,000. See **Reg. §1.752-1(g)**.

(4) **Planning Pointer: Avoid the Liabilities-in-Excess-of-Basis Problem.** Since taxpayers typically are not interested in triggering gain on the formation of a partnership, care must be taken when property encumbered by liabilities in excess of basis is contributed. The contributing partner may wish to remain personally liable on the debt or may wish to contribute additional assets so as to ensure adequate overall basis in the

partnership interest and thereby avoid gain recognition under §731.

iii. **Nonrecourse Liabilities**

(1) The regulations under §752 provide special rules for allocating basis to the partners for their respective shares of nonrecourse liabilities. Reg. §1.752-3. The regulations governing nonrecourse liabilities are complex and lengthy, and nonrecourse liabilities tend to be uncommon, so they will not be examined closely in this outline. A few important points, however, should be made.

(2) Nonrecourse liabilities, as well as recourse liabilities, are taken into account in determining outside basis of the partners in their partnership interests. How the liabilities are "shared" for purposes of determining how much each partner has "contributed" or "received" in a deemed distribution, however, differs depending on whether a liability is recourse or nonrecourse.

(a) Recourse liabilities are "shared" by the partners, in general, in the same manner they share losses.

(b) Nonrecourse liabilities are "shared" by the partners, in general, in the same manner they share profits.

(3) A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability. [Reg. §1.752-1(a)(2)]

(4) Whether a partner bears an "economic risk of loss" is determined under Reg. §1.752-2.

(a) In general, the regulations seek to identify who will have the ultimate legal responsibility for paying the debt.

(b) General partners usually have economic risk of loss, while limited partners do not.

(c) Then, to determine how much to allocate to each general partner, the regulations assume all partnership property becomes worthless and the partnership disposes of its assets and liquidates.

- ❑ In simple situations, the results are predictable. For example, in an equal two-partner general partnership, each partner will be allocated an equal share of the debt.

- ❑ In other situations, however, the calculations of "economic risk of loss" can be quite complex and a careful review of the regulations is recommended.

(5) Be aware of these exceptions to the general rule (i.e., nonrecourse debt is usually shared by all partners—general and limited—according to their shares of partnership profits):

(a) the regulations require allocations of nonrecourse debt to correspond with allocation of "minimum gain" [Reg. §1.752-3(a)(1)];

(b) the regulations require allocations of nonrecourse debt to correspond with allocations of §704(c) precontribution gain on mortgaged property [Reg. §1.752-3(a)(2)];

(c) the regulations permit nonrecourse liabilities to be allocated in the same manner as other deductions attributable to the liabilities [Reg. §1.752-3(a)(3)];

(d) if the nonrecourse debt is a loan from a partner to the partnership, the liability is allocated to that partner ... unless the debt is "qualified nonrecourse financing" [Reg. §1.752-2(c)(1)];

(e) if a partner guarantees payment of a nonrecourse debt, the liability is allocated to that partner [Reg. §1.175-2(b)(1)]; and

(f) the nonrecourse debt will be allocated entirely to a partner who contributes to the partnership money or property used solely to secure the nonrecourse debt. [Reg. §1.752-2(e)]

(6) Note that with respect to LLC's and LLP's more liabilities may be nonrecourse because of the limited liability shield available through these entities (absent contractual provisions negating the limitation of liability).

e. **Receipt of Partnership Interests for Services**

i. Contributions of Services vs. Contributions of Property

(1) While §721 provides for nonrecognition of gain or loss when "property" is contributed to a partnership, the nonrecognition rule is not applicable to a situation wherein taxpayer receives a partnership interest in exchange for services. Both the partnership and the service partner may be required to report gain/income depending on the circumstances.

(2) Many of the cases that address this issue involve situations in which the contribution by the partner has some attributes of "property" and some attributes of a "service."

ii. Profit Interest vs. Capital Interest

(1) A distinction must be drawn between the receipt of a profits-only interest and the receipt of a capital interest in a partnership. A **profits-only interest** entitles the service partner only to a share of the future profits of the partnership; the service partner has no share in the assets of the partnership. By contrast, a service partner receiving a **capital interest** in a partnership has a claim on the net assets of the partnership.

(2) Generally, the receipt of a profits-only interest will not result in any current taxation. Instead, the service partner will simply report income as the partnership recognizes profit. But see, *Diamond v. Comm'r*, 492 F.2d 286 (7th Cir. 1974). (The Service in **Rev. Proc. 93-27**, 1993-24 I.R.B. 63 provides a broad safe harbor for profits-only interests. The ruling generally confirms that such interests will not result in current taxation to either the service partner or the partnership.)

iii. Timing and Basis of Income Inclusion by Partner and Deduction by Partnership

(1) A service partner receiving a capital interest must report the fair market value of that interest as ordinary income. **§83.** The timing of reporting by the service partner of the fair market value of a capital interest may be different if the interest is subject to a "substantial risk of forfeiture." In this situation, the income does not have to be reported until the lapse of the "substantial risk of forfeiture" unless the partner elects under §83(b) to report the value at the time of receipt. In situations in which the capital

interest has a low value at the time of receipt, the §83(b) election can be very advantageous.

(2) In turn, the service partner will have a basis in her partnership interest equal to the amount reported as income. **§1012.** In other words, it is just as though the partnership transferred a share of each partnership asset to the service partner and the service partner then contributed the assets back to the partnership.

(3) The partnership will be entitled to a §162 deduction (subject to §263) for the fair market value of the capital interest. Gain or loss, however, may also result to the partnership. To the extent that the partnership is treated as satisfying an obligation to the service partner by using appreciated or depreciated property, gain or loss recognition is required. Furthermore, in view of the fact that the service partner is treated as receiving and then recontributing a share of each asset of the partnership, the partnerships's basis in its assets will change to reflect that a portion of the asset has been recontri buted with a fair market value basis to the contributor.

f. **Receipt of Boot**

i. Recognition of Gain

(1) In many contexts in the tax code (e.g., §§351 and 1031), the receipt of property other than qualified property can generate tax consequences - usually gain recognition - to the transferor. This seems appropriate since the taxpayer essentially is exchanging one asset for another.

(2) Subchapter K, however, generally provides that amounts received by partners from a partnership are nontaxable. §731.

ii. Disguised Sales

(1) However, §707(a)(2)(B) prevents partners from disguising what is essentially a sale of property to a partnership (or another partner) or an exchange of property with a partnership (or another partner) as a contribution of property to the partnership followed by a non-taxable distribution from the partnership.

(2) For example, if a partner transfers appreciated property to a partnership and there is a direct or indirect transfer of cash or other property from the partnership to that

partner, the Service may recharacterize the transaction as a sale or exchange thus triggering gain to the partner.

(3) **Example:** X is a partner in the XYZ partnership. X's basis in his partnership interest is $10,000. X owns property worth $5,000 which has an adjusted basis of $1,000. If X were to sell the property for $5,000, X would recognize $4,000 of gain. If X were to contribute the property to a partnership and the partnership were later to distribute $5,000 in cash or other property to X, X could argue that no gain was recognized because of the operation of §721 and §731 (no gain on distribution unless the amount of money received exceeds partner's adjusted basis in partnership interest.) See **Reg. 1.721-1(a) and 1.731-1(c)(3).** But under §707(a)(2)(B), this transaction will likely be characterized as a sale with the result that X will be required to report $4,000 of gain.

g. **Organizational, Syndication and Start-up Expenditures**

i. **Organizational Expenditures**

(1) Organization expenditures are those incident to the creation of a partnership which are chargeable to a capital account and which would be amortizable over the life of the partnership.

(2) §709(b) provides that if the partnership has an ascertainable life, organizational expenditures may, at the election of the entity, be amortized over a 60 month period, beginning with the month during which the partnership commences business.

ii. **Syndication Expenditures**

(1) Syndication expenditures are those incurred to promote and sell partnership interests.

(2) These are not deductible. [I.R.C. §709(a); Reg. §1.709-2(b)]

iii. **Start-up Expenses**

(1) Start-up expenses are generally capital expenditures.

(2) §195, however, authorizes an election whereby such expenditures may be amortized over a period of 60 months or more (beginning with the month in which the active trade or business begins.).

h. **Significant State Law Issues Related to Formation**

i. LLC's

(1) The default provisions of the MLLCA dealing with transferability of interests, dissociation and dissolution, and management were drafted to ensure that a LLC formed under these default provisions would avoid at least two of the corporate characteristics, as required by the IRS to qualify for partnership tax treatment. The new "check the box" rules allow far greater flexibility in these matters. Accordingly, these default provisions should be critically reviewed and modified as appropriate.

(2) Most LLC statutes, including the MLLCA, have imported concepts from corporation as well as partnership law. Notable among the provisions imported from corporate law is the ability to include in the Articles of Organization or Operating Agreement a provision eliminating or limiting, under certain circumstances, the personal liability of a member or manager for monetary damages for breach of certain duties owed to the company or its members and to provide for the indemnification of members or managers under certain circumstances. MCA 35-8-404. Inclusion of such a provision in the Articles of Organization or Operating Agreement will "plug" one of the possible holes in the limited liability shield.

(3) Unlike most other LLC statutes, the MLLCA does permit the formation of a one-member LLC. Under the new "check the box" rules, one-member LLC's may be a viable organization choice for one-owner enterprises that formerly were limited to the corporate form. The LLC statutes in most other states do not permit the formation of a one-member LLC but those statutes will undoubtedly be amended to permit one-member LLC's.

(4) Most LLC statutes follow a corporate/limited partnership model with respect to the allocation of financial interests, providing for allocation on a pro rata basis by contributions or the value of members' interests. The MLLCA, however, follows the partnership model of equal sharing of profits and losses. MCA 35-8-503. This default provision, of course, is easily modified by a provision in the Articles of Organization or the Operating Agreement.

(5) In contrast to the quite specific default provisions under the MUPA with respect to the buy-out of a partner's interest in the event of a dissociation that does not cause a dissolution (see MCA 35-10-619), the default buy-out provisions of the MLLCA are dangerously vague. MCA 35-8-602 provides that a dissociated member is entitled to receive, "within a reasonable time after dissociation, the fair value of the member's interest in the [LLC] based on the member's right to share in distributions from the [LLC]." In addition to being an invitation to litigation because of its vagueness, this default provision does not seem to allow the application of a minority discount in valuing the dissociated member's interest. Accordingly, buy-out provisions should be drafted carefully and included in the Articles or Organization of Operating Agreement.

(6) One of the significant advantages of a LLC over a partnership, including a LLP, is the ability to impose significant restrictions on the authority of a member to act for and bind the entity. Another advantage is the ability to restrict or eliminate entirely the power of a member to dissociate. It is virtually impossible to achieve either of these objectives under the MUPA.

(7) The MLCCA imports from statutory close corporation statutes a narrow limitation on liability of members for failure to comply with formalities. The scope of this limitation on liability, however, is significantly narrower that the limitation under the Montana Close Corporation Act (MCCA). The MCCA provides that the "failure of a statutory close corporation to observe the usual corporate formalities or requirements relating to the exercise of its corporate powers or management of its business and affairs is not a ground for imposing personal liability on the shareholders for liabilities of the corporation." MCA 35-9-306. The MLLCA on the other hand merely limits liability for "failure of the [LLC] to keep or maintain [certain] records and information." MCA 35-8-405(4). Some commentators suggest including a broad limitation of liability provision in the Operating Agreement, similar in scope to the limitation of liability provision included in many statutory close corporation statutes. The efficacy of such a provision, particularly in light of the more narrow limitation in the MLLCA, is doubtful.

ii. LLP's

(1) The liability shield available to partners in a LLP is among the broadest shields provided under comparable statutes in any state. It is hard to imagine a situation in which it would not be appropriate to advise a client to register a general partnership as a limited liability partnership. The registration process is simple and inexpensive.

(2) The MUPA is silent on the vote required by the partners to convert a general partnership to a limited liability partnership. Many statutes provide that the registration must be approved by a "majority-in-interest" of the partners. The MUPA simply requires that the application for registration "be executed by one or more partners authorized to execute the application and registration." MCA 35-10-701(2).

(3) The availability of limited liability for partners should cause attorneys to rethink their longstanding presumptions about the allocation of rights and responsibilities among the partners.

iii. General Concerns

(1) There are three issues with respect to LLC's that must be carefully analyzed:

(a) whether the right of a member to withdraw should be circumscribed;

(b) how buy-out provisions should be structured; and

(c) whether membership interests (including the right to participate in management) should be more freely transferable than is the case under the default provisions.

(2) These same considerations should be addressed in the context of a LLP but the statutory provisions applicable to LLC's do not provide as much latitude with respect to these issues as the statutory provisions applicable to LLC's. Carefully crafted provisions in organizational documents are essential if disputes with respect to these critical issues are to be minimized.

4. TAXING THE OPERATION OF A PARTNERSHIP OR LLC

a. In General

i. Conduit Treatment

(1) Although §703 provides that a partnership computes its taxable income in the same manner as an individual, **a partnership (or LLC taxed as a partnership) is not a**

taxpaying entity.

(2) It is a conduit through which profits, losses, etc. generated at the partnership (or LLC) level are passed to the partners.

ii. Entity vs. Aggregate Theory

(1) There are entity aspects to the tax treatment of partnerships.

(2) However, the aggregate theory of partnerships dominates with respect to the reporting of income.

b. **Tax Year of the Partnership or LLC**

i. Tax Year Determined by Partners

(1) §706(b) requires that partnerships adopt the same taxable years as the partners owning a majority interest in the partnership profits and capital. If partners owning a majority of partnership profits and capital do not have the same taxable year, the partnership is required to adopt the same taxable year of all of its principal partners.

(2) If the partners owning a majority of partnership profits and capital do not have the same taxable year, and if all of the partnership's principal partners do not have the same taxable year, the partnership is required to adopt a calendar year.

ii. Tax Year Determined by Business Purpose

(1) If it can show a business purpose, the partnership may use a taxable year other than that described in the above rules. §706(b)(1)(C).

c. **Tax Rates**

i. Partner Level Tax

(1) Because the partnership is not a tax entity, the partners will report the income and expenses of the partnership pursuant to their allocable shares.

ii. Tax Rate

(1) Individual partners are subject to income tax rates pursuant to a progressive schedule with the highest rate being 39.6%.

d. **Fringe Benefits**

i. Classification of Guaranteed Payments

(1) A partner who receives a guaranteed payment is not considered as receiving the payment as an employee for purposes of the various employee fringe benefit provisions of the Internal Revenue Code.

(2) Reg. Sec. 1.707-1(c) specifically provides: "... Guaranteed payments are regarded as a partner's distributive share of ordinary income.

ii. Effect of Classification on Fringe Benefits

(1) Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of a personal injuries or sickness is not entitled to exclude such payments from his gross income under §105(d)."

(2) *See,* however, Armstrong v. Phinney, 394 F.2d 661 (5th Cir. 1968) indicating that a partner who received a guaranteed payment may be treated as an employee for purposes of the meals and lodging exclusion of §119.

e. **Accounting Methods**

i. Methods Allowed

(1) Generally, a partnership may select a method of accounting so long as it clearly reflects income.

(2) The election is made at the partnership level. §703(b) and Reg. §1.703-1(b).

ii. Restrictions

(1) §448, however, provides that partnerships with a C corporation as a partner

may not use the cash receipts and disbursements method of accounting.

(2) Exceptions are made for farming businesses or businesses whose average annual gross receipts do not exceed $5,000,000 during a specified period.

f. **The Subchapter K "Pass-thru" Structure**

i. Conduit vs. Entity Theory

(1) The partnership is a conduit and accordingly each partner is taxed on his distributive share of partnership income and loss. §702(a).

(2) The computation and characterization of income and loss, however, occurs at the partnership level. §§702(b) and 703.

ii. Separately Stated Items

(1) §702(a) requires that the partner's distributive share of certain items of income and loss be separately stated because of their potentially varying tax consequences in each partner's tax computation.

(2) Thus, for example, a partner's share of long term capital gain or loss must be separately stated. See Reg. §1.702-1(a).

(3) Amounts of income and expense allocated to partners will be reflected in their capital accounts and also in their outside basis (i.e., the basis in their partnership interests.)

g. **Determining a Partner's Distributive Share**

i. The Partnership Agreement

(1) The determination of a partner's distributive share is made with reference to the partnership agreement.

(2) Generally, if, for example, there are two equal partners in a general partnership, the partnership agreement will provide either directly or by implication that the various items of income and expense of the partnership are to be allocated on a 50/50 basis.

(3) The statutory default rule for sharing of profits and losses under the MLLCA with respect to LLC's and the MUPA with respect to partnerships is equal sharing of profits and losses. The MLLCA departs in this regard from most other LLC statutes, which are either silent on the question of sharing of profits and losses, or provide for pro rata rather than per capita sharing.

ii. Special Allocations

(1) A partnership agreement may, however, provide for the allocation of tax items in a manner that does not reflect the division of ownership. Thus, in the two person partnership mentioned, the partnership agreement could provide that one of the partners was entitled to claim all of the depreciation with respect to certain property.

