



# Exiting a Partnership the “Right” Way:

## How to Exit a Partnership in a Tax-Efficient Manner

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# Notice

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# Agenda

- 1 Introduction to Liquidating Distributions
- 2 Recognition of Gain/Loss on Liquidating Distributions
- 3 Basis of Property Distributed in Liquidating Distributions
- 4 Exceptions to Nonrecognition of Liquidating Distributions
- 5 Alternative Nonrecognition Exit Strategies

**01**

Distributions in  
Liquidation  
of a Partnership  
Interest:

Introduction

# General Nonrecognition Treatment of Partnership Distributions

- Section 731 generally provides nonrecognition treatment (no gain or loss recognized) to the transferor and transferee when a partnership distributes cash or property to a partner.
  - Consistent with passthrough nature of partnership taxation & flexibility of partnership form
- Section 731(b): Nonrecognition for partnerships
  - Partnership does not recognize gain or loss on a distribution of property to a partner in liquidation of the partner's interest (a "liquidating distribution") or otherwise (a "current distribution")
- Section 731(a) Nonrecognition for partners
  - Partner does not recognize gain on a distribution of property from partnership, except for any money distributed in excess of the adjusted basis of the partner's interest prior to distribution
  - Partner may recognize loss in certain cases involving liquidating distributions of money, unrealized receivables, or inventory (or combination thereof)
- Subchapter K contains a host of exceptions to the section 731 nonrecognition rule

# Current Distributions versus Liquidating Distributions

- Current Distributions
  - Any distribution that does not terminate a partner's entire interest. Treas. Reg. § 1.761-1(d)
  - Includes distributions in partial liquidation of a partner's interest and distributions of a partner's distributive share of partnership items
- Liquidating Distributions
  - Completely terminates partner's interest in the partnership.
  - Can be a single terminating distribution or a series of distributions culminating in termination
- Rules only available for liquidating distributions
  - Loss recognition to partner (only for liquidating distribution of money and/or section 751(b) property and no other property)
  - Basis adjustment under section 732(b) for the disparities between inside basis (in the partnership property) and outside basis (in the partner's interest)

# Series of Liquidating Distributions

- A liquidating distribution can be effected through a series of payments over multiple years
- No gain is recognized until the cumulative distributions exceed partner's outside basis
  - Compare to section 453 installment sale treatment, where the total gain is spread out and a portion is recognized on each payment.
  - Thus, a series of liquidating distributions more closely resembles a liquidating distribution by the partnership to the partner of a note receivable
- The distributee remains a partner for USFIT purposes for all future years until the series of liquidating distributions is complete, even if no longer a partner for state law purposes
- *EXAMPLE:*

**Facts:** Partner C has an adjusted basis in Partnership D of \$40,000. As part of a series of liquidating distributions, Partner C receives \$20,000 in cash in year one, \$15,000 in cash in year two, and \$10,000 in cash in year three.

**Result:** C only recognizes gain in year three, when the cumulative distributions of \$45,000 exceed C's outside basis of \$40,000.

# Distributions versus Guaranteed Payments

- Guaranteed payments under section 707(c) are those received by a partner from a partnership for services or the use of capital that are determined without regard to the income of the partnership
- Guaranteed payments are taxed as ordinary income to the recipient partner under section 61(a)
- Character creates important tax implications for classification of a payment as either a guaranteed payment (ordinary income) or a distribution (return of capital, generating capital gain if in excess of partner's outside basis)
- Complex economic arrangements in certain partnership agreements can create uncertainty in classifying payments under the agreement as either a guaranteed payment or a distribution
  - E.g., often not clear whether certain payments to partners are determined “without regard to the income of the partnership”



# Section 736 Withdrawal Payments

- Section 736 applies to payments made by a partnership to a retiring partner or to a deceased partner's successor-in-interest in liquidation of such partner's interest in the partnership, and are either taxed under section 736(b) or section 736(a).
- Section 736(b) provides that if such payments are deemed made in exchange for partnership property, are considered liquidating distributions (with certain exceptions for general partners where capital not a material income-producing factor)
- Section 736(a) provides that all other such payments are either a distributive share (if with regard to partnership income) or a guaranteed payment (if without regard to partnership income)
- Similar tax implications due to differences in character:
  - Section 736(b) payments yield capital gain (to the extent exceeding partner's outside basis)
  - Section 736(a) payments will generally be taxed as ordinary income