(2) So long as such allocations have "substantial economic effect", §704(b) provides that the allocation will be respected.

(3) The regulations, as discussed below, provide a comprehensive guide for determining whether allocations have an "economic effect" and whether that effect is "substantial."

(4) If special allocations made by the partnership agreement do not satisfy the "substantial economic effect" standard, then the distributive share of a partner will "be determined in accordance with the partner's interest in the partnership."

h. **Adjustments to Outside Basis as a Result of Operations of the Partnership**

i. Adjustments to basis to reflect a partner's distributive share of items of income and expense

(1) §705 provides that a partner's basis shall be increased by the partner's distributive share for the taxable year and prior taxable years of the taxable income of the partnership and income of the partnership exempt from tax.

(2) A partner's basis shall be decreased by the partner's distributive share for the taxable year and prior taxable years of losses of the partnership.

(3) **Example A:** Assume the AB general partnership. A and B are equal partners. Assume that A and B, upon formation of the partnership in Year 1, each contribute

$50,000 to the partnership and that the partnership in the same year uses the $100,000 in contributions to make a down payment on a $500,000 apartment building. The partnership borrowed on a recourse basis the other $400,000. Assume that as a result of its Year 1 operations, the partnership had the following income and expenses:

(a) rental income	$ 25,000
(b) depreciation	(17,500)
(c) maintenance	(2,500)
(d) interest expense	(30,000)
Tax loss	**$ (25,000)**

(a) A and B, as indicated previously, would have had a $50,000 outside basis each to reflect their contributions to the partnership. Upon the borrowing of the $400,000, the outside basis of both A and B would have been increased (just as though they made an additional contribution) by 200,000. Thus, A and B each have a $250,000 basis in their respective partnership interests.

(b) As a result of the pass-thru regime of Subchapter K, A and B each were entitled to report one-half of the $25,000 of loss reported by the AB partnership (Form 1065). A and B did not receive any distributions from the partnership during the year. It is appropriate therefore to decrease their outside bases to reflect the deduction which each was entitled to report. Thus, A and B will each have a $237,500 adjusted basis in their partnership interest at the beginning of the second year of the partnership.

(4) **Example B:** Assume the facts of Example A and in addition assume that in Year 2, the partnership had the following items of income and expense:

Rental income	$ 60,000
Depreciation	(17,500)
Maintenance	(2,500)
Interest expense	(30,000)
Taxable income	**$ 10,000**

(a) Consistent with §705(a), A and B will increase their bases to reflect the inclusion in income by each of $5,000 or one-half of the taxable income of the partnership.

(b) Again, we will assume that A and B received no distributions from the partnership. Their adjusted basis will now be $242,500 each.

ii. Adjustments to reflect payment of debt

(1) As previously noted, to the extent that a partnership incurs liabilities, the partners' outside bases are increased to reflect the obligation to repay.

(2) The partners are treated as making additional contributions to the partnership. The flip side of this treatment is reflected when a partnership repays an obligation. To the extent that an individual partner's share of liabilities is reduced by such repayment, the partner is treated as having received a distribution of money from the partnership. A partner's outside basis is reduced by the amount of money distributed to the partner. §733.

(3) **Example C:** Assume the same facts as in Example B above. If the partnership had repaid $40,000 of the debt during the year, A and B would each be treated as having received a cash distribution in the amount of $20,000. This in turn would have resulted in a reduction in their outside bases of $20,000 each. Thus, A and B would each have had an outside basis of $222,500.

i. **Maintenance of Capital Accounts**

i. Relationship of Capital Account to Outside Basis

(1) In addition to keeping track of the changing outside bases of partners, it is also necessary to maintain a capital account for each partner. The capital accounts reflect the partner's economic deal. As is demonstrated below, the partner's capital account balance will not necessarily match the partner's outside basis.

(2) Regulation §1.704-1(b)(2)(iv)(b) spells out basic rules for the maintenance of capital accounts:

....[E]ach partner's capital account is increased by (1) the amount of money

contributed by him to the partnership, (2) the fair market value of property contributed by him to the partnership (net of liabilities secured by such contributed property that the partnership is considered to assume or take subject to under section 752), and (3) allocations to him of partnership income and gain (or items thereof)....; and decreased by (4) the amount of money distributed to him by the partnership, (5) the fair market value of property distributed to him by the partnership (net of liabilities secured by such distributed property that such partner is considered to assume or take subject to under section 752), (6) allocations to him of [certain expenditures for which the partnership cannot take a deduction and which are not chargeable to a capital account], and (7) allocations of partnership loss and deductions (or items thereof)...

(3) **Example D:** Assume the facts of Examples A and B above. The capital accounts of A and B would change as follows:

	A	B
Beginning Capital Account Year 1	$ 50,000	$ 50,000
Less: Partnership Loss Year 1	(12,500)	(12,500)
Ending Capital Acct. Year 1	37,500	37,500
Plus Partnership Income Year 2	5,000	5,000
Ending Capital Account Year 2	$ 42,500	$ 42,500

Essentially, in this simple example, if the partnership liquidated at the end of Year 2, its balance sheet would be as follows:

(Stated at Book Value)

Assets		**Liability**	$400,000
Cash	$ 20,000	**Capital Accounts**	
Apartment	465,000	A	42,500
		B	42,500
TOTAL	$485,000		$485,000

Assuming that the apartment had a value exactly equal to its book value, the partnership

would sell the apartment building and use $400,000 of the proceeds to repay the liability encumbering the building. It would have $85,000 in cash left and that would be distributed to A and B pursuant to their capital accounts. Note that the capital accounts total exactly $85,000. This result is precisely what we would expect considering that A and B are equal partners.

(4) Drafting Pointer: As a practical matter, many partnerships maintain separate capital and income accounts, with different restrictions imposed on withdrawals from each account. The intentions of the partners with respect to withdrawals from capital and income accounts (if applicable) should be clearly set forth in the partnership agreement. The MLLCA, like most LLC statutes, provides members with no right to receive distributions of any kind prior to dissociation. Accordingly, it is essential the Articles of Organization or the Operating Agreement describe in detail the circumstances under which a member has a right to a distribution.

j. **Special Allocations - The "Economic Effect" Requirement**

i. Applies to Special Allocations

(1) As previously noted, in the AB partnership described in the examples above, the partners would be free to enter into an agreement whereby they allocated items of income and expense in a manner other than the 50/50 arrangement assumed above.

(2) For those allocations to be respected, however, the allocations would have to satisfy the "substantial economic effect" test of §704(b).

(3) This test has two prongs: The allocation must have "economic effect" and the economic effect must be "substantial." Both requirements are briefly explained below.

ii. "Economic Effect" Test

(1) In general, according to **Reg. §1.704-1(b)(ii)(b)**, an allocation has "economic effect" under §704(b) only:

(a) If it is reflected as an appropriate increase or decrease in a partner's capital account which must be maintained in accordance with the regulations. (**The capital account maintenance test);**

(b) If, on liquidation, each partner is entitled to a distribution of the positive amount shown in his capital account adjusted for the taxable year in which the liquidation occurs. **(The liquidating distributions test); and**

(c) If any partner with a "deficit balance in his capital account following the liquidation of his interest in the partnership... is unconditionally obligated to restore the amount of such deficit balance to the partnership, which amount, shall upon liquidation of the partnership be paid to the creditors of the partnership or distributed to other partners in accordance with their positive capital account balances." Reg. §1.704-1(b)(2)(ii)(b)(3). (**The deficit restoration test.)**

(2) Thus, a tax allocation of a dollar of income, gain, deduction, or loss to a partner is valid only if it increases or decreases the partner's potential entitlement on liquidation. In effect, the partner to whom an allocation is made must receive the economic benefit (e.g., receive an increase upon liquidation if partner has been allocated more income) or bear the economic burden (e.g., suffer any economic loss associated with depreciation if the partner is allocated the depreciation deductions.)

(3) **In other words, economic effect means that the allocations reflect the actual economic arrangement between and among the partners.**

iii. "Substantiality" Test

(1) The "substantiality test" is met only if "there is a reasonable possibility that the allocation... will affect substantially the dollar amounts to be received from the partnership, independent of tax consequences." **Reg. §1.704-1(b)(2)(iii).** The regulations provide special rules with respect to so-called "shifting" or "transitory" allocations.

(2) The following example demonstrates the application of the "substantial economic effect" test.

(a) **Example E**: Assume the same facts as in Examples A and B except that the parties agree that B will be entitled to deduct all of the depreciation associated with the apartment complex. For this arrangement to be respected under §704(b), the partnership agreement would have to meet the "economic effect" test (i.e., satisfy the three requirements met above or the

alternative tests provided by the regulations). Assume that the partnership agreement satisfies these requirements. Consider the respective capital accounts of A and B at the end of Year 2:

Beginning Capital Account Year 1	$ 50,000	$ 50,000
Less: Partnership Loss Year 1*	(3,750)	(3,750)
Less: Depreciation Year 1	(0)	(17,500)
Ending Capital Account Year 1	46,250	28,750
Plus: Partnership Income Year 2**	13,750	13,750
Less: Depreciation Year 2	(0)	(17,500)
Ending Capital Account Year 2	$ 60,000	$ 25,000

* Bottom line partnership loss for Year 1 would be determined without taking into account the specially allocated depreciation deduction. Thus, there would be a $7,500 loss instead of a $25,000 loss.

** Bottom line partnership income for Year 2 would be determined without taking into account the specially allocated depreciation deduction. Thus, there would be $27,500 income instead of $10,000.

(b) Assume that under the facts of Example D, the partnership were to liquidate at the end of Year 2. Under the requirements for "economic effect", it would be necessary to distribute to partner A $60,000 of the $85,000 in cash that would be available and the remainder, $25,000, would be allocated to partner B. Under these circumstances, there is no question regarding substantiality since partner B clearly has received less dollars than he would have normally been entitled to receive as a 50/50 partner. Indeed, B has borne the burden of the decreasing value of the apartment building. **The special allocation thus satisfies the "substantial economic effect" test of §704(b).**

(c) One assumes that B might not be particularly pleased with the result in Example E. The parties in this situation would likely include a gain-

charge back provision which would come into play were the apartment building to increase in value during the two year period. Under this provision, D would be required to report gain up to the amount of the depreciation deductions which D claimed. The balance of the gain, if any, would be divided equally between A and B. Thus, if during the two year period, the apartment building did not decrease in value but retained a value of $500,000 at the time of the liquidation, the partnership would recognize $35,000 of gain on the sale of the building. Under a gain-charge back provision, all of this gain would be allocated to partner B. This would in turn increase B's outside basis as well as increase B's capital account. The result would be that B's capital account would now equal A's (i.e., both would have a capital account of 60,000.) The partnership in this scenario would have $120,000 of cash after paying the liability, and this cash would be divided pursuant to the capital accounts. A and B would thus each receive $60,000.

(d) **Planning Pointer**: While the availability of special allocations provides a flexibility that doesn't exist under Subchapter S or Subchapter C, it also creates drafting problems resulting in ridiculously long partnership agreements. One suspects that most clients are not interested in making special allocations but rather will insist that those who provide the money get the benefits and bear their appropriate share of burdens. As a result, except in the case of more sophisticated operations, it is not suggested that special allocations be used.

k. **Limitation on the Pass-through of Losses**

i. Basis Limitation [§704(d)]

(1) As discussed *infra***,** the outside bases of partners are significant in determining the tax consequences of distributions to partners and sales and exchanges of partnerships interests. Perhaps, more importantly, a partner's outside basis limits the extent to which a partner may deduct his share of partnership losses. **§704(d).**

(2) Given this limitation, the computation of the outside basis of a partner is extremely important. As noted previously, a partner's share of partnership liabilities is reflected in the partners' outside bases. This rule enables a partner to deduct more

losses.

(3) Any excess of the partner's share of loss over the partner's outside basis is carried forward until the partner acquires additional outside basis, e.g., by means of additional contributions or his distributive share of partnership income. There are, of course, other provisions which limit the deductibility of losses by partners, e.g., §465 (the at-risk rules) and §469 (the passive activity loss rules).

ii. At Risk Limitation [§465]

(1) The "at risk" rules prevent taxpayers from deducting losses in excess of the taxpayer's actual economic investment in the activity. The "at-risk" rules apply at the partner level.

(2) With respect to partnership debt, a partner is deemed "at risk" for purposes of §465 to the extent the partner is personally liable for repayment of a partnership liability and is not protected against loss.

(3) The 1986 Tax Reform Act extended the "at risk" rules to the activity of holding real property. An important exception, however, exists for "qualified nonrecourse financing." This exception may prove particularly beneficial to a partner since the partner may include a portion of the "qualified nonrecourse financing" in his basis, thus increasing opportunity to deduct losses under §704(b).

iii. Passive Loss Limitation [§469]

(1) The 1986 Tax Reform Act added §469 to prevent taxpayers from offsetting losses from passive activities against either portfolio income (stocks and bonds) or income from activities that are nonpassive.

(2) Losses disallowed by §469 can be carried forward indefinitely.

(3) Furthermore, suspended losses from passive activities are allowed in full (subject to the §1211 rules) upon disposition by the taxpayer of his entire interest in the activity.

(4) Passive activities include (i) trade or business or income producing activities in which the taxpayer does not materially participate; (ii) rental of tangible property; and

(iii) any other activity which the Service deems passive.

(5) A taxpayer having a limited partner's interest in an activity will be considered involved in a passive activity.

l. **Self-employment Tax**

i. Employment Tax Treatment of Members

(1) LLC's are often structured to be taxed as partnerships. Some practitioners consider this a disadvantage, when contrasted to S corporations, because partners are subject to employment tax on all their net earnings,[2] whereas shareholders of S corporations may take part of their income as dividends, which are not subject to employment tax. There now may be a means to achieve this same tax treatment for members of LLC's.

(2) In a proposed regulation [Prop. Reg. §1.1402(a)-18], the IRS states that a member of a LLC will not be subject to employment tax if (1) the member is not a manager, and (2) the LLC could have been formed as a limited partnership rather than as a LLC in the same jurisdiction and the member could have qualified as a limited partner in that limited partnership under applicable law. If a member of a LLC is treated as a limited partner under this proposed regulation, then the member's distributive share of income or loss from the LLC will not be included in net earnings from self-employment, except for guaranteed payments for services. [*See* §707 for the treatment of guaranteed payments.]

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[2] Section 1402(a) defines net earnings from self-employment generally as the gross income derived by an individual from any trade or business carried on by such individual, less the allowable deductions, plus the individual's distributive share, whether or not distributed, of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which the individual is a member, unless a specific exception applies.

ii. The Requirements for Exemption From Self-Employment Tax

(1) *The Member is Not a Manager*

(a) A manager is defined as a person who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the LLC was formed.

(b) Under the proposed regulation, if there are no designated or elected managers of the LLC who have continuing exclusive authority to manage the LLC, then all of the members will be treated as managers even if some members have greater management authority than others under the applicable LLC statute and the LLC's controlling documents. [Prop. Reg. §1.1402(a)-18(c)(3)]

(2) *The Entity Could Have Been Formed as a Limited Partnership Rather than as a LLC in the Same Jurisdiction and the Member Could Have Qualified as a Limited Partner in that Limited Partnership under Applicable Law*

(a) Some states prohibit the conduct of certain activities through partnerships generally or limited partnerships in particular. So, one purpose of this requirement is to make it clear that a business operating as a LLC does not obtain a result for self-employment tax purposes that it would not be able to achieve by operating as a limited partnership.

(b) Second, under applicable law, a limited partner may become liable for the obligations of a limited partnership as a general partner when the limited partner participates in the management or control of the business. Thus, another purpose of this requirement is to ensure that both a member of a LLC and a limited partner in a limited partnership who participate in the management or control of the entity to the same extent are treated in the same manner for self-employment tax purposes.

(3) Proposed Effective Date

(a) This regulation is proposed to be effective for the member's first taxable year beginning on or after the date on which this regulation is published as

a final regulation in the Federal Register.

iii. A Caution

(a) For purposes of these proposed regulations, the LLC must be classified as a partnership for Federal tax purposes. [Prop. Reg. §1.1402(a)-18(c)]

(b) Consequently, members of LLC's that are taxed as corporations will not qualify for this exemption from self-employment tax.

5. OPERATING DISTRIBUTIONS

a. Overview

i. Distinguishing Operating From Liquidating Distributions

(1) Operating (or "non-liquidating") distributions must be distinguished from liquidating (or "terminating") distributions.

(2) Distributions in liquidation of a partner's interest are what we refer to here as "liquidating distributions," and "operating distributions" are all other distributions to the partner.

(3) 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. [§761(d)]

(4) Most LLC statutes, including the MLLCA, imported corporate types of restrictions on distributions. Specifically, the MLLCA states that a distribution may not be made if, after the distribution the LLC would be unable to pays its debts as they become due or if the LLC fails the traditional insolvency test (i.e., liabilities exceed assets). M.C.A. 35-8-604. A member or manager who votes for or assents to a distribution in violation of these restrictions is personally liable to the LLC, but not to other persons, for the amount of the distribution in excess of that which was permitted under these restrictions. M.C.A. 35-8-605. This approach is different that the approach of most corporation statutes which limits liability to directors who approved the unlawful distribution.

ii. Why It Matters

(1) Loss is never recognized by a partner in an operating distribution, but may be recognized in a liquidating distribution. [§731(a)(2)]

(2) Different rules apply to the basis the partner takes in the distributed assets, depending on whether the distribution is an operating or liquidating distribution. [§732(a) and (b)]

(3) Liquidating distributions come within §736, which provides a great deal of flexibility to the partners in structuring tax consequences.

iii. Gain / Loss

(1) A distribution from a partnership will not trigger gain to the partner unless money distributed exceeds the partner's basis in his partnership interest (which is referred to here as the partner's ***"outside basis"***).

(a) Indeed, this is one of the principal advantages of partnerships over other forms of business organizations.

(b) A distribution of property by a corporation to a shareholder is usually taxable, either as compensation or as a dividend (it may also be repayment of a loan, in which event only the interest portion would be taxable income to the shareholder).

(2) Even when the partner is required to recognize gain or loss, the partnership is not.

(a) **§731(b):** *No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.*

(3) Other Provisions May Override

(a) The nonrecognition provisions of §731 are overridden by other Code provisions in applicable instances.

(b) **§731(d):** *This section shall not apply to the extent otherwise provided by*

section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest), section 751 (relating to unrealized receivables and inventory items), and section 737 (relating to recognition of pre-contribution gain in case of certain distributions).

iv. Basis

(1) The partner will generally take a transferred basis in the distributed assets. [§732(a)(1)]

(a) But if the basis of the property distributed exceeds the basis of the partner's partnership interest, the transferred basis will be limited to the amount of the basis in the partnership interest. [§732(a)(2)]

(b) The partner then reduces the partnership interest basis by the basis taken in the distributed property. [§733]

(2) The rules differ for liquidating distributions. *See* 6.e.i

v. Capital Accounts

(1) If a partnership distributes property with a fair market value not equal to book value, other adjustments may be necessary.

(2) Partnerships maintaining books in accordance with the §704(b) regulations (requiring that special allocations have "substantial economic effect") will have to adjust capital accounts for deemed gain or loss on the distributed property.

(3) The partnership may, in the alternative, restate the partnership assets and partner capital accounts at current fair market value. *See* Reg. §1.704-1(b)(2)(iv)(r).

b. **Consequences to the Partner**

i. Gain / Loss [§731]

(1) **In General**: A partner will recognize neither gain nor loss on a distribution. [§731]

(2) **Distributions of Money**

(a) A distribution of money will trigger gain recognition only to the extent it exceeds the basis of the partner's outside basis. [§731(a)(1)] Until then, it is tax-free.

(b) "Money" may consist of more than just cash. Relief from liabilities is treated as a distribution of money under §752(b). Consequently, gain may have to be recognized even though the partner has not received cash.

(3) **Distributions of Other Property:** A distribution of property other than money will not trigger gain, even if it exceeds the basis of the partner's interest, but there will be appropriate adjustments to basis to preserve subsequent recognition of gain.

(4) **Loss:** An operating distribution will not trigger loss recognition by the partner, even if the distribution is entirely money. (The result would be different if this were a liquidating distribution. *See* 6.a.ii.) [§731(a)(2)]

(5) **Distributions of Encumbered Property (Rev. Rul. 79-205)**

(a) Remember, a distribution of money in excess of a partner's outside basis will result in gain under §731. When a partnership distributes property subject to liability, the partners' shares of the liability will be adjusted under §752. Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, is considered as a distribution of money to the partner by the partnership. [§752(b)] For this purpose, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property. [§752(c)]

(b) As we have seen, the distribution of "money" can trigger gain under §731. If the partner does not receive "credit" for the liabilities assumed in the distribution at the same time as the partner is deemed to have received a distribution of money from the relief of liability, it could trigger gain recognition under §731, even though the partner ultimately did not end up with a distribution in excess of basis. The question is whether the deemed

"distribution" of money from the partner's relief from partnership liabilities precedes the assumption of individual liabilities, or whether they are treated simultaneously.

(c) In Rev. Rul. 79-205, the IRS answered that increases in two partners' individual liabilities and decreases in their shares of partnership liabilities resulting from a transaction involving non-liquidating distributions to each partner of partnership properties subject to liabilities will be treated as occurring simultaneously for purposes of determining the amount of money considered distributed or contributed. The computation shows each partner's recognized gain or loss (if any), basis in the distributed property, and the new adjusted basis in the partnership interest.

		Property Distributed	
Partner	Outside Basis	Inside Basis	Liabilities
A	1,000	2,000	1,600
B	1,500	3,200	2,800

(d) Here, there is a decrease in each partner's share of partnership liabilities in the amount of $2,200 (i.e., ($1,600 + $2,800)/2) — The property was distributed by the partnership, so the partners are deemed to be relieved of their shares of the liability. [§752 (c)]

(e) But the distributee partner also is treated as being responsible for the entire amount of the liability to which the property is subject, so in A's case, there was a net decrease in liabilities of $600, his $2,200 reduction in partnership liabilities, followed by his $1,600 assumption of liabilities for the distributed property. On the other hand, B was relieved of $2,200 of partnership liabilities, but assumed $2,800 of individual liabilities, resulting in a $600 increase in liabilities for her.

(f) The results are summarized as follows:

Item	A	B	How Computed
Net Cash Distribution (Contribution)	$600	($600)	Decrease in liabilities minus assumption of liabilities
Basis in Distributed Property	$400	$2,100	Lesser of (i) inside basis or (ii) outside basis minus cash distributed
Basis in Partnership Interest	$0	$0	Initial outside basis minus cash distribution minus basis of property distributed

(6) **Exception for Unrealized Receivables and Substantially Appreciated Inventory.**

(a) When a partnership distributes unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in other partnership property (including money), the distribution will be treated as a sale or exchange of property under the provisions of §751(b). [Reg. §1.732-1(e)] This generally results in recognition of ordinary income to the distributee partner.

- ❑ "Unrealized receivables" are defined in §751(c).
- ❑ "Substantially appreciated inventory" is defined in §751(d).
- ❑ These rules apply to the converse situation as well, i.e., when a partnership distributes partnership property (including money) other than unrealized receivables or substantially appreciated inventory items in exchange for any part of a partner's interest in the partnership's unrealized receivables or substantially appreciated inventory items.

(b) §732 (including subsection(d)) then applies to determine the partner's basis of the property which he is treated as having sold to or exchanged with the partnership (as constituted after the distribution). [Reg. §1.732-

1(e)]

(c) The partner is considered as having received such property in a current distribution and, immediately thereafter, as having sold or exchanged it. See §751(b) and paragraph (b) of §1.751-1. However, §732 does not apply in determining the basis of that part of property actually distributed to a partner which is treated as received by him in a sale or exchange under §751(b). Consequently, the basis of such property shall be its cost to the partner. [Reg. §1.732-1(e)]

ii. Basis [§§732 & 733]

(1) **Basis of Partner's Interest [§733]**

(a) The adjusted basis of the partner's interest in the partnership (i.e., the outside basis) is reduced (but not below zero) by—

- ❑ the amount of any money distributed to such partner, and
- ❑ the amount of the basis to such partner of distributed property other than money, as determined under §732.

(b) This section applies only to operating distributions, not liquidating distributions.

(c) For an example of the effect of a distribution in excess of outside basis, see 5.b.ii.(2)(f) below.

(2) **Basis of the Distributed Property [§732]**

(a) **§732(b):** *The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.*

(b) **In General.** The basis of property (other than money) received by a partner in a distribution from a partnership is its adjusted basis to the

partnership immediately before the distribution. [Reg. §1.732-1(a)]

(c) **Exception:** The basis of the property to the partner can not exceed the partner's outside basis, reduced by the amount of any money distributed to him in the same transaction. [Reg. §1.732-1(a)]

(d) **Allocation of Basis Among Properties Distributed to a Partner.** If the partner's outside basis, after having been reduced by the amount of any money received as part of the distribution, is less than the partnership's basis in the other property distributed, the partner must allocate the basis of his partnership interest to the property distributed, as follows:

❑ First, allocate basis to distributed unrealized accounts receivable and inventory, but not in excess of their "inside basis" (i.e., the partnership's adjusted basis in them).

✔ Note: Unrealized receivables usually have a zero basis.

✔ If the partner's outside basis is less than the partnership's basis in the distributed receivables and inventory, then allocate the partner's basis to the receivables and inventory in proportion to the bases they have in the hands of the partnership.

✔ Exception: The partner can take a greater-than-inside basis in the receivables in two instances:

a) When the distribution is treated as a sale or exchange under §751(b), or

b) When the distributee partner has a special basis adjustment for the distributed property under §732(d) or §743(b).

❑ Any remaining outside basis is allocated to the other distributed properties, in proportion to the bases of such other properties in the hands of the partnership before distribution. [Reg. §1.732-1(c)(1)]

❑ **Remember:** If the partner's outside basis (after it is reduced for any money distributed) exceeds the inside basis of the assets (other than

money) distributed, no allocation is necessary. [§732(c)]

(e) **Example of a Distribution Not In Excess of Outside Basis:** Partner A, with an adjusted basis of $15,000 for his partnership interest, receives in a current distribution property having an adjusted basis of $10,000 to the partnership immediately before distribution, and $2,000 cash. The basis of the property in A's hands will be $10,000. Under §§733 and 705, the basis of A's partnership interest will be reduced by the distribution to $3,000 ($15,000 less $2,000 cash, less $10,000, the basis of the distributed property to A). [Reg. §1.732-1(a), Example (1)]

(f) **Example of Limitation for a Distribution In Excess of Outside Basis:** Partner R has an adjusted basis of $10,000 for his partnership interest. He receives a current distribution of $4,000 cash and property with an adjusted basis to the partnership of $8,000. The basis of the distributed property to partner R is limited to $6,000 ($10,000, the adjusted basis of his interest, reduced by $4,000, the cash distributed). [Reg. §1.732-1(a), Example (2)]

(g) **Planning Pointer:** Notice how the order of distributions may make a difference. If in separate, independent distributions, the property had been distributed first and the money second, the partner would have a recognized gain of $2,000 on the cash distribution. Obviously it is preferable for the distributions, as in the preceding example, to be simultaneous or, if they are separate, for cash to be distributed first.

(h) **Example of How to Apportion Basis within a Category of Distributed Property:** Partner A, whose partnership interest in partnership ABC has an adjusted basis of $15,000, receives as a distribution inventory items having a basis to the partnership of $6,000. In addition, he receives cash of $5,000, and two parcels of real property with adjusted bases to the partnership of $6,000 and $2,000, respectively. Basis in the amount of $10,000 is allocated $6,000 to inventory items, and $3,000 and $1,000, respectively, to the two parcels of real property. [Reg. §1.732-1(c)(1), Example] The results follow:

A's original basis in interest	$ 15,000
Less cash distributed	(5,000)
Remaining basis allocable to property distributed	$ 10,000
Less basis to A of inventory (use partnership basis)	(6,000)
Remaining basis allocable to other property distributed	$ 4,000
Less basis to A of Parcel 1: ($4,000 x ($6,000/$8,000))	$ 3,000
Less basis to A of Parcel 2: ($4,000 x ($2,000/$8,000))	1,000
Basis allocated to other property distributed	$ 4,000
Remaining basis of A's partnership interest	$ 0

- ❑ **Note:** The results would be the same whether this were an operating or a liquidating distribution. [Reg. §1.732-1(c)(1)]

(i) **Example Showing Allocation of Basis When Basis in Unrealized Receivables and Inventory Exceed Partner's Outside Basis:** Partner C, whose interest in partnership ABC has an adjusted basis to him of $9,000, receives a distribution of cash of $6,000, inventory items having an adjusted basis to the partnership of $6,000, and real property having a basis to the partnership of $4,000. The cash payment reduces C's basis to $3,000, which is allocated entirely to inventory items. The real property has a zero basis in C's hands. The partnership bases not carried over to C for the distributed properties are lost unless an election under §754 is in effect requiring the partnership to adjust the bases of remaining partnership properties under §734(b). [Reg. §1.732-1(c)(2), Example (1)]

- ❑ Note that this example applies either to an operating distribution in which the partner's outside basis is less than the inside basis of the property distributed, or to a liquidating distribution. [Reg. §1.732-1(c)(1)]

iii. Special Partnership Basis to Transferee Under §732(d)

(1) **When the Election is Available**

(a) A partner who receives either an operating or a liquidating distribution of partnership property may take a special basis in the distributed property if

the partner had acquired the interest by "transfer."

(b) A "transfer" of a partnership interest occurs upon a sale or exchange of an interest or upon the death of a partner.

(c) §732(d) provides a special rule for the determination of the basis of property distributed to a transferee partner who acquired any part of his partnership interest in a transfer with respect to which the election under §754 (relating to the optional adjustment to basis of partnership property) was not in effect. [Reg. §1.732-1(d)(1)(i)]

(d) If a §754 election is in effect, §743(b) and paragraph (b) of §1.743-1 and §1.732-2 would govern. [Reg. §1.732-1(d)(1)(ii)]

(e) Otherwise, if a transferee partner receives a distribution of property from the partnership within 2 years after he acquired his interest in the partnership by a transfer, he may elect to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in §743(b) were in effect. [Reg. §1.732-1(d)(1)(iii)]

- ❑ This applies only to distributions of property other than money.

- ❑ This may apply to partial interests as well as entire interests acquired within the two year period.

- ❑ If the partnership must has a §754 election in effect at the time the partner acquires the interest, §732(d) does not apply.

(f) Note that this is an election made by the partner, not by the partnership. Consequently, this contrasts to a §754 election, which must be made by the partnership.

(2) **How the Election is Made**

(a) *Time of Election:* A transferee partner who wishes to elect under §732(d) makes the election with his tax return:

- ❑ For the year of the distribution, if the distribution includes any property

subject to the allowance for depreciation, depletion, or amortization, or

- ❑ For any taxable year no later than the first taxable year in which the basis of any of the distributed property is pertinent in determining his income tax, if the distribution does not include any such property subject to the allowance for depreciation, depletion or amortization. [Reg. §1.732-1(d)(2)]

(b) *Method of Election:* A partner electing §732(d) shall submit with the return in which the election is made a schedule setting forth the following:

- ❑ That under §732(d) he elects to adjust the basis of property received in a distribution; and

- ❑ The computation of the special basis adjustment for the property distributed and the properties to which the adjustment has been allocated. For rules of allocation, §755 controls. [Reg. §1.732-1(d)(3)]

(3) **When §732(d) is Mandatory**

(a) Although §732(d) is usually elective, it may also be mandatory. A partner who acquired any part of his partnership interest in a transfer to which the election provided in §754 was not in effect, is <u>required</u> to apply the special basis rule contained in §732(d) to a distribution to him, whether or not made within 2 years after the transfer, if at the time of his acquisition of the transferred interest the following conditions are present:

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

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

- ❑ A special basis adjustment under §743(b) would change the basis to the transferee partner of the property actually distributed. [Reg. §1.732-1(d)(4)]

iv. Subsequent Sales of Distributed Property [§735]

(1) **§735(a): "Taint"**

(a) *Unrealized receivables:* If the distributee partner receives unrealized receivables from the partnership, the partner will have ordinary income whenever he sells or collects the receivables.

- For purposes of §735, the §751(c) definition of "unrealized receivables" is used.

- **§751(c):** *[T]he term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or (2) services rendered, or to be rendered. ...*

- This definition of "unrealized receivables" is broader than one might expect. In Ledoux v. Comm'r, (USTC 1981), John Ledoux owned a 25--percent interest in a partnership which had a multi-year written agreement to operate and manage a dog racing track. As consideration for the agreement, the partnership was to pay to the owner of the track the first $200,000 of annual net profit from operations. The arrangement proved to be quite successful and the partnership realized substantial income from the venture. Ledoux then arranged to sell his interest in the partnership for a price computed by capitalizing the partnership's most recent annual earnings. The sales agreement did not allocate the price among the assets, and stated that no portion of the sales price was attributable to goodwill. §751 provides that upon the sale of an interest in a partnership, the amount attributable to unrealized receivables is characterized as ordinary income. Unrealized receivables are defined to include any right to payment for services rendered or to be rendered. Ledoux reported the proceeds as capital gains, but the IRS asserted that the agreement was in the nature of a management employment contract, and that Ledoux sold the right to receive income in the future for yet-to-be rendered personal services. The IRS argued that this was evidenced by the fact that the price was deter-

mined by capitalizing annual income. The Tax Court ruled in favor of the IRS, because the agreement gave the partnership the right to operate a business for a period of years and to earn ordinary income in return for payments to the owner of the track.