02

Liquidating  
Distributions:

Recognition of Gain or  
Loss

# Loss Recognition Upon Liquidation: Section 731(a)(2)

- Section 731(a)(2) allows a partner receiving a liquidating distribution to recognize a loss in respect of its partnership interest only if the distribution consists solely of money, unrealized receivables, or inventory (or a combination thereof).
  - If any other property distributed in connection with the liquidation, no loss may be recognized
- If met, loss may be taken to the extent the partner's adjusted basis in its interest exceeds the total amount of money, unrealized receivables, and inventory received.
- Losses generally treated as capital, with exceptions including section 751(b) hot assets.
- *EXAMPLE: Distribution of Hot Assets*

**Facts:** Partner L has a \$25,000 basis in Partnership M.

**L receives \$20,000 in unrealized receivables in a liquidating distribution from M.**

**Result:** L recognizes a \$5,000 ordinary loss as attributable to the receivables

# Loss Recognition Upon Liquidation: Examples

## *EXAMPLE: Distribution of Cash and Inventory*

### Facts:

- Partner J has a \$70,000 adjusted basis in Partnership S.
- In liquidation of J's partnership interest, S distributes \$50,000 in cash and \$10,000 of inventory to J.

### Result:

- The total distribution is \$60,000, which is \$10,000 less than J's \$70,000 adjusted basis.
- Because the distribution is liquidating and consists only of cash and inventory, J recognizes a \$10,000 capital loss

## *EXAMPLE: Distribution of Cash, Inventory & RE*

### Facts:

- Partner K has a \$50,000 basis in Partnership R.
- In a liquidating distribution to K, R distributes to K \$10,000 of cash, \$20,000 of inventory, and \$15,000 of real property.

### Result:

- Though the \$45,000 total distribution does not exceed K's adjusted basis in R, no loss is recognized because real property was included in the distribution

# Gain Recognition Upon Liquidation: Section 731(a)(1)

- Gain on Liquidating Distribution: Money
  - Section 731(a)(1) provides that a partner recognizes gain on a liquidating distribution to the extent the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution
  - The amount of "money" includes cash, "marketable securities" under section 731(c), and any liabilities assumed or relieved as part of the distribution under section 752.
- Gain on Liquidating Distribution: Property
  - No gain is recognized with respect to a distribution of property other than money until the partner sells or otherwise disposes of such property (with exceptions for sections 736 & 751)
- Character of Gain
  - Generally, gain recognized under section 731(a)(1) is capital gain, with certain limited exceptions including for section 751 property (hot assets)

# Gain Recognition Upon Liquidation: Examples

## *EXAMPLE: Distribution of Cash and Inventory*

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03

Liquidating  
Distributions:

Basis of Distributed  
Property

# Basis of Distributed Property: Distributee-Partner

- Under section 732(b), if no gain or loss is recognized on a liquidating distribution, the partner's aggregate basis in any property received equals the basis in the partner's partnership interest immediately prior to the distribution, reduced by the amount of cash and marketable securities distributed.
- Section 732(c) governs the allocation of basis among distributed properties where:
  - Multiple properties are distributed in a liquidating distribution by a partnership or
  - Total aggregate basis of the properties distributed exceeds partner's OB in their interest
- Depreciation and holding periods
  - Distributee partner "steps into the shoes" of the distributor-partnership for any remaining depreciation of property received in liquidating distribution, but only to the extent the partner's basis in the property does not exceed the partnership's basis (any excess treated as newly-acquired property that was placed in service at the time of the distribution)
  - Under section 735(b), when receiving a distribution of property (except inventory), distributee partner adds/"tacks" distributor partnership's own holding period onto its own



# Basis of Distributed Property: Distributee-Partner (Examples)

## *EXAMPLE: Carryover of Inside Basis*

### Facts:

- R is a partner in RST partnership with an adjusted basis in its interest of \$5,500.
- In liquidation of R's interest, RST distributes to R \$1,500 cash plus real estate with FMV of \$5,000 that RST purchased.
- RST has an inside basis of \$3,000 in the RE.