(b) *Inventory:* If the distributee partner receives inventory items from the partnership, the partner will have ordinary income if he sells them within 5 years of distribution.

- ❑ For purposes of §735, the §751(d)(2) definition of "inventory" is used, without any requirement that it be substantially appreciated as defined in 751(d)(1).

- ❑ The term "inventory items," as defined by §751(d)(2), means—

  - ✔ property of the partnership of the kind described in §1221(1) (i.e., property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business)

  - ✔ any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in §1231,

  - ✔ any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under subsection (a) of §1246 (relating to gain on foreign investment company stock), and

  - ✔ any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described above.

(c) Items that are both unrealized receivables and inventory are treated as receivables (so no time limit to taint).

(2) **§735(b): Tacking**

(a) In determining the period for which a partner has held property received in

a distribution from a partnership, the holding period of the partnership is included. [§735(b)]

(b) Note: this does not apply for purposes of determining whether inventory is sold within the 5 year period.

c. **Consequences to the Partnership.**

i. Gain / Loss [§731]

(1) **In General [§731(b)]:** No gain or loss is recognized by a partnership on distribution of property to partner, including money.

(2) **Exceptions [§731(d)]:** There are three Code sections that may override §731's general rule of nonrecognition:

(a) §736 (relating to payments to a retiring partner or a deceased partner's successor in interest).

- For example, payments under §736(a), which are considered as a distributive share or guaranteed payment, are taxable as such under that section. [Reg. §1.731-1(c)(1), flush language];

(b) §751 (relating to unrealized receivables and inventory items); and

(c) §737 (relating to recognition of precontribution gain in case of certain distributions).

ii. Inside Basis [§734]

(1) **General rule [§734(a)]:** The basis of partnership property shall not be adjusted as the result of a distribution of property to a partner.

(2) **Problem:** Distortion of the inside basis of assets can result from a distribution of property from the partnership to a partner. Basis can be "lost" under §732(a)(2) or (b). (*See*, for example, 5.b.ii.(2)(f), 5.b.ii.(2)(h) and 5.b.ii.(2)(i) above.) As a result, more income will be taxed to the remaining partners.

(3) **Exception:** An adjustment must be made if a §754 election is in effect.

(a) If partner has gain, partnership increases basis of retained assets. [§734(b)-(1)(A)]

(b) If partner has loss, partnership decreases basis of retained assets. [§734(b)-(2)(A)]

(c) If step-up in basis of assets when distributed from partnership to partner, partnership must decrease basis of similar class of retained assets. [§734(b)(2)(B)]

(4) **Method of Adjustment [§734(b)].** If a distribution of property to a partner is made at a time when a §754 election is in effect, the partnership will adjust the inside basis of partnership property.

(a) *Increases to Inside Basis.* The partnership will increase its basis in property remaining after the distribution:

- ❑ For the amount of gain recognized by partner under §731(a)(1), i.e., money distributed to the partner exceeds outside basis;

- ❑ For the step-down in basis when partner receives an operating distribution and his basis in the distributed property is limited to the outside basis of his partnership interest under §732(a)(2); and

- ❑ For the step-down in basis when partner receives a liquidating distribution and, therefore, his basis in the distributed property is equal to the outside basis of his partnership interest (reduced by money distributed) under §732(b).

(b) *Decreases to Inside Basis.* The partnership will decrease its basis in property remaining after the distribution:

- ❑ For the amount of loss recognized to the distributee partner under §731(a)(2): partner receives a liquidating distribution and the only property he receives consists of:

- ✔ Money (including liabilities);
- ✔ Unrealized receivables; and
- ✔ Inventory.

- ❑ For the amount of the step-up in basis of property distributed by partnership to the distributee partner under §732(b), that partner receives a liquidating distribution and, therefore, his basis in the distributed property is equal to the outside basis of his partnership interest (reduced by money distributed).

(5) **Allocation of Basis [§734(c)]:** The allocation of basis among partnership properties is made in accordance with the rules provided in §755.

(a) §755 in general requires that the adjustment be made in two steps:

- ❑ First, the amount of any increase or decrease in the adjusted basis of the partnership property is divided between (i) capital assets and 1231 assets and (ii) any other property of the partnership.

- ❑ Then, the portion of the increase or decrease allocated to each class is further allocated to the bases of the properties within the class in a manner which will reduce the difference between the fair market value and the adjusted basis of the partnership properties. [Reg. §1.755-1(a)(1)(i)]

(b) **Example of an Allocation of Adjustment to Basis of Partnership Property.** Assume that partnership ABC has three assets: X, a capital asset with an adjusted basis of $1,000 and a value of $1,500; Y, a depreciable asset with an adjusted basis of $1,000 and a value of $900; and Z, inventory items with an adjusted basis of $700 and a value of $600. A sells his interest to D (when an election under 754 is in effect) for $1,000 (⅓ of $3,000, the total value of partnership assets). D's share of the adjusted basis of partnership property is $900 (⅓ of $2,700). Therefore, under section 743(b), D has a special basis adjustment of $100 ($1,000 minus $900). This adjustment must be allocated entirely to property X, since such allocation will have the effect of reducing the difference between the value and basis of such asset. Therefore, D has a special basis adjustment

of $100 with respect to property X, which now has a special basis to him of $1,100. No part of the adjustment is made to depreciable property Y or inventory items Z, since any such adjustment would increase the difference between the basis and value of each such asset. [Reg. §1.755-1(c), Example 1]

iii. Capital Accounts [§704]

(1) Amount of adjustment

(a) Remember: §704 requires that capital accounts be maintained in accordance with fair market value.

(b) To satisfy this requirement, the capital accounts of the partners first must be adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in such property would be allocated among the partners if there were a taxable disposition of such property for the fair market value of such property on the date of distribution. [Reg. §1.704-1(b)(2)(iv)(e)] An example of this type of adjustment may be found at Reg. §1.704-1(b)(5), Example 14(v).

(2) Three steps:

(a) Deemed sale;

(b) Allocate to capital accounts; and

(c) Debit distributee partner's capital account for fair market value of distribution.

(3) **Previous adjustments.** Remember: Adjust for unrealized gain or loss only to the extent an adjustment has not previously been made, e.g., for built-in gain upon contribution of property.

iv. Transactions Not Covered

(1) Loans by the partnership to a partner are not within the distribution rules of §732, but rather are treated as loans under §707(a). To the extent that such an obliga-

tion is canceled, the obligor partner will be considered to have received a distribution of money or property at the time of cancellation. [Reg. §1.731-1(c)(2)]

(2) Draws or advances. [Reg. §1.731-1(a)(1)(ii)]

(a) Treated as loans until last day of partnership year.

(b) Partnership agreement should provide obligation to repay if draws exceed distributive share.

d. **Distributions Affecting Ordinary Income Property**

i. Application of §751(b)

(1) §751(b) treats certain distributions of unrealized receivables and inventory as a sale or exchange of those items between the distributee partner and the partnership.

(2) §751(b) applies whether the deemed sale is from the partner to the partnership or from the partnership to the partner.

ii. Purpose of §751(b)

(1) Prevent shifting of income.

(2) Prevent conversion of ordinary income to capital gain.

(3) **Example**: AB equal partnership owns inventory and securities. Each has a basis of $5,000 and a value of $10,000. The partnership is liquidated. A receives and sells the inventory. B receives and sells the securities. Absent §751(b), A would emerge with $5,000 of ordinary income and B with $5,000 of capital gain.

iii. Scope

(1) Applies to amounts received by partner in exchange for his partnership interest.

(2) Applies whether amounts are received in exchange for part or all of the partner's interest.

(3) To the extent money or property is received by the partner for his interest in the partnership attributable to:

(a) Unrealized receivables; or

(b) Substantially appreciated inventory

(4) That amount is treated as sale or exchange of property resulting in ordinary income.

(5) §751 does not apply to §736(a) payments. [§751(b)(2)(B)]. §736(a) payments include amounts attributable to the retiring or deceased partner's interest in unrealized receivables, which are also §751 assets. *See* 6.c.iv. Therefore, in a liquidating distribution (which is the only kind of distribution to which §736(a) applies) disregard unrealized receivables for purposes of determining the partner's share of §751 assets.

(6) Note that in an operating distribution, unrealized receivables are included in the determination of whether there has been a disproportionate distribution with respect to §751 assets, but they are excluded from that determination in a liquidating distribution. On the other hand, §736(a) will operate to include the retiring or deceased partner's share of the unrealized receivables in his or his successors' income, the same result intended by §751.

(7) §751(b) still applies to disproportionate distributions of substantially appreciated inventory and remaining §741 assets. [Reg. §1.751-1(b)(4)(ii)]

(8) Steps

(a) Divide §736 payments into §736(a) and §736(b) portions.

(b) The §736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under §751(b) and payments treated as a distribution under §§731 through 736.

iv. Operation

(1) Distribution of §751 assets [Reg. §1.751-1(b)(2)]

(a) Partnership is deemed to sell §751 assets to distributee partner.

- ❑ Gain or loss will be measured by the difference between fair market value of other assets received by the partnership as consideration in the deemed sale and the inside basis in §751 assets "sold" to the distributee partner.

- ❑ Gain or loss on deemed sale allocated only to partners other than the distributee and separately taken into account under §702(a)(8).

(b) Distributee partner is deemed to sell non-§751 assets to the partnership.

- ❑ *Gain or loss* is measured by the difference between fair market value of §751 assets received by him and his outside basis in the other assets given up.

- ❑ *The distributee partner's basis* in non-§751 assets determined by deemed operating distribution of those assets to him under §732, therefore, he gets transferred basis not to exceed his outside basis in his partnership interest.

- ❑ This deemed distribution occurs just prior to his sale of the non-§751 assets to the partnership.

(c) *Character of gain or loss to distributee partner:* Determined by the character of the non-§751 assets in hands of the distributee partner.

(2) Distribution of other assets [Reg. §1.751-1(b)(3)]

(a) Mirror image of rules for distribution of §751 assets.

(b) That is, there is a deemed sale of the non-§751 assets by the partnership to the partner and a deemed sale of the §751 assets by the partner to the partnership.

v. Exceptions

(1) Assets distributed which the distributee partner contributed to the partnership.

(2) Payments made to a retiring partner or to a deceased partner under §736(a), i.e.:

(a) Distributive share; or

(b) Guaranteed payment

(3) §736(b) payments would not be excluded.

(4) Not applicable to pro-rata distribution to all partners.

(5) Not applicable to non-exchange distributions, e.g., drawings, payments for services or use of capital.

6. LIQUIDATING DISTRIBUTIONS

a. The Path From §731 to §736 and Back Again

i. Gain [§731(a)]

(1) The provisions for gain recognition are the same whether the distribution is an operating or a liquidating distribution.

(2) Gain is not recognized by the distributee partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. [§731(a)]

ii. Loss [§731(b)]

(1) Loss recognition does differ, depending on whether the distribution is operating or liquidating.

(2) Loss is never recognized by the distributee partner upon an operating distribution.

(3) Loss may be recognized by the distributee partner upon a liquidating distribution if and to the extent:

(a) no property other than "loss property" is distributed to such partner; and

(b) the adjusted basis of such partner's interest in the partnership exceeds the

sum of "loss property."

(4) "Loss property" is:

- ❑ any money distributed, and
- ❑ the basis to the distributee, of any unrealized receivables and inventory.

iii. Character of Gain or Loss [§§731 ➡ 741 ➡ 751]

(1) Any gain or loss recognized under §731(a) is considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner. [§731(a), flush language]

(2) §741 provides that in the case of a sale or exchange of an interest in a partnership, gain or loss is recognized to the transferor partner.

(a) In general, it is considered as gain or loss from the sale or exchange of a capital asset.

(b) However, §751 overrides, and requires recognition of ordinary income or loss to the extent the sale or exchange is attributable to unrealized receivables and inventory items which have appreciated substantially in value. [§741]

iv. Getting to §731 in the First Place [§736]

(1) Before we can apply any of these rules taking us on our journey from §731 to §741 and possibly §751, there is a special provision that governs payments to retiring or deceased partners.

(2) §736 provides for classification of payments to a retiring or deceased partner. It is simply a classification section, and only indirectly governs the tax treatment of distributions.

(3) §736 will classify payments either as "distributions," (under §736(b)) which then come within the purview of §731, or as "distributive shares" or "guaranteed payments," (under §736(a)) which are governed by other Code sections and are taxed as

the partner's share of current operations.

(a) Rule of Thumb: The retiring partner or deceased partner's successor wants §736(b) treatment, and the continuing partners want §736(a) treatment.

(b) To the extent the transaction is classified under §736(b), the retiring partner or deceased partner's successor may get nonrecognition treatment on part or all of the payments, and if gain is recognized, may get capital gain treatment rather than ordinary income.

(c) To the extent the transaction is classified under §736(a), the continuing partners get to deduct them.

v. Payments Not Within §736 [Reg. §1.736-1(a)(1)(i)]

(1) *Operating Distributions.* §736 applies solely to liquidating distributions, and will never have any application to operating distributions.

(2) *Continuing Partners:* §736 does not apply if the estate or other successor in interest of a deceased partner continues as a partner in its own right under local law. [Reg. §1.736-1(a)(1)(i)] Distributions to the successor presumably would be operating distributions.

(3) *Partner-to-Partner Transactions [§741]:* These rules apply only to transactions between a partnership and a partner. Consequently, a sale of one partner's partnership interest to another partner would not come within §736. [Reg. §1.736-1(a)(1)(i)] Instead, it would be treated as a sale under §741. *See* 6.a.vi.

vi. Distinguishing Sales of Partnership Interests [§741] From Liquidations [§736]

(1) §736 does not apply to partner-to-partner sales of partnership interests. [Reg. §1.736-1(b)(1)]

(a) **Planning Pointer:** This provides a great deal of flexibility. If the partners want to structure the transaction purely as a sale, they can do a partner-to-partner transaction.

❑ Such a sale is analyzed beginning with §741.

- ❑ §736 would not apply, and consequently, neither would §731.

  - ✔ The retiring partner would not be eligible for nonrecognition treatment under §731.

  - ✔ The remaining partners would not be eligible for the deductions under §736(a).

(b) If the transaction is structured as a liquidation of the partner's partnership interest, then §736 comes into play, and the parties have some further choices to make. In this part of the outline, we will examine how to proceed through §736 and the difference in tax treatments that are available.

(c) For now, the important point is that the parties have a choice in how they structure their transaction. Form, not just substance, counts for a great deal.

(d) The parties are not always clear in their documentation of the transaction, and after their tax advisors have explained the difference in tax treatment, they often have differing recollections of what everyone's intent was at the time. Such is the genesis of a lawsuit.

(e) **Example:** *Foxman v. Comm'r.,* 352 F.2d 466 (3rd Cir. 1965). Two partners bought out a third. Documentation showed that the purchasing partners were acting in their individual capacities and referred to the transaction as a "sale." Promissory notes were executed in the name of a related corporation, and signed by the two continuing partners as guarantors. The continuing partners treated the payments that exceeded the retiring partner's interest in partnership property as guaranteed payments under §736(a)(2) and deducted the payments on the partnership income tax return. The retired partner treated the excess payments as a sale of his partnership interest to the other two partners under §741. The IRS was not happy. The regulations specify that a sale of a partnership interest from one partner to another is not within §736. Here, the payments were made through the partnership, so the remaining partners argued that the transaction fell within §736, and because the partnership agreement was not specific as to goodwill, the portion of the payments in excess of the retiring partner's interest in partnership property fell within §736(a). The Third Circuit held that this was a <u>sale</u>, not a <u>liquidation</u>, therefore §741 applied.

Partners are free to structure transaction either as sale or liquidation, but the facts here indicated the partners intended a sale, even though the payments on the note were not made directly by the two continuing partners.

b. **Classifying Liquidating Distributions [§736]**

i. Payments to Retiring or Deceased Partners

(1) §736 applies only to payments made to a retiring partner or a deceased partner's successor in interest in liquidation of such partner's entire interest in the partnership. [Reg. §1.736-1(a)(1)(i)]

(2) A partner "retires" when he ceases to be a partner under local law. [Reg. §1.736-1(a)(1)(ii)]

(a) However, a retired partner or a deceased partner's successor will be treated as a partner until his interest in the partnership has been completely liquidated. [Reg. §1.736-1(a)(1)(ii)]

(b) For the impact this has on termination of the partnership, see 6.h.