### Result:

- R reduces its \$5,500 adjusted basis in RST by the \$1,500 of cash received.
- Remaining OB of \$4,000 ( $\$5,500 - \$1,500$ ) becomes R's basis in the RE distributed.
- Though the RE has a FMV of \$5,000, R does not recognize any gain/loss under section 732

# Basis of Distributed Property: Distributee-Partner

- Section 732(c) generally allocates partner's OB in their interest proportionately among the properties received in the liquidating distribution, with special rules for inventory and unrealized receivables
- Ordering rules for basis allocation among distributed properties:
  - (1) Reduce partner's OB in their partnership interest by the amount of cash and marketable securities received in the liquidating distribution
  - (2) Allocate any remaining OB after (1) to any unrealized receivables and inventory distributed in an amount equal to the partnership-distributor's inside basis in each such asset
  - (3) Allocate any remaining OB after (2) to the other distributed assets in amounts equal to the partnership's adjusted basis in such assets
  - (4) Any basis increase (the distributee partner's OB in excess of partnership's inside basis in distributed assets) allocated to appreciated assets (other than unrealized receivables and inventory) based on each asset's unrealized appreciation (but not in excess of asset FMV)
  - (5) Any remaining basis increase is allocated to assets (other than unrealized receivables and inventory) in proportion to their FMV

# Basis of Distributed Property: Distributee-Partner (Examples)

## EXAMPLE Basis of Allocation Across Properties

### Facts:

- A is a 25% partner in partnership ABCD with an adjusted basis in its interest of \$650.
- In liquidation of A's interest, ABCD distributes Asset X, Asset Y, and inventory to A.
- Asset X has FMV of \$400 and inside basis to ABCD of \$50. Asset Y has a FMV of \$100 and an inside basis to ABCD of \$100. The inventory has a FMV of \$200 and inside basis to ABCD of \$100.

### Result:

- A does not reduce its basis for any cash received, so allocates its entire adjusted basis of \$650 across Asset X, Asset Y, and the inventory. Under the section 732(c) ordering rules:
  - A's \$650 basis is allocated first to the inventory items in an amount equal to its inside basis (i.e., \$100).
  - Then, A allocates its remaining basis of \$550 (\$650 – \$100) between Asset X and Y.
    - First, \$50 allocated to Asset X and \$100 to Asset Y (equal to their inside basis), leaving \$400 of OB
    - Next, \$350 of basis is allocated to the unrealized appreciation in Asset X (\$400 – \$50).
    - Finally, the last \$50 is allocated between Asset X and Asset Y relative to their FMVs—here, \$40 to Asset X and \$10 to Asset Y (since Asset X is worth 4 times more than Asset Y).
- Final result: A has an adjusted bases of: \$440 in Asset X, \$110 in Asset Y, and \$100 in inventory.

# Basis of Partnership & Remaining Partners: Sections 734 & 754

- Upon a liquidating distribution of property, the partnership and the remaining partners may be entitled to a basis adjustment to remaining partnership property under section 734(b) to reflect the exiting partner's share of the gain or loss in the remaining property
  - This adjustment prevents the redeemed partner's share of gain from being allocated inappropriately to the other remaining partners
- The section 734(b) basis adjustment increases (or *decreases*) the inside basis of the partnership's remaining property by any gain (or *loss*) recognized by distributee partner and any basis decreases (or *increases*) the partner makes under section 732(b) to the assets distributed
- Total amount of such basis increase or decrease is allocated among the bases of the partnership's remaining assets in accordance with the rules of Treas. Reg. § 1.755-1(c)
- Partnership may generally only make a section 734(b) adjustment if it has made a section 754 election in effect for the tax year of the liquidating distribution
  - However, a negative section 734(b) basis adjustment is required, even if the partnership does not have a section 754 election in effect, if the downward adjustment would exceed \$250,000

# Basis of Partnership & Remaining Partners: Examples

## *EXAMPLE: Gain Recognition & Basis Increase*

### Facts:

- Partnership T has a section 754 election in effect.
- Partner M receives a liquidating distribution and recognizes a \$15,000 gain.

### Result:

- Partnership T increases the basis of its remaining assets by \$15,000 under section 734(b) and allocates such basis in accordance with the fair market values of such assets.

## *EXAMPLE: Loss Recognition & Basis Decrease*

### Facts:


- Partner N receives a liquidating distribution from Partnership U and recognizes a \$300,000 loss.