(3) The "liquidation of a partner's interest" is 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. [§761(d)]

(4) The Uniform Partnership Act (1994) made substantial changes in the rights of retiring partners and the estates of deceased partners. The Uniform Partnership Act (1914) afforded to retiring partners and the estates of deceased partners a special status that allowed the retiring partner or the estate of a deceased partner in a partnership whose business is continued without the settlement of accounts to elect to continue to receive, as an ordinary creditor, the applicable allocation of profits or an interest payment on the value of the partner's interest. This right to an election was eliminated in the Uniform Partnership Act (1994) and in the Montana Uniform Partnership Act.

ii. Classification of Payments Between §736(a) and §736(b)

(1) §736(a) payments

(a) Attributable to:

❑ Unrealized receivables;

❑ Goodwill (to the extent not stated in the partnership agreement); and

❑ "Premium" payments, that is, excess over partner's share of value of partnership property

(b) Tax treatment:

❑ Distributive share if determined with regard to partnership income; or

❑ Guaranteed payment if determined without regard to partnership income.

(2) §736(b) payments

(a) Attributable to:

❑ Payments for partner's interest in partnership property

❑ Other than unrealized receivables and unstated goodwill.

(b) Tax treatment:

❑ Distribution by the partnership;

❑ Not as distributive share or guaranteed payment.

c. **Tax Treatment of §736 Payments**

i. How to Obtain a Benefit for the Retiring or Deceased Partner [§736(b)]

(1) The only liquidating payments that come within §736(b) are those made in

exchange for the interest of a partner in partnership property.

(2) For this reason, the amount of payments under §736(b) cannot exceed the reasonable value of the partner's interest in partnership property.

(a) 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. [Reg. §1.736-1(b)(1)]

(b) If such valuation reflects only the partner's net interest in the property (i.e., total assets less liabilities), it must be adjusted so that both the value of the partner's interest in property and the basis for his interest take into account the partner's share of partnership liabilities. [Reg. §1.736-1(b)(1)]

(3) Subsection (b) then provides that payments made in liquidation of the interest of a retiring partner or a deceased partner are considered as a distribution by the partnership. [§736(b)(1)]

(4) This takes us back to §731.

(a) §736(b) classifies payments as "distributions."

(b) And "distributions" are governed by §731, so we are right back to where we started above. *See* 6.a

(5) Of course, there are exceptions:

(a) Payments that otherwise would be considered to be made "in exchange for the interest of such partner in partnership property," and therefore governed by §736(b), will instead fall under §736(a) to the extent they are attributable to:

❑ unrealized receivables of the partnership (as defined in §751(c)), or

❑ good will of the partnership. [§736(b)(2)]

(6) And exceptions to the exceptions:

(a) The "property of the partnership" will include goodwill, if there is any.

(b) Consequently, for a partnership with goodwill, the payments to the retiring or decease partner will have to be allocated in part to the partner's interest in the goodwill.

(c) Without a special provision, payments for goodwill would come under §736(b). A special provision *is* found, however, at §736(b)(2)(B), which states that "payments in exchange for an interest in partnership property shall not include amounts paid for ... good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will . . .."

(d) In other words, payments "in exchange for the interest of such partner in partnership property" that are attributable to goodwill are:

- ❑ §736(b) payments if the partnership agreement specifically provides for them; or

- ❑ §736(a) payments if the partnership agreement is silent.

(7) And exceptions to the exceptions to the exceptions:

(a) Ignore everything you just read about the exceptions under §736(b) if:

- ❑ capital is not a material income-producing factor for the partnership, and

- ❑ the retiring or deceased partner was a general partner in the partnership.

(b) In those situations, all payments "in exchange for the interest of such partner in partnership property" will be classified under §736(b).

- ❑ So even if the payment is attributable to goodwill or unrealized receivables, it still will be treated as a distribution, starting us on our journey under §731.

- ❑ This is the result even if the payments are attributable to goodwill, and the partnership agreement makes no provisions for payments with respect to

goodwill.

(8) So why should you care whether the payments come under §736(b)?

(a) In short:

- ❑ The retiring or deceased partner may be able to avoid recognition of gain on part or all of the distribution. [§731(a)]

- ❑ And any gain that were recognized would qualify for capital gain treatment, except to the extent the distribution were attributable to unrealized receivables or substantially appreciated inventory. [§741]

- ❑ But, also would not be able to recognize loss, unless certain exceptions applied.

- ❑ The remaining partners are allowed no deduction for §736(b) payments since they represent either a distribution or a purchase of the withdrawing partner's capital interest by the partnership (composed of the remaining partners). [Reg. §1.736-1(a)(2)]

(b) For the details, go back to 6.a.

ii. How to Make Liquidating Distributions Deductible by the Remaining Partners [§736(a)]

(1) §736(a) governs the portion of the payments made to a withdrawing partner for his share of unrealized receivables, good will (in the absence of an agreement to the contrary), or otherwise not in exchange for his interest in assets. Those payments will be treated either as:

(a) A <u>distributive share</u> of partnership income, if the amount of payment is determined <u>with regard</u> to income of the partnership; or

(b) A <u>guaranteed payment</u> under §707(c), if the amount of the payment is determined <u>without regard</u> to income of the partnership. [Reg. §1.736-1(a)(3)]

(2) Either way, these are items of ordinary income to the partner (except, of course to the extent of the partner's distributive share of partnership capital gain or §1231 income) and, in effect, deductible to the remaining partners, since they have less partnership income to report.

(3) Character [Reg. §1.736-1(a)(4)].

(a) §736(a)(1) payments (Distributive Share)

❑ Partner reports as distributive share under §702; and

❑ Remaining partners reduce their distributive shares.

(b) §736(a)(2) payments (Guaranteed Payment)

❑ Deductible by partnership; and

❑ Reported as ordinary income by partner. [§707(c)]

(4) **Planning Pointer:** The partners should give some consideration to whether they wish the §736(a) payment to be treated as a guaranteed payment or as a distributive share. A guaranteed payment is deducted by the partnership in determining its net income, which is the allocated to the partners as their distributive shares. A guaranteed payment is ordinary income to the recipient. A distributive share may have several items included within it, such as capital gain or loss, charitable contributions, and so forth. See §702(a) for items that must be separately stated when reporting a partner's distributive share.

iii. Payments for Goodwill [Reg. §1.736-1(b)(3)]

(1) Goodwill can be classified either under §736(a) or §736(b), as the parties decide.

(2) If nothing is stated, payments attributable to goodwill are treated as §736(a) payments. As such, the partnership gets a deduction (either as a guaranteed payment or as a reduction in the other partners' distributive shares) and the retiring partner reports ordinary income.

(3) If the partnership agreement provides for a reasonable payment with respect to goodwill, those payments come within §736(b). As such, the partnership gets no deduction and the retiring partner has no ordinary income.

(4) Thus, significant tax consequences flow from whether the payments for goodwill are stated.

(a) **Example:** *Comm'r. v. Jackson Investment Co.,* 346 F.2d 187 (9th Cir. 1965). Payments for goodwill to a retiring partner were deducted by the partnership. The original partnership agreement did not provide for payments for goodwill. The partnership agreement was then amended to provide for the partner's retirement and stated that the part in controversy was "a guaranteed payment or a payment for goodwill." This did little to clarify matters, since guaranteed payments come within §736(a) and payments for goodwill, if the partnership agreement provides for them, come within §736(b). The Ninth Circuit said that §736 allows the partners to fix the tax consequences of payments of goodwill. Although the language of amendment was not clear, its intent was to provide for goodwill, and accordingly was taxed under §736(b)(2)(B).

(b) **Planning Pointer:** The partners should carefully consider which treatment they want and the partnership agreement should clearly state their intentions. If nothing is stated in the partnership agreement, amounts paid for goodwill will be treated under §736(a), resulting in ordinary income to the retiring partner and a deduction to the remaining partners. But as *Jackson* makes clear, the partnership agreement can also be amended at the time of the liquidating distributions.

iv. Payments for Unrealized Receivables [§736(b)(2)(A)]

(1) The "property of the partnership" will include unrealized receivables, if there are any.

(a) Consequently, for a partnership with unrealized receivables (i.e., a cash basis partnership) the payments to the retiring or decease partner will have to be allocated in part to the partner's interest in the goodwill.

(b) Without a special provision, payments for unrealized receivables would

come under §736(b). A special provision *is* found, however, at §736(b)(2)(A), which states that "payments in exchange for an interest in partnership property shall not include amounts paid for ... unrealized receivables of the partnership (as defined in section 751(c)) . . .."

(2) Therefore, all liquidating distributions made in exchange for a partner's share of unrealized receivables of the partnership (as defined in §751(c)) are classified as §736(a) distributions.

(3) Amounts received by a retiring partner for his share of unrealized receivables are taxable as ordinary income even though the partnership is on the cash basis. *Jerome Wiltse,* T.C. Memo. 1963-270.

(4) Remember, the definition of "unrealized receivables" is quite broad. *See* 5.b.iv.(1)(a)(iii).

d. **Allocation And Timing of §736 Payments**

i. Allocation [Reg. §1.736-1(b)(5)]

(1) §736 tax consequences occur in year of payment.

(2) The recipient must segregate that portion of each §736 payment which is determined to be in exchange for the partner's interest in partnership property and treated as a distribution under §736(b) from that portion treated as a distributive share or guaranteed payment under §736(a). [Reg. §1.736-1(b)(5)]

(a) Fixed Amounts [Reg. §1.736-1(b)(5)(i)]

- ❑ If a fixed amount is to be received over a fixed number of years, the portion of each payment to be treated as a distribution under §736(b) for the taxable year shall bear the same ratio to the total fixed agreed payments for such year (as distinguished from the amount actually received) as the total fixed agreed payments under §736(b) bear to the total fixed agreed payments under §736 (a) and (b).

- ❑ The balance, if any, of such amount received in the same taxable year is treated as a distributive share or a guaranteed payment under §736(a) (1) or

(2).

(b) Open Amounts [Reg. §1.736-1(b)(5)(ii)]

- ❑ If the retiring partner or deceased partner's successor in interest receives payments which are not fixed in amount, such payments are first treated as payments in exchange for his interest in partnership property under §736(b) to the extent of the value of that interest and, thereafter, as payments under §736(a).

(c) Elective Treatment. [Reg. §1.736-1(b)(5)(iii)]

- ❑ The allocation of each annual payment between §736 (a) and (b) may be made in any manner to which all the remaining partners and the withdrawing partner or his successor in interest agree, provided that the total amount allocated to property under §736(b) does not exceed the fair market value of such property at the date of death or retirement.

ii. Timing [Reg. §1.736-1(a)(5)]

(1) §736(a) payments are included in the income of the recipient for his taxable year with or within which ends the partnership taxable year for which the payment is a distributive share, or in which the partnership is entitled to deduct such amount as a guaranteed payment.

(2) §736(b) payments are taken into account by the recipient for his taxable year in which such payments are made.

e. **Basis**

i. Basis of Distributed Property [§732]

(1) The basis rules for liquidating distributions differ from rules for operating distributions

(a) Operating Distributions:

- ❑ The partner will generally take a transferred basis in the distributed assets.

[§732(a)(1)]

- ❑ But if the basis of the property distributed exceeds the basis of the partner's partnership interest, the transferred basis will be limited to the amount of the basis in the partnership interest. [§732(a)(2)]

- ❑ The partner then reduces the partnership interest basis by the basis taken in the distributed property. [§733]

(b) Liquidating Distributions

- ❑ The basis of the partner's partnership interest is first reduced by the amount of money distributed.

- ❑ The basis of the partner's partnership interest that remains is then allocated to the assets distributed.. [§732(b)]

ii. Basis of Partnership Interest [§733]

(1) §733 applies only to operating distributions.

f. **Subsequent Disposition of Distributed Property [§735]**

(1) §735 applies to all distributions, operating and liquidating.

(2) Consequently, inventory will have a 5 year ordinary income taint, and receivables will be ordinary income to the distributee partner whenever they are collected. [§735(a)]

(3) The distributee partner will tack the holding period of the partnership. [§735(b)]

g. **Capital Accounts**

i. Book

(1) Capital accounts reflect book amounts, but they determine the amount that each of the partners will receive upon liquidation of the partnership.

(2) Realized Gain or Loss on Property Distributed [Reg. §1.704-1(b)(2)(iv)(e)(1)]

(a) If the partnership wishes to comply with the substantial economic effect regulations, they require that a partner's capital account be decreased by the fair market value of property distributed by the partnership to such partner (whether in connection with a liquidation or otherwise).

(b) To satisfy this requirement, the capital accounts of the partners must be adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for the fair market value of such property on the date of distribution.

(3) Restatement of Capital Accounts [Reg. §1.704-1(b)(2)(iv)(f)]

(a) The partnership might also restate the book values of <u>all</u> its remaining property and correspondingly adjust the capital accounts of the continuing partners.

(b) This would affect more than just the property distributed.

ii. Tax

(1) The tax consequences of liquidating distributions are governed by §736 and related Code sections.

(2) Consequently, gain or loss on a distribution might be realized for book purposes, and reflected in the capital accounts, when no gain or loss—or a different amount of gain or loss—was recognized for tax purposes.

(3) The capital accounts reflect only the book consequences.

h. **Termination of the Partnership**

i. In General [§708(a)]

(a) A partnership continues until it is "terminated." [§708(a)]

(b) The exact language of §708 provides one of my favorite examples of Code-speak: "an existing partnership shall be considered as continuing if it is not terminated."

ii. Termination [§708(b)(1)]

(1) A partnership is considered as terminated only if—

(a) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

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

(2) Termination is on date of sale of an interest that puts sale at or over 50%.

(a) Partnership tax year closes on that date. If the partnership is on a fiscal year, "bunching" problem may be presented.

(b) The termination triggers a deemed distribution followed by deemed contribution of the distributed property by the continuing partners back to the partnership. [Reg. §1.708-1(b)(1)(iii)]

(c) New elections are required, because it is in effect a new partnership.

(3) Whether or not the partnership is dissolved under state law is irrelevant.

(a) Death, withdrawal, bankruptcy or incompetence of general partner does not, of itself, terminate a partnership though such may cause dissolution.

(b) Termination may exist absent dissolution, e.g., sale of 50% interest or more by limited partner.

(4) The details provide some planning opportunities

(a) How much:

❑ Sale or exchange of 50% or more of total interest in capital and profits.

- ❑ Different interests of 50% or more; not same 25% interest twice.

(b) Some ways to avoid termination

- ❑ Sell less than 50% in either profits or capital. For example, the sale of a partnership interest in 30% of the partnership capital and 60% of the partnership profits would not cause termination. [Reg. §1.708-1(b)(1)(ii)]

- ❑ Spread the sale over a period exceeding 12 months. If, however, this appears to be no more than a step transaction, the Service might argue that the "sale" occurred at the time the agreement was entered into.

- ❑ Give away part of the interest. §708 applies only to sales or exchanges, not gifts.

- ❑ Liquidate the interest. A liquidation is not a sale or exchange within the meaning of §708. [Reg. §1.708-1(b)(ii)]

(5) Some applications of the termination rules

(a) If the partnership business is sold and all the assets distributed to the partners in complete liquidation, the partnership is terminated.

(b) The partnership was not terminated where the business was sold but the partnership retained and collected purchaser's notes (*David A. Foxman,* 41 T.C. 535, 1964, aff'd. 352 F.2d 466, 3rd Cir., 1965: *Baker Commodities, Inc.,* 415 F.2d 519, 9th Cir., 1969, aff'd. 48 T.C. 374, 1967).

(c) The partnership is terminated if business continued by single ex-partner as sole proprietor.

(d) No new partnership when 3 of 5 equal partners purchased business of partnership at judicial sale (Rev. Rul. 66-264, 1966-2 C.B. 248). Rationale: continuation of old partnership with withdrawing partners having sold or liquidated their interest.

(6) Two person partnerships

- ❑ A retiring partner who is receiving payments from the partnership is regarded as a partner until his entire interest is liquidated. [Reg. §1.736-1(a)(6)]

- ❑ Therefore, if one of the members of a 2-partner partnership retires under a plan whereby the partner is to receive payments under §736, the partnership will not be considered terminated, nor will the partnership year close with respect to either partner, until the retiring partner's entire interest is liquidated, since the retiring partner continues to hold a partnership interest in the partnership until that time.

- ❑ Similarly, if a partner in a 2-partner partnership dies, and the partner's estate or other successor in interest receives payments under §736, the partnership shall not be considered to have terminated upon the death of the partner but shall terminate as to both partners only when the entire interest of the decedent is liquidated. [Reg. §1.736-1(a)(6)]

- ❑ *Rev. Rul. 77-412* (Liquidation of 2 person partnership)

  - ✔ Two partners; complete liquidation.

  - ✔ If one partner receives disproportionate distribution of §751 property, treat as a sale or exchange of such properties between the partner and the partnership.

    a) The partnership as constituted <u>after</u> the distribution, that is, the remaining partner is treated as the "partnership."

    b) Doesn't matter which partner is treated as the remaining partner.

7. SALE OF A PARTNERSHIP INTEREST

a. In General

(1) Considering that Subchapter K generally approaches partnership (and thus LLC) taxation from an aggregate as opposed to an entity standpoint, one might assume that the sale of a partnership interest would be viewed as a sale by a partner of an undivided interest in each partnership asset, That, however, is not the approach of the

Code. Generally, an entity approach is used by Subchapter K in this context.

(2) As will be discussed, aggregate notions do, however, play a role here. Specifically, to the extent that there are "hot assets" (i.e., §751 assets,) in the partnership, §751 will be applicable, forcing a selling partner to report ordinary income under certain circumstances. In addition, if the partnership makes a §754 election, the individual purchasing the partnership interest will be entitled to adjust the basis of partnership assets to reflect depreciation and appreciation in those assets.

(3) The default rules on transfer of partnership interests under MUPA and MLLCA draw the standard distinction between the transfer of a "profit interest" and the transfer of all the rights and obligations associated with the partnership or LLC interest, including the right to participate in management (the "Membership Interest," to borrow a phrase from Professor Ribstein.) The "profit interest" is, of course, freely transferable. The Membership Interest, on the other hand, may not be transferred without the unanimous approval of the other partners or members. In an entity in which the owners have limited liability and in which the management functions are centralized, transfer restrictions impose many costs that may exceed their benefits. The statutory default provisions with respect to transfer may be modified by agreement of the parties in both LLC's and LLP's. If the parties wish to eliminate these restrictions, however, it is important to restrict any such transfer that triggers undesirable tax consequences, such as a termination under §708 or a violation of federal or state securities regulations. The right of first refusal option that is a cornerstone of most shareholder buy-sell agreements may provide a viable alternative to the absolute prohibition on transferability that is more common in partnership arrangements.

b. **Consequences to the Selling Partner**

i. Capital Gain / Loss [§741]

(1) §741 provides that upon the sale of a partnership interest, *gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided by section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).*

(2) This provision is applicable to the sale of either a partner's entire partnership interest or a part of that interest.

(3) **Example 1:** Assume that the AB partnership in which A and B are equal partners has the following assets, with adjusted bases and fair market values as indicated:

Asset	A/B	FMV
Cash	$25,000	$25,000
Land used in the business	$15,000	$100,000
Stock	$50,000	$75,000
Total	$90,000	$200,000

Assume that A sells her partnership interest to C for $100,000. Assume that A has a $40,000 adjusted basis in her partnership interest. Under §741, A will recognize a gain of $60,000. Considering that there are no §751 assets held by the partnership, all of the gain will be capital gain. Assuming a long term holding period, A's gain will be long term capital gain.

ii. Ordinary Income [§751]

(1) If the partnership has §751 assets, i.e., unrealized receivables or substantially appreciated inventory, §751 (a) provides that "the amount of any money, or the fair market value of any property, received by the transferor partner in exchange for ... his interest in the partnership attributable (to those assets) shall be considered as an amount realized from the sale or exchange of property other than a capital asset."

(2) Implementing this provision, Reg. §1.751-1 (a) requires the selling partner to allocate part of the amount realized on the sale to the §751 property and also to allocate part of the partner's basis in her partnership interest to the §751 property.

(a) The regulations provide that the portion of the amount realized allocated to the §751 property will be determined by the selling partner and the buyer in an arms length agreement. The assumption here is that the interests of the parties are sufficiently adverse that the allocation they make should be respected.

a) The parties should specify in the sales agreement the amounts they are allocating to the §751 assets.

(b) The basis to be allocated to the §751 property shall be the basis that the selling partner would have had in such property had it been distributed to the partner by the partnership immediately before the sale. See §732.

(3) Having determined the amount realized from the §751 property and the adjusted basis of that property, the selling partner will then determine the gain or loss resulting from the sale of that property. That gain or loss will be ordinary.

(4) "The difference between the remainder, if any, of the partner's adjusted basis for his partnership interest and the balance, if any of the amount realized is the transferor's capital gain or loss on the sale of the partnership interest." Reg. §1. 751 -1 (a)(2).

(5) **Example 2**: Assume that the ABC partnership in which A, B and C are equal partners has the balance sheet:

	A/B	FMV		A/B	FMV
Assets			**Liabilities**		$ 0
			Equity		
Cash	$50,000	$ 50,000	A	$20,000	75,000
Land	10,000	100,000	B	20,000	75,000
Accts.	0	75,000	C	20,000	75,000
Total	$60,000	$225,000		$60,000	$225,000

Assume that A sells her partnership interest to D for $75,000. Assume that A has a $20,000 adjusted basis in her partnership interest. A thus realizes $55,000 of gain. Since the accounts receivable constitute an "unrealized receivable," A will be required to apply §751 (a) and report part of the sales transaction as an ordinary income transaction.

(a) In this case, $25,000 of the $75,000 amount realized will be allocated to the §751 asset (one half of the accounts receivable). For purposes of the §751 computation, $0 of A's partnership basis will be allocated to the §751 property because if one half of the accounts receivable had been distributed to A immediately before the sale, A would have received them with a $0 basis. §732. Thus, A will be required to report $25,000 of ordinary gain (A/R of $25,000 less A/B of $0 = $25,000).

(b) The remaining amount realized ($50,000) less the remaining adjusted basis ($20,000) results in a capital gain of $30,000.

(c) Thus, of the $55,000 of gain that was inherent in this situation, $25,000 was reportable as ordinary gain and the balance of $30,000 was reportable by A as capital gain. Again, the character of the capital gain as long term or short term will depend upon A's holding period in the partnership interest.

(6) Note that A could use the installment method of reporting gain. §453 treatment, however, is not available for §751 items. Rev. Rul. 89-108, 1989-2 C.B. 100. Thus, installment sales treatment is only available for the capital gain portion of the transaction. All ordinary income would have to be reported immediately.

c. **Consequences to the Buyer**

i. Basis

(1) The party purchasing a partnership interest will take a §1012 basis in that interest and the buyer's holding period will begin at the time of purchase.

(2) From the buyer's perspective, however, an issue arises as to the treatment of the gain or loss inherent in the assets held by the partnership. Does the buyer have the benefit of a fair market value basis in these assets? If not, when the partnership sells an asset or collects a receivable and gain is triggered, will the buyer be required to report gain or loss?

ii. §754 Elections

(1) Consider under the facts of Example 2 above that the partnership collects all $75,000 of the accounts receivable in the year following the purchase. Will D, the buyer, be required to report $25,000 of income? Can D argue that D had paid $25,000 for the accounts? (After all, the agreement which D entered with A specifically allocated $25,000 of the purchase price to the accounts receivable.) Furthermore, A will have already reported $25,000 of ordinary income representing A's share of the accounts receivable.

(2) If the partnership has not and does not make a §754 election, D in fact will

report $25,000 of ordinary income. There will be a significant disparity, in other words, between D's outside basis and D's share of the inside basis of the partnership. D will simply be standing in A's shoes vis-a-vis the inside basis of the partnership. For that matter, D also inherits A's capital account.

(3) Assuming no §754 election is in effect, D will report the $25,000 of income and this in turn will increase D's outside basis from $75,000 to $100,000. Everything, of course, will work out in the end in that if the partnership were to be liquidated at this point in time, D would receive $75,000 of assets and would ultimately recognize $25,000 of loss to offset the $25,000 of ordinary income which she had to include as a result of the collection of the receivables. The problem, however, is both one of timing and character -- D will have reported $25,000 of ordinary income and some time down the road will have an offsetting $25,000 capital loss!

(4) If, however, the partnership has a §754 election in effect, D's circumstances will be different. §743(b) will provide a special basis for D in the assets of the partnership. The effect of this special basis rule will be to conform D's outside basis with D's share of the inside basis of the assets.

(5) §743(b) provides that D shall increase the adjusted basis of the partnership property by the excess of D's basis in her partnership interest over her proportionate share of the adjusted basis of the partnership property. (Were D's basis to be less than her proportionate share of the inside basis of the assets, that inside basis would be reduced.) Note: §743(b) makes clear that this special basis adjustment is for the benefit of the transferee partner only.

(a) Thus, in Example 2, D's share of the inside basis of the assets is $20,000 while her outside basis is $75,000. Therefore, a $55,000 inside basis adjustment is in order. §743(c) indicates that the $55,000 basis adjustment will be allocated among the partnership assets pursuant to §755.

(b) §755 and the regulations thereunder essentially require that the $55,000 adjustment be allocated between two classes of partnership assets: capital assets (including §1231 assets) and all other assets. That allocation is made based upon the proportionate amount of appreciation (or depreciation, in the case of a negative adjustment) reflected by each class.

❑ In Example 2 the land will be in one class (capital asset) and the accounts

receivable will be in the noncapital asset class. There is $90,000 of gain inherent in the land and $75,000 of gain inherent in the accounts receivable. Thus, the aggregate gain is $165,000. As a result, the allocation of the $55,000 adjustment will be as follows:

Capital asset allocation:	90,000/165,000 X 55,000	=	$30,000
Noncapital allocation:	75,000/165,000 X 55,000	=	$25,000

- ❑ Were there more than one asset in either of the classes, the adjustment allocated to that class would have to be allocated again within the class. That allocation would also occur on the basis of relative appreciation (or depreciation).

- ❑ Furthermore, §755 appropriately requires that any adjustment must have the effect of decreasing the gap between the value of the property and its adjusted basis. Thus, a positive adjustment can only be applied to assets which have a fair market value greater than basis; a negative adjustment can only be applied to assets with a fair market value that is less than basis.

- ❑ Here, the entire $30,000 allocated to the capital asset will become a special basis in the land for the benefit of D. (This special basis will be in addition to D's share of the partnership basis of $10,000 in the land.) Thus, if the partnership were to sell the land for $100,000, D, instead of reporting gain of $30,000, will report no gain. Likewise, D will have a special basis of $25,000 in the accounts receivable.

- ❑ Note that if the adjustment is made to depreciable property, the effect of a positive adjustment will be to increase the amount of depreciation deductions available to D.

iii. §732(d) Basis Adjustments

(1) If no §754 election is in effect, Subchapter K nonetheless does provide some relief for the purchaser of a partnership interest. Assume, for example, in Example 2 that subsequent to the purchase of A's interest, D received a distribution from the partnership

of one-third of the accounts receivable. Under §732(a), D's basis in the accounts would be $0 (no 743(b) adjustment having occurred.) §732(d), however, allows D to elect to treat the basis of the accounts (assuming the distribution occurred within two years after D purchased A's interest) as though a 743(b) adjustment had been made. If such an adjustment had been made, D's "personal inside basis" in the accounts would have been $25,000. Therefore, under §732(a), D would be entitled to a $25,000 basis in the accounts rather than a $0 basis.

iv. Capital Accounts

(1) With respect to capital accounts, Reg. Section. 1.704-1 (b)(iv)(1) provides that "the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner."

(2) Reg. §1.704-1 (b)(iv)(m)(2) provides that where there is a transfer of a partnership interest and a §754 election is in effect, "adjustments to the adjusted tax basis of partnership property under §743 shall not be reflected in the capital account of the transferee partner or on the books of the partnership."

d. **Issues Related to the Sale of a Partnership Interest**

i. Termination of Partnership

(1) §708(b)(2) provides that a partnership will be considered terminated if "within a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits."

(2) Thus, for example, if we have the XY Partnership in which X and Y are equal partners and X were to sell his 50% interest to Z, that sale would result in the termination of the partnership for tax purposes.

(3) Reg. §1.708-1(b)(iv) provides that in the event of such a termination, the following events are considered to occur:

(a) The partnership distributes its properties to the purchaser and the other remaining partners in proportion to their respective interests in the partnership properties; and,

(b) immediately thereafter, the purchaser and the other remaining partners contribute the properties to a new partnership, either for the continuation of the business or its dissolution and winding up.

(4) Note that if there is a termination in the circumstances above, there is not a capital account carryover to the purchasing party but rather new capital accounts will be established consistent with the constructive liquidation of the partnership described above.

ii. Closing Of the Partnership's Taxable Year

(1) The partnership's taxable year closes when the partnership terminates. Thus, if there is a sale of 50% or more of the partnership interests during a 12 month period and a termination results under §708, the partnership tax year will terminate.

(2) For this kind of termination, however, §706(c)(1) provides that the taxable year of a partnership generally does not close as a result of the sale or exchange of a partner's interest in the partnership.

(3) §706(c)(2)(A)(1), however, provides that the taxable year of a partnership shall close "with respect to a partner who sells or exchanges his entire interest in the partnership."

(a) The question which arises is how will the selling partner's share of income, gain, loss, deductions, and credits be determined for the year in which the sale occurs.

(b) §706(d)(I) indicates that it will be determined using "any method prescribed by the Secretary by regulations which take into account the varying interests of the partners in the partnership during such taxable year."

(c) An interim closing of the books method or a proration method could be used. See Reg. §1,706-1 (c)(2)(ii). Under the interim closing of the books method, it is just as though the tax year of the partnership ended and income and loss are computed at that time. Under the proration method (the less burdensome method), one would simply wait until the end of the tax year of the partnership and then prorate items. There are, however, special limitations provided.

APPENDIX

INTERNAL REVENUE CODE — SUBCHAPTER K

Part I -- Determination of tax liability

Sec. 701. Partners, not partnership, subject to tax

A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.

Sec. 702. Income and credits of partner

(a) General rule

In determining his income tax, each partner shall take into account separately his distributive share of the partnership's--

(1) gains and losses from sales or exchanges of capital assets held for not more than 1 year,

(2) gains and losses from sales or exchanges of capital assets held for more than 1 year,

(3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),

(4) charitable contributions (as defined in section 170(c)),

(5) dividends with respect to which there is a deduction under part VIII of subchapter B,

(6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, and

(8) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

(b) Character of items constituting distributive share

The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

(c) Gross income of a partner

In any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership.

(d) Cross reference

For rules relating to procedures for determining the tax treatment of partnership items see subchapter C of chapter 63 (section 6221 and following).

Sec. 703. Partnership computations

(a) Income and deductions

The taxable income of a partnership shall be computed in the same manner as in the case of an individual except that--

(1) the items described in section 702(a) shall be separately stated, and

(2) the following deductions shall not be allowed to the partnership:

(A) the deductions for personal exemptions provided in section 151,

(B) the deduction for taxes provided in section 164(a) with respect to taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(C) the deduction for charitable contributions provided in section 170,

(D) the net operating loss deduction provided in section 172,

(E) the additional itemized deductions for individuals provided in part VII of subchapter B (sec. 211 and following), and

(F) the deduction for depletion under section 611 with respect to oil and gas wells.

(b) Elections of the partnership

Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that any election under--

(1) subsection (b)(5) or (c)(3) of section 108 (relating to income from discharge of indebtedness),

(2) section 617 (relating to deduction and recapture of certain mining exploration expenditures), or

(3) section 901 (relating to taxes of foreign countries and possessions of the United States),

shall be made by each partner separately.

Sec. 704. Partner's distributive share

(a) Effect of partnership agreement

A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

(b) Determination of distributive share

A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if--

(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

(c) Contributed property. --

(1) In general. --

Under regulations prescribed by the Secretary --

(A) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution, and

(B) if any property so contributed is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 5 years of being contributed --

(i) the contributing partner shall be treated as recognizing gain or loss (as the case may be) from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner under subparagraph (A) by reason of the variation described in subparagraph (A) if the property had been sold at its fair market value at the time of the distribution,

(ii) the character of such gain or loss shall be determined by reference to the character of the gain or loss which would have resulted if such property had been sold by the partnership to the distributee, and

(iii) appropriate adjustments shall be made to the adjusted basis of the contributing partner's interest in the partnership and to the adjusted basis of the property distributed to reflect any gain or loss recognized under this subparagraph.

(2) Special rule for distributions where gain or loss would not be recognized outside partnerships. --

Under regulations prescribed by the Secretary, if --

(A) property contributed by a partner (hereinafter referred to as the 'contributing partner') is distributed by the partnership to another partner, and

(B) other property of a like kind (within the meaning of section 1031) is distributed by the partnership to the contributing partner not later than the earlier of --

(i) the 180th day after the date of the distribution described in subparagraph (A), or

(ii) the due date (determined with regard to extensions) for the contributing partner's return of the tax imposed by this chapter for the taxable year in which the distribution described in subparagraph (A) occurs,

then to the extent of the value of the property described in subparagraph (B), paragraph (1)(B) shall be applied as if the contributing partner had contributed to the partnership the property described in subparagraph (B).

(3) Other rules. --

Under regulations prescribed by the Secretary, rules similar to the rules of paragraph (1) shall apply to contributions by a partner (using the cash receipts and disbursements method of accounting)

of accounts payable and other accrued but unpaid items. Any reference in paragraph (1) or (2) to the contributing partner shall be treated as including a reference to any successor of such partner.