### Result:

- Partnership U decreases the basis of its remaining assets by \$300,000, regardless of whether it has a section 754 election in effect by operation of section 734(d).
- Partnership U allocates such decreases in accordance with the remaining assets' fair market values

04

Liquidating  
Distributions:  
Exceptions to  
Nonrecognition  
Treatment



# Nonrecognition Exception: Distributions of Marketable Securities *Section 731(c)*

# Distributions of Marketable Securities: Section 731(c)

- Section 731(c) treats distributions of “marketable securities” as distributions of money for purposes of determining gain recognition under section 731.
  - Serves to create parity with distributions of cash to prevent avoidance of ordinary gain by distributing items that can immediately be sold for cash instead of distributing actual cash
  - Defined broadly to include stocks, bonds & other readily tradable instruments, with exceptions
- However, amount of marketable securities treated as money is reduced (but not below zero) by distributee partner’s share of the partnership’s unrealized gain in the securities
  - This reduction essentially serves to only treat as money the partner’s disproportionate or non-pro rata share of the gain in the partnership’s marketable securities
  - Under section 731(c)(3)(B), such reduction is equal to the excess of:
    - (1) the distributee partner’s share of net gain that would be realized if all of partnership’s marketable securities held immediately before the distribution were sold, over
    - (2) the distributee partner’s share of the net gain that would be realized if all of partnership’s marketable securities held immediately after the distribution were sold



# Distributions of Marketable Securities: Section 731(c) (*cont.*)

- Basis of the distributed marketable securities equals the basis distributee partner would have taken under section 732 plus the amount of gain recognized.
- Basis is allocated among the distributed marketable securities in proportion to the unrealized appreciation thereof.
- Treas. Reg. § 1.731-2 provides exceptions to marketable securities rules, including:
  - No gain recognition on marketable securities that the partner itself contributed to partnership
  - Certain securities not considered “marketable securities” when acquired by partnership are exempted if they later become marketable securities
  - Exception from definition if (1) the marketable securities were acquired by a partnership in a nonrecognition transaction, (2) less than 20% of the property exchanged by the partnership in such transaction consisted of marketable securities, and (3) the marketable securities are distributed within five years of the acquisition date (or date they became marketable)
  - Exception for distribution of marketable securities by an “investment partnership” (as defined in section 731(c)(3)(C)(i)) to an “eligible partner” (as defined in section 731(c)(3)(C)(iii))

# Distributions of Marketable Securities: Examples

## *EXAMPLE: Distribution of Marketable Securities*

### Facts:

- Partner D has a \$40,000 basis in Partnership Z.
- In liquidation of D's interest, Z distributes to D \$30,000 in cash and marketable securities with a fair market value of \$20,000.

### Result:

- For purposes of section 731(a), the total "money" distributed is \$50,000 (\$30,000 cash plus \$20,000 marketable securities).
- Therefore, D recognizes \$10,000 of gain.

# Distributions of Marketable Securities: Examples

*EXAMPLE: Reduction in Amount Treated as Money*

## Facts:

- Partner A contributes Property (FMV=\$500,000, AB=\$125,000) to Partnership ABC for a one-third interest. Partners B and C contribute a combined \$1,000,000 cash for the remaining two-thirds interest.
- ABC uses the cash to purchase three marketable securities. Several months later, Security #1 has basis of \$200,000 and value of \$250,000. Security #2 has basis of \$150,000 and value of \$200,000. Security #3 has basis of \$175,000 and value of \$150,000. Thus, the net partnership gain would be \$75,000 if all were sold.
- In connection with a liquidating distribution of A's interest, ABC distributes Security #1 to A.

## Result:

- The net gain in Security #2 and Security #3 after the distribution is \$25,000 (\$50,000 gain for Security #2 and \$25,000 loss for Security #3).
- A's share of the net gain on the securities before the distribution was \$25,000 (1/3 of \$75,000), and A's share after the distribution is \$0 (as its interest is liquidated).
- Distribution of Security #1 is treated as a distribution of money equal to its \$250,000 FMV reduced by the \$25,000 reduction in Partner A's share of the net gain in the partnership's marketable securities—\$225,000.
- Thus, A recognizes \$100,000 of gain on the liquidating distribution (i.e., the excess of the \$225,000 distribution of marketable securities treated as money over A's \$125,000 adjusted basis in its interest).