(d) Limitation on allowance of losses

A partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

(e) Family partnerships

(1) Recognition of interest created by purchase or gift

A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

(2) Distributive share of donee includible in gross income

In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

(3) Purchase of interest by member of family

For purposes of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

(f) Cross reference

For rules in the case of the sale, exchange, liquidation, or reduction of a partner's interest, see section 706(c)(2).

Sec. 705. Determination of basis of partner's interest

(a) General rule

The adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined under section 722 (relating to contributions to a partnership) or section 742 (relating to transfers of partnership interests)--

(1) increased by the sum of his distributive share for the taxable year and prior taxable years of--

(A) taxable income of the partnership as determined under section 703(a),

(B) income of the partnership exempt from tax under this title, and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion;

(2) decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable year and prior taxable years of--

(A) losses of the partnership, and

(B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account; and

(3) decreased (but not below zero) by the amount of the partner's deduction for depletion for any partnership oil and gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such partner under section 613A(c)(7)(D).

(b) Alternative rule

The Secretary shall prescribe by regulations the circumstances under which the adjusted basis of a partner's interest in a partnership may be determined by reference to his proportionate share of the adjusted basis of partnership property upon a termination of the partnership.

Sec. 706. Taxable years of partner and partnership

(a) Year in which partnership income is includible

In computing the taxable income of a partner for a taxable year, the inclusions required by section 702 and section 707(c) with respect to a partnership shall be based on the income, gain, loss, deduction, or credit of the partnership for any taxable year of the partnership ending within or with the taxable year of the partner.

(b) Taxable year

(1) Partnership's taxable year

(A) Partnership treated as taxpayer

The taxable year of a partnership shall be determined as though the partnership were a taxpayer.

(B) Taxable year determined by reference to partners

Except as provided in subparagraph (C), a partnership shall not have a taxable year other than--

(i) the majority interest taxable year (as defined in paragraph (4)),

(ii) if there is no taxable year described in clause (i), the taxable year of all the principal partners of the partnership, or

(iii) if there is no taxable year described in clause (i) or (ii), the calendar year unless the Secretary by regulations prescribes another period.

(C) Business purpose

A partnership may have a taxable year not described in subparagraph (B) if it establishes, to the satisfaction of the Secretary, a business purpose therefor. For purposes of this subparagraph, any deferral of income to partners shall not be treated as a business purpose.

(2) Partner's taxable year

A partner may not change to a taxable year other than that of a partnership in which he is a principal partner unless he establishes, to the satisfaction of the Secretary, a business purpose therefor.

(3) Principal partner

For the purpose of this subsection, a principal partner is a partner having an interest of 5 percent or more in partnership profits or capital.

(4) Majority interest taxable year; limitation on required changes

(A) Majority interest taxable year defined

For purposes of paragraph (1)(B)(i)--

(i) In general

The term "majority interest taxable year" means the taxable year (if any) which, on each testing day, constituted the taxable year of 1 or more partners having (on such day) an aggregate interest in partnership profits and capital of more than 50 percent.

(ii) Testing days

The testing days shall be--

(I) the 1st day of the partnership taxable year (determined without regard to clause (i)), or

(II) the days during such representative period as the Secretary may prescribe.

(B) Further change not required for 3 years

Except as provided in regulations necessary to prevent the avoidance of this section, if, by reason of paragraph (1)(B)(i), the taxable year of a partnership is changed, such partnership shall not be required to change to another taxable year for either of the 2 taxable years following the year of change.

(5) Application with other sections

Except as provided in regulations, for purposes of determining the taxable year to which a partnership is required to change by reason of this subsection, changes in taxable years of other persons required by this subsection, section 441(i), section 584(h), section 645, or section 1378(a) shall be taken into account.

(c) Closing of partnership year

(1) General rule

Except in the case of a termination of a partnership and except as provided in paragraph (2) of this subsection, the taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner's interest in the partnership, or the sale or exchange of a partner's interest in the partnership.

(2) Partner who retires or sells interest in partnership

(A) Disposition of entire interest

The taxable year of a partnership shall close--

(i) with respect to a partner who sells or exchanges his entire interest in a partnership, and

(ii) with respect to a partner whose interest is liquidated, except that the taxable year of a partnership with respect to a partner who dies shall not close prior to the end of the partnership's taxable year.

(B) Disposition of less than entire interest

The taxable year of a partnership shall not close (other than at the end of a partnership's taxable year as determined under subsection (b)(1)) with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to a partner whose interest is reduced (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise).

(d) Determination of distributive share when partner's interest changes

(1) In general

Except as provided in paragraphs (2) and (3), if during any taxable year of the partnership there is a change in any partner's interest in the partnership, each partner's distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by the Secretary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.

(2) Certain cash basis items prorated over period to which attributable

(A) In general

If during any taxable year of the partnership there is a change in any partner's interest in the partnership, then (except to the extent provided in regulations) each partner's distributive share of any allocable cash basis item shall be determined--

(i) by assigning the appropriate portion of such item to each day in the period to which it is attributable, and

(ii) by allocating the portion assigned to any such day among the partners in proportion to their interests in the partnership at the close of such day.

(B) Allocable cash basis item

For purposes of this paragraph, the term "allocable cash basis item" means any of the following items with respect to which the partnership uses the cash receipts and disbursements method of accounting:

(i) Interest.

(ii) Taxes.

(iii) Payments for services or for the use of property.

(iv) Any other item of a kind specified in regulations prescribed by the Secretary as being an item with respect to which the application of this paragraph is appropriate to avoid significant misstatements of the income of the partners.

(C) Items attributable to periods not within taxable year

If any portion of any allocable cash basis item is attributable to--

(i) any period before the beginning of the taxable year, such portion shall be assigned under subparagraph (A)(i) to the first day of the taxable year, or

(ii) any period after the close of the taxable year, such portion shall be assigned under subparagraph (A)(i) to the last day of the taxable year.

(D) Treatment of deductible items attributable to prior periods

If any portion of a deductible cash basis item is assigned under subparagraph (C)(i) to the first day of any taxable year--

(i) such portion shall be allocated among persons who are partners in the partnership during the period to which such portion is attributable in accordance with their varying interests in the partnership during such period, and

(ii) any amount allocated under clause (i) to a person who is not a partner in the partnership on such first day shall be capitalized by the partnership and treated in the manner provided for in section 755.

(3) Items attributable to interest in lower tier partnership prorated over entire taxable year

If--

(A) during any taxable year of the partnership there is a change in any partner's interest in the partnership (hereinafter in this paragraph referred to as the "upper tier partnership"), and

(B) such partnership is a partner in another partnership (hereinafter in this paragraph referred to as the "lower tier partnership"),

then (except to the extent provided in regulations) each partner's distributive share of any item of the upper tier partnership attributable to the lower tier partnership shall be determined by assigning the appropriate portion (determined by applying principles similar to the principles of subparagraphs (C) and (D) of paragraph (2)) of each such item to the appropriate days during which the upper tier partnership is a partner in the lower tier partnership and by allocating the portion assigned to any such day among the partners

in proportion to their interests in the upper tier partnership at the close of such day.

(4) Taxable year determined without regard to subsection (c)(2)(A)

For purposes of this subsection, the taxable year of a partnership shall be determined without regard to subsection (c)(2)(A).

Sec. 707. Transactions between partner and partnership

(a) Partner not acting in capacity as partner

(1) In general

If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

(2) Treatment of payments to partners for property or services

Under regulations prescribed by the Secretary--

(A) Treatment of certain services and transfers of property

If--

(i) a partner performs services for a partnership or transfers property to a partnership,

(ii) there is a related direct or indirect allocation and distribution to such partner, and

(iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership,

such allocation and distribution shall be treated as a transaction described in paragraph (1).

(B) Treatment of certain property transfers

If--

(i) there is a direct or indirect transfer of money or other property by a partner to a partnership,

(ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property,

such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

(b) Certain sales or exchanges of property with respect to controlled partnerships

(1) Losses disallowed

No deduction shall be allowed in respect of losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between--

(A) a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or

(B) two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

In the case of a subsequent sale or exchange by a transferee described in this paragraph, section 267(d) shall be applicable as if the loss were disallowed under section 267(a)(1). For purposes of section 267(a)(2), partnerships described in subparagraph (B) of this paragraph shall be treated as persons specified in section 267(b).

(2) Gains treated as ordinary income

In the case of a sale or exchange, directly or indirectly, of property, which in the hands of the transferee, is property other than a capital asset as defined in section 1221--

(A) between a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or profits interest, in such partnership, or

(B) between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interest or profits interests,

any gain recognized shall be considered as ordinary income.

(3) Ownership of a capital or profits interest

For purposes of paragraphs (1) and (2) of this subsection, the ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) other than paragraph (3) of such section.

(c) Guaranteed payments

To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

Sec. 708. Continuation of partnership

(a) General rule

For purposes of this subchapter, an existing partnership shall be considered as continuing if it is not terminated.

(b) Termination

(1) General rule

For purposes of subsection (a), a partnership shall be considered as terminated only if--

(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or

(B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

(2) Special rules

(A) Merger or consolidation

In the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.

(B) Division of a partnership

In the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) shall, for purposes of this section, be considered a continuation of the prior partnership.

Sec. 709. Treatment of organization and syndication fees

(a) General rule

Except as provided in subsection (b), no deduction shall be allowed under this chapter to the partnership or to any partner for any amounts paid or incurred to organize a partnership or to promote the sale of (or to sell) an interest in such partnership.

(b) Amortization of organization fees

(1) Deduction

Amounts paid or incurred to organize a partnership may, at the election of the partnership (made in accordance with regulations prescribed by the Secretary), be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the partnership (beginning with the month in which the partnership begins business), or if the partnership is liquidated before the end of such 60-month period, such deferred expenses (to the extent not deducted under this section) may be deducted to the extent provided in section 165.

(2) Organizational expenses defined

The organizational expenses to which paragraph (1) applies, are expenditures which--

(A) are incident to the creation of the partnership;

(B) are chargeable to capital account; and

(C) are of a character which, if expended incident to the creation of a partnership having an ascertainable life, would be amortized over such life.

Part II -- Contributions, distributions, and transfers

Subpart A -- Contributions to a partnership

Sec. 721. Nonrecognition of gain or loss on contribution

(a) General rule

No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership

in exchange for an interest in the partnership.

(b) Special rule

Subsection (a) shall not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated.

Sec. 722. Basis of contributing partner's interest

The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

Sec. 723. Basis of property contributed to partnership

The basis of property contributed to a partnership by a partner shall be the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

Sec. 724. Character of gain or loss on contributed unrealized receivables, inventory items, and capital loss property

(a) Contributions of unrealized receivables

In the case of any property which--

(1) was contributed to the partnership by a partner, and

(2) was an unrealized receivable in the hands of such partner immediately before such contribution,

any gain or loss recognized by the partnership on the disposition of such property shall be treated as ordinary income or ordinary loss, as the case may be.

(b) Contributions of inventory items

In the case of any property which--

(1) was contributed to the partnership by a partner, and

(2) was an inventory item in the hands of such partner immediately before such contribution,

any gain or loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as ordinary income or ordinary loss, as the case may be.

(c) Contributions of capital loss property

In the case of any property which--

(1) was contributed by a partner to the partnership, and

(2) was a capital asset in the hands of such partner immediately before such contribution,

any loss recognized by the partnership on the disposition of such property during the 5-year period beginning on the date of such contribution shall be treated as a loss from the sale of a capital asset to the extent that, immediately before such contribution, the adjusted basis of such property in the hands of the partner exceeded the fair market value of such property.

(d) Definitions

For purposes of this section--

(1) Unrealized receivable

The term "unrealized receivable" has the meaning given such term by section 751(c) (determined by treating any reference to the partnership as referring to the partner).

(2) Inventory item

The term "inventory item" has the meaning given such term by section 751(d)(2) (determined by treating any reference to the partnership as referring to the partner and by applying section 1231 without regard to any holding period therein provided).

(3) Substituted basis property

(A) In general

If any property described in subsection (a), (b), or (c) is disposed of in a nonrecognition transaction, the tax treatment which applies to such property under such subsection shall also apply to any substituted basis property resulting from such transaction. A similar rule shall also apply in the case of a series of non-recognition transactions.

(B) Exception for stock in C corporation

Subparagraph (A) shall not apply to any stock in a C corporation received in an exchange described in section 351.

Subpart B -- Distributions by a partnership

Sec. 731. Extent of recognition of gain or loss on distribution

(a) Partners

In the case of a distribution by a partnership to a partner--

(1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and

(2) loss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of--

(A) any money distributed, and

(B) the basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 751(d)(2)).

Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

(b) Partnerships

No gain or loss shall be recognized to a partnership on a distribution to a partner of property, including money.

(c) Treatment of marketable securities. --

(1) In general. --

For purposes of subsection (a)(1) and section 737 --

(A) the term 'money' includes marketable securities, and

(B) such securities shall be taken into account at their fair market value as of the date of the distribution.

(2) Marketable securities. --

For purposes of this subsection:

(A) In general. --

The term 'marketable securities' means financial instruments and foreign currencies which are, as of the date of the distribution, actively traded (within the meaning of section 1092(d)(1)).

(B) Other property. --

Such term includes --

(i) any interest in --

(I) a common trust fund, or

(II) a regulated investment company which is offering for sale or has outstanding any redeemable security (as defined in section 2(a)(32) of the Investment Company Act of 1940) of which it is the issuer,

(ii) any financial instrument which, pursuant to its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable securities,

(iii) any financial instrument the value of which is determined substantially by reference to marketable securities,

(iv) except to the extent provided in regulations prescribed by the Secretary, any interest in a precious metal which, as of the date of the distribution, is actively traded (within the meaning of section 1092(d)(1)) unless such metal was produced, used, or held in the active conduct of a trade or business by the partnership,

(v) except as otherwise provided in regulations prescribed by the Secretary, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of marketable securities, money, or both, and

(vi) to the extent provided in regulations prescribed by the Secretary, any interest in an entity not described in clause (v) but only to the extent of the value of such interest which is attributable to marketable securities, money, or both.

(C) Financial instrument. --

The term 'financial instrument' includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, and derivatives.

(3) Exceptions. --

(A) In general. --

Paragraph (1) shall not apply to the distribution from a partnership of a marketable security to a partner if --

(i) the security was contributed to the partnership by such partner, except to the extent that the value of the distributed security is attributable to marketable securities or money contributed (directly or indirectly) to the entity to which the distributed security relates,

(ii) to the extent provided in regulations prescribed by the Secretary, the property was not a marketable security when acquired by such partnership, or

(iii) such partnership is an investment partnership and such partner is an eligible partner thereof.

(B) Limitation on gain recognized. --

In the case of a distribution of marketable securities to a partner, the amount taken into account under paragraph (1) shall be reduced (but not below zero) by the excess (if any) of --

(i) such partner's distributive share of the net gain which would be recognized if all of the 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, over

(ii) such partner's distributive share of the net gain which is attributable to the marketable securities of the same class and issuer as the distributed securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under clause (i).

Under regulations prescribed by the Secretary, all marketable securities held by the partnership may be treated as marketable securities of the same class and issuer as the distributed securities.

(C) Definitions relating to investment partnerships. --

For purposes of subparagraph (A)(iii):

(i) Investment partnership. --

The term 'investment partnership' means any partnership which has never been engaged in a trade or business and substantially all of the assets (by value) of which have always consisted of --

(I) money,

(II) stock in a corporation,

(III) notes, bonds, debentures, or other evidences of indebtedness,

(IV) interest rate, currency, or equity notional principal contracts,

(V) foreign currencies,

(VI) interests in or derivative financial instruments (including options, forward or futures contracts, short positions, and similar financial instruments) in any asset described in any other subclause of this clause or in any commodity traded on or subject to the rules of a board of trade or commodity exchange,

(VII) other assets specified in regulations prescribed by the Secretary, or

(VIII) any combination of the foregoing.

(ii) Exception for certain activities. -- A partnership shall not be treated as engaged in a trade or business by reason of --

(I) any activity undertaken as an investor, trader, or dealer in any asset described in clause (i), or

(II) any other activity specified in regulations prescribed by the Secretary.

(iii) Eligible partner. --

(I) In general. --

The term 'eligible partner' means any partner who, before the date of the distribution, did not contribute to the partnership any property other than assets described in clause (i).

(II) Exception for certain nonrecognition transactions. --

The term 'eligible partner' shall not include the transferor or transferee in a nonrecognition transaction involving a transfer of any portion of an interest in a partnership with respect to which the transferor was not an eligible partner.

(iv) Look-thru of partnership tiers. --

Except as otherwise provided in regulations prescribed by the Secretary --

(I) a partnership shall be treated as engaged in any trade or business engaged in by, and as holding (instead of a partnership interest) a proportionate share of the assets of, any other partnership in which the partnership holds a partnership interest, and

(II) a partner who contributes to a partnership an interest in another partnership shall be treated as contributing a proportionate share of the assets of the other partnership.

If the preceding sentence does not apply under such regulations

with respect to any interest held by a partnership in another partnership, the interest in such other partnership shall be treated as if it were specified in a subclause of clause (i).

(4) Basis of securities distributed. --

(A) In general. --

The basis of marketable securities with respect to which gain is recognized by reason of this subsection shall be --

(i) their basis determined under section 732, increased by

(ii) the amount of such gain.

(B) Allocation of basis increase. --

Any increase in basis attributable to the gain described in subparagraph (A)(ii) shall be allocated to marketable securities in proportion to their respective amounts of unrealized appreciation before such increase.

(5) Subsection disregarded in determining basis of partner's interest in partnership and of basis of partnership property. --

Sections 733 and 734 shall be applied as if no gain were recognized, and no adjustment were made to the basis of property, under this subsection.

(6) Character of gain recognized. --

In the case of a distribution of a marketable security which is an unrealized receivable (as defined in section 751(c)) or an inventory item (as defined in section 751(d)(2)), any gain recognized under this subsection shall be treated as ordinary income to the extent of any increase in the basis of such security attributable to the gain described in paragraph (4)(A)(ii).

(7) Regulations. --

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations to prevent the avoidance of such purposes.

(d) Exceptions

This section shall not apply to the extent otherwise provided by section 736 (relating to payments to a retiring partner or a deceased partner's successor in interest) section 751 (relating to unrealized receivables and inventory items), and section 737 (relating to recognition of precontribution gain in case of certain distributions).

Sec. 732. Basis of distributed property other than money

(a) Distributions other than in liquidation of a partner's interest

(1) General rule

The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest shall, except as provided in paragraph (2), be its adjusted basis to the partnership immediately before such distribution.

(2) Limitation

The basis to the distributee partner of property to which paragraph (1) is applicable shall not exceed the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(b) Distributions in liquidation

The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction.

(c) Allocation of basis

The basis of distributed properties to which subsection (a)(2) or subsection (b) is applicable shall be allocated--

(1) first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) in an amount equal to the adjusted basis of each such property to the partnership (or if the basis to be allocated is less than the sum of the adjusted bases of such properties to the partnership, in proportion to such bases), and

(2) to the extent of any remaining basis, to any other distributed properties in proportion to their adjusted bases to the partnership.

(d) Special partnership basis to transferee

For purposes of subsections (a), (b), and (c), a partner who acquired all or a part of his interest by a transfer with respect to which the election provided in section 754 is not in effect, and to whom a distribution of property (other than money) is made with respect to the transferred interest within 2 years after such transfer, may elect, under regulations prescribed by the Secretary, to treat as the adjusted partnership basis of such property the adjusted basis such property would have if the adjustment provided in

section 743(b) were in effect with respect to the partnership property. The Secretary may by regulations require the application of this subsection in the case of a distribution to a transferee partner, whether or not made within 2 years after the transfer, if at the time of the transfer the fair market value of the partnership property (other than money) exceeded 110 percent of its adjusted basis to the partnership.

(e) Exception

This section shall not apply to the extent that a distribution is treated as a sale or exchange of property under section 751(b) (relating to unrealized receivables and inventory items).

Sec. 733. Basis of distributee partner's interest

In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by--

(1) the amount of any money distributed to such partner, and

(2) the amount of the basis to such partner of distributed property other than money, as determined under section 732.

Sec. 734. Optional adjustment to basis of undistributed partnership property

(a) General rule

The basis of partnership property shall not be adjusted as the result of a distribution of property to a partner unless the election, provided in section 754 (relating to optional adjustment to basis of partnership property), is in effect with respect to such partnership.

(b) Method of adjustment

In the case of a distribution of property to a partner, a partnership, with respect to which the election provided in section 754 is in effect, shall--

(1) increase the adjusted basis of partnership property by--

(A) the amount of any gain recognized to the distributee partner with respect to such distribution under section 731(a)(1), and

(B) in the case of distributed property to which section 732(a)(2) or (b) applies, the excess of the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by section 732(d)) over the basis of the distributed property to the distributee, as determined under section 732, or

(2) decrease the adjusted basis of partnership property by--

(A) the amount of any loss recognized to the distributee partner with respect to such distribution under section 731(a)(2), and

(B) in the case of distributed property to which section 732(b) applies, the excess of the basis of the distributed property to the distributee, as determined under section 732, over the adjusted basis of the distributed property to the partnership immediately before such distribution (as adjusted by section 732(d)).

Paragraph (1)(B) shall not apply to any distributed property which is an interest in another partnership with respect to which the election provided in section 754 is not in effect.

(c) Allocation of basis

The allocation of basis among partnership properties where subsection (b) is applicable shall be made in accordance with the rules provided in section 755.

Sec. 735. Character of gain or loss on disposition of distributed property

(a) Sale or exchange of certain distributed property

(1) Unrealized receivables

Gain or loss on the disposition by a distributee partner of unrealized receivables (as defined in section 751(c)) distributed by a partnership, shall be considered as ordinary income or as ordinary loss, as the case may be.

(2) Inventory items

Gain or loss on the sale or exchange by a distributee partner of inventory items (as defined in section 751(d)(2)) distributed by a partnership shall, if sold or exchanged within 5 years from the date of the distribution, be considered as ordinary income or as ordinary loss, as the case may be.

(b) Holding period for distributed property

In determining the period for which a partner has held property received in a distribution from a partnership (other than for purposes of subsection (a)(2)), there shall be included the holding period of the partnership, as determined under section 1223, with respect to such property.

(c) Special rules

(1) Waiver of holding periods contained in section 1231

For purposes of this section, section 751(d)(2) (defining inventory item) shall be applied without regard to any holding period in section 1231(b).

(2) Substituted basis property

(A) In general

If any property described in subsection (a) is disposed of in a nonrecognition transaction, the tax treatment which applies to such property under such subsection shall also apply to any substituted basis property resulting from such transaction. A similar rule shall also apply in the case of a series of nonrecognition transactions.

(B) Exception for stock in C corporation

Subparagraph (A) shall not apply to any stock in a C corporation received in an exchange described in section 351.

Sec. 736. Payments to a retiring partner or a deceased partner's successor in interest

(a) Payments considered as distributive share or guaranteed payment

Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, except as provided in subsection (b), be considered--

(1) as a distributive share to the recipient of partnership income if the amount thereof is determined with regard to the income of the partnership, or

(2) as a guaranteed payment described in section 707(c) if the amount thereof is determined without regard to the income of the partnership.

(b) Payments for interest in partnership

(1) General rule

Payments made in liquidation of the interest of a retiring partner or a deceased partner shall, to the extent such payments (other than payments described in paragraph (2)) are determined, under regulations prescribed by the Secretary, to be made in exchange for the interest of such partner in partnership property, be considered as a distribution by the partnership and not as a distributive share or guaranteed payment under subsection (a).

(2) Special rules

For purposes of this subsection, payments in exchange for an interest in partnership property shall not include amounts paid for--

(A) unrealized receivables of the partnership (as defined in section 751(c)), or

(B) good will of the partnership, except to the extent that the partnership agreement provides for a payment with respect to good will.

(3) Limitation on application of paragraph (2). --

Paragraph (2) shall apply only if --

(A) capital is not a material income-producing factor for the partnership, and

(B) the retiring or deceased partner was a general partner in the partnership.

(c) [Stricken]

Sec. 737. Recognition of Precontribution Gain In Case of Certain Distributions To Contributing Partner.

(a) General rule.

In the case of any distribution by a partnership to a partner, such partner shall be treated as recognizing gain in an amount equal to the lesser of --

(1) the excess (if any) of (A) the fair market value of property (other than money) received in the distribution over (B) the adjusted basis of such partner's interest in the partnership immediately before the distribution reduced (but not below zero) by the amount of money received in the distribution, or

(2) the net precontribution gain of the partner.

Gain recognized under the preceding sentence shall be in addition to any gain recognized under section 731. The character of such gain shall be determined by reference to the proportionate character of the net precontribution gain.

(b) Net precontribution gain.

For purposes of this section, the term "net precontribution gain" means the net gain (if any) which would have been recognized by the distributee partner under section 704(c)(1)(B) if all property which --

(1) had been contributed to the partnership by the distributee partner within 5 years of the distribution, and

(2) is held by such partnership immediately before the distribution,

had been distributed by such partnership to another partner.

(c) Basis rules. --

(1) Partner's interest.

The adjusted basis of a partner's interest in a partnership shall be increased by the amount of any gain recognized by such partner under subsection (a). For purposes of determining the basis of the distributed property (other than money), such increase shall be treated as occurring immediately before the distribution.

(2) Partnership's basis in contributed property.

Appropriate adjustments shall be made to the adjusted basis of the partnership in the contributed property referred to in subsection (b) to reflect gain recognized under subsection (a).

(d) Exceptions.

(1) Distributions of previously contributed property.

If any portion of the property distributed consists of property which had been contributed by the distributee partner to the partnership, such property shall not be taken into account under subsection (a)(1) and shall not be taken into account in determining the amount of the net precontribution gain. If the property distributed consists of an interest in an entity, the preceding sentence shall not apply to the extent that the value of such interest is attributable to property contributed to such entity after such interest had been contributed to the partnership.

(2) Coordination with section 751.

This section shall not apply to the extent section 751(b) applies to such distribution.

(e) Marketable securities treated as money. --

For treatment of marketable securities as money for purposes of this section, see section 731(c).

Subpart C -- Transfers of interests in a partnership

Sec. 741. Recognition and character of gain or loss on sale or exchange

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).

Sec. 742. Basis of transferee partner's interest

The basis of an interest in a partnership acquired other than by contribution shall be determined under part II of subchapter O (sec. 1011 and following).

Sec. 743. Optional adjustment to basis of partnership property

(a) General rule

The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to such partnership.

(b) Adjustment to basis of partnership property

In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 754 is in effect shall--

(1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, or

(2) decrease the adjusted basis of the partnership property by the 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.

Under regulations prescribed by the Secretary, such increase or decrease shall constitute an adjustment to the basis of partnership property with respect to the transferee partner only. A partner's proportionate share of the adjusted basis of partnership property shall be determined in accordance with his interest in partnership capital and, in the case of property contributed to the partnership by a partner, section 704(c) (relating to contributed property) shall apply in determining such share. In the case of an adjustment under this subsection to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for the transferee partner with respect to his interest in such property.

(c) Allocation of basis

The allocation of basis among partnership properties where subsection (b) is applicable shall be made in accordance with the rules provided in section 755.

Subpart D -- Provisions common to other subparts

Sec. 751. Unrealized receivables and inventory items

(a) Sale or exchange of interest in partnership

The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to--

(1) unrealized receivables of the partnership, or

(2) inventory items of the partnership which have appreciated substantially in value,

shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

(b) Certain distributions treated as sales or exchanges

(1) General rule

To the extent a partner receives in a distribution--

(A) partnership property described in subsection (a)(1) or (2) in exchange for all or a part of his interest in other partnership property (including money), or

(B) partnership property (including money) other than property described in subsection (a)(1) or (2) in exchange for all or a part of his interest in partnership property described in subsection (a)(1) or (2),

such transactions shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

(2) Exceptions

Paragraph (1) shall not apply to--

(A) a distribution of property which the distributee contributed to the partnership, or

(B) payments, described in section 736(a), to a retiring partner or successor in interest of a deceased partner.

(c) Unrealized receivables

For purposes of this subchapter, the term "unrealized receivables" includes, to the extent not previously includible in income under the method of accounting used by the partnership, any rights (contractual or otherwise) to payment for--

(1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or

(2) services rendered, or to be rendered.

For purposes of this section and, sections 731 and 741 (but not for purposes of section 736), such term also includes mining property (as defined in section 617(f)(2)), stock in a DISC (as described in section 992(a)), section 1245 property (as defined in section 1245(a)(3)), stock in certain foreign corporations (as described in section 1248), section 1250 property (as defined in section 1250(c)), farm land (as defined in section 1252(a)), franchises, trademarks, or trade names (referred to in section 1253(a)), and an oil, gas, or geothermal property (described in section 1254) but only to the extent of the amount which would be treated as gain to which section 617(d)(1), 995(c), 1245(a), 1248(a), 1250(a), 1252(a), 1253(a), or 1254(a) would apply if (at the time of the transaction described in this section or section 731 or 741, as the case may be) such property had been sold by the partnership at its fair market value. For purposes of this section and, sections 731 and 741 (but not for purposes of section 736), such term also includes any market discount bond (as defined in section 1278) and any short-term obligation (as defined in section 1283) but only to the extent of the amount which would be treated as ordinary income if (at the time of the transaction described in this section or section 731 or 741, as the case may be) such property had been sold by the partnership.

(d) Inventory items which have appreciated substantially in value

(1) Substantial appreciation. --

(A) In general. --

Inventory items of the partnership shall be considered to have appreciated substantially in value if their fair market value exceeds 120 percent of the adjusted basis to the partnership of such property.

(B) Certain property excluded. --

For purposes of subparagraph (A), there shall be excluded any inventory property if a principal purpose for acquiring such property was to avoid the provisions of this section relating to

inventory items.

(2) Inventory items

For purposes of this subchapter the term "inventory items" means--

(A) property of the partnership of the kind described in section 1221(1),

(B) any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231,

(C) any other property of the partnership which, if sold or exchanged by the partnership, would result in a gain taxable under subsection (a) of section 1246 (relating to gain on foreign investment company stock), and

(D) any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described in subparagraph (A), (B), or (C).

(e) Limitation on tax attributable to deemed sales of section 1248 stock

For purposes of applying this section and sections 731 and 741 to any amount resulting from the reference to section 1248(a) in the second sentence of subsection (c), in the case of an individual, the tax attributable to such amount shall be limited in the manner provided by subsection (b) of section 1248 (relating to gain from certain sales or exchanges of stock in certain foreign corporation).

(f) Special rules in the case of tiered partnerships, etc.

In determining whether property of a partnership is--

(1) an unrealized receivable, or

(2) an inventory item,

such partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner. Under regulations, rules similar to the rules of the preceding sentence shall also apply in the case of interests in trusts.

Sec. 752. Treatment of certain liabilities

(a) Increase in partner's liabilities

Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(b) Decrease in partner's liabilities

Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

(c) Liability to which property is subject

For purposes of this section, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property.

(d) Sale or exchange of an interest

In the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.

Sec. 753. Partner receiving income in respect of decedent

The amount includible in the gross income of a successor in interest of a deceased partner under section 736(a) shall be considered income in respect of a decedent under section 691.

Sec. 754. Manner of electing optional adjustment to basis of partnership property

If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in section 734 and, in the case of a transfer of a partnership interest, in the manner provided in section 743. Such an election shall apply with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent taxable years. Such election may be revoked by the partnership, subject to such limitations as may be provided by regulations prescribed by the Secretary.

Sec. 755. Rules for allocation of basis

(a) General rule

Any increase or decrease in the adjusted basis of partnership

property under section 734(b) (relating to the optional adjustment to the basis of undistributed partnership property) or section 743(b) (relating to the optional adjustment to the basis of partnership property in the case of a transfer of an interest in a partnership) shall, except as provided in subsection (b), be allocated--

(1) in a manner which has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties, or

(2) in any other manner permitted by regulations prescribed by the Secretary.

(b) Special rule

In applying the allocation rules provided in subsection (a), increases or decreases in the adjusted basis of partnership property arising from a distribution of, or a transfer of an interest attributable to, property consisting of--

(1) capital assets and property described in section 1231(b), or

(2) any other property of the partnership,

shall be allocated to partnership property of a like character except that the basis of any such partnership property shall not be reduced below zero. If, in the case of a distribution, the adjustment to basis of property described in paragraph (1) or (2) is prevented by the absence of such property or by insufficient adjusted basis for such property, such adjustment shall be applied to subsequently acquired property of a like character in accordance with regulations prescribed by the Secretary.

Part III -- Definitions

Sec. 761. Terms defined

(a) Partnership

For purposes of this subtitle, the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a corporation or a trust or estate. Under regulations the Secretary may, at the election of all the members of an unincorporated organization, exclude such organization from the application of all or part of this subchapter, if it is availed of--

(1) for investment purposes only and not for the active conduct of a business,

(2) for the joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted, or

(3) by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities,

if the income of the members of the organization may be adequately determined without the computation of partnership taxable income.

(b) Partner

For purposes of this subtitle, the term "partner" means a member of a partnership.

(c) Partnership agreement

For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.

(d) Liquidation of a partner's interest

For purposes of this subchapter, 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.

(e) Distributions of partnership interests treated as exchanges

Except as otherwise provided in regulations, for purposes of--

(1) section 708 (relating to continuation of partnership),

(2) section 743 (relating to optional adjustment to basis of partnership property), and

(3) any other provision of this subchapter specified in regulations prescribed by the Secretary,

any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange.

(f) Cross reference

For rules in the case of the sale, exchange, liquidation, or reduction of a partner's interest, see sections 704(b) and 706(c)(2).