# Nonrecognition Exception: Distributions of Hot Assets *Section 751*

# Distributions of Hot Assets: Section 751

- Section 751 addresses the distribution of so-called “hot assets,” which generally include unrealized receivables and inventory items of the partnership. These are generally taxed at ordinary rates.
  - Unrealized receivables include rights (contractual or other) to payment not otherwise previously included in income for goods or services
  - Inventory items include section 1221(a)(1) property and other partnership property which is not a capital asset or section 1231 property
- Under section 751(b), if a partner receives a distribution of unrealized receivables or “substantially appreciated inventory” (together, “section 751(b) property”) for all or part of partner’s interest in other partnership property, or vice versa (i.e., receives partnership property in exchange for section 751(b) property), this is treated as a sale/exchange of the property between partner & partnership
  - Formally, Treas. Reg. § 1.751-1(b)(3) deems that (1) partner receives a non-liquidating distribution of their share of the receivables, then (2) partner sells the receivables back to the partnership in exchange for cash, with such cash being taxed as ordinary income
  - Essentially, the rule requires sale treatment for distributions where partner gets more or less than their pro rata share of the partnership’s section 751(b) hot assets
  - Purpose: preventing shifting of ordinary income from the hot assets between partners

# Distributions of Hot Assets: Section 751 (*cont.*)

- When a liquidating distribution includes both hot assets and other property, gain must be allocated based on the relative FMVs of each type (section 751 and non-section 751) and the respective partnership bases of the assets
- When a partner receives a distribution of hot assets as part of a liquidating distribution, any gain attributable to the hot assets is recognized as ordinary income rather than capital gain, regardless of the partner's holding period or basis in such item.
- Subsequent sales of distributed property:
  - Section 735(a) generally provides rules for the tax treatment of gain associated with sales of certain hot asset items after such items are distributed by a partnership to a partner
  - Specifically, gain or loss on a subsequent sale of section 751(c) unrealized receivables received by a distributee partner will be treated as ordinary income
  - Section 751(d) inventory items are treated in the same way, regardless of holding period, but only if sold or exchanged within five years of the original distribution to the partner
  - In both cases, if such property is subsequently disposed in a nonrecognition transaction, the ordinary gain rules will apply to any substituted basis property received in the nonrecognition transaction (except for corporate stock received in a section 351 transaction)

# Distributions of Hot Assets: Examples

## *EXAMPLE: Disproportionate Distribution of Cash*

### Facts:

- Partnership XYZ is owned equally by Partners X, Y, and Z, and each partner has an adjusted basis in their interest of \$1,000.
- XYZ owns \$3,000 of cash and a \$3,000 unrealized receivable with a zero basis.
- XYZ distributes \$2,000 cash to Z in liquidation of Z's interest.

### Result:

- Because Z receives \$2,000 of cash instead of his proportionate share of property (i.e., \$1,000 of cash and \$1,000 of receivable), Z is deemed to be exchanging his proportionate \$1,000 receivable for \$1,000 cash.
- Under Treas. Reg. § 1.751-1(b)(3)(iii), Z is deemed to receive a current distribution of Z's share of the receivable (i.e., \$1,000). Since the basis of such receivable is zero, Z's outside basis is not reduced.
- Z is then deemed to sell back the receivable to XYZ for \$1,000 of cash (what Z actually received instead of the \$1,000 receivable). Z recognizes \$1,000 of ordinary income on the deemed taxable exchange.
- Then, the remaining \$1,000 of cash distributed to Z reduces Z's \$1,000 outside basis in XYZ to zero, with no gain or loss recognized in addition to the \$1,000 of ordinary income.



# Distributions of Hot Assets: Examples

## *EXAMPLE: Distribution of Inventory*

### Facts:

- Partnership ABC is owned equally by partners A, B, and C. Partner A's adjusted basis in the partnership interest is \$1,000.
- In liquidation of A's interest, ABC distributes to A \$500 in cash and \$500 of inventory with inside basis to the partnership of \$300.

### Result:

- The \$500 of inventory is A's pro rata share of ABC's section 751(b) property, so that there is no deemed exchange under section 751(b).
- The \$500 cash distribution reduces A's outside basis from \$1,000 to \$500.
- A's basis in the inventory is limited to ABC's pre-distribution inside basis of \$300.
- Therefore, there is \$200 of excess basis after A's adjusted basis of \$1,000 is reduced by \$500 of cash and \$300 basis of inventory. Thus, A recognizes a capital loss of \$200.
- A subsequent sale of the inventory by A will generate ordinary income, just as the gain on the inventory when distributed to A was ordinary in character (as section 751(b) property).





# Nonrecognition Exception: Distributions of Built-in Gain Property

*Section 737 & Section 704 Mixing  
Bowl Rules*

# Distributions of Built-In Gain Property: Sections 737 & 704

- The mixing bowl rules of section 704(c)(1)(B) and section 737 prevent partners from using a partnership to exchange property between themselves through nonrecognition transactions with the partnership when such exchange would otherwise be taxable
  - Thus, the rules trigger income recognition to a partner receiving certain distributions from the partnership
- Section 704(c)(1)(B) governs a mixing bowl transaction where section 704(c) built-in gain property contributed by one partner is distributed to a different partner
  - If section 704(c) property is distributed by the partnership (other than to the contributing partner) within seven years of being contributed, the contributing partner recognizes gain/loss equal to the amount of gain/loss the contributing partner would be allocated under section 704(c)(1)(A) had the partnership sold the section 704(c) property at its FMV on the date of distribution (i.e. its remaining built-in gain/loss).
- Conversely, section 737 governs distributions of *other* property to the *same* partner who contributed built-in gain property
  - A partner who previously contributed built-in gain property to a partnership, upon a distribution of other property to such partner, recognizes any precontribution gain on the original contributed property to the extent the value of property subsequently distributed to the partner exceeds the partner's adjusted basis
  - Section 737 applies whether or not the distribution reduces the partner's interest in the partnership
  - Like section 704(c)(1)(B), does not apply if distribution occurs >7 years after the original contribution

# Distributions of Built-In Gain Property: Examples

*EXAMPLE: Same Property, Different Partner*

## Facts:

- Partner A acquires an interest in Partnership ABC by contributing Property X, nondepreciable real property, to the ABC.
- Property X has FMV of \$10,000 and adjusted basis of \$4,000 and thus is section 704(c) property.
- Three years later, when X is still worth \$10,000 with adjusted basis of \$4,000, ABC distributes X to C in liquidation of C's interest in ABC.

## Result:

- A recognizes gain under section 704(c)(1)(B) since X was distributed to C within 7 years.
- As determined under section 704(c)(1)(A), A's amount of gain recognized is \$6,000.


*EXAMPLE: Different Property, Same Partner*

## Facts:

- Partner A acquires an interest in Partnership ABC by contributing Property Y, nondepreciable real property with FMV of \$10,000 and adjusted basis of \$4,000, to ABC.
- In the same year, Partner B contributes to ABC Property Z, nondepreciable real property with FMV and adjusted basis both equal to \$30,000.
- Five years later, ABC distributes Z to A in liquidation of A's interest. At the time, A's interest is worth \$30,000, Z's FMV is equal to \$30,000, and A's adjusted basis in its partnership interest is \$20,000.

## Result:

- Since the value of Z exceeds A's adjusted basis in its interest at the time of the liquidating distribution, A recognizes a gain of \$6,000 under section 737 (the amount of its precontribution gain in Y)



# Nonrecognition Exception: Distributions of Property Subject to Liabilities *Section 752*

# Distributions of Property Subject to Liabilities: Section 752

- Section 752 governs the treatment of partnership liabilities. In general, section 752(a) provides that any increase in a partner's share of liabilities of a partnership is considered a contribution of money by the partner, thereby increasing the partner's basis under section 705.
- Section 752(b) provides that any decrease in a partner's share of partnership liabilities (or its share of individual liabilities upon assumption by the partnership) is considered a distribution of money to such partner.
  - Thus, when a partner is relieved of partnership liabilities as part of a liquidating distribution, the amount of liability reduction is treated as a distribution of money, potentially triggering section 731(a) gain (if in excess of partners' outside basis).
  - Treas. Reg. § 1.752-1 provides rules for determining the amount of partnership liabilities allocated to each partner and netting increases/decreases in liabilities resulting from the same transaction.
- A partner's share of partnership liabilities is determined immediately before the distribution.
- The amount of liability relief is added to cash and other money distributed to determine if gain is recognized under section 731(a).



# Distributions of Property Subject to Liabilities: Section 752 (cont.)

- When and how a liability is deemed relieved (and thus considered a deemed distribution of cash) depends on whether the liability is a “recourse liability” or a “nonrecourse” liability
  - Treas. Reg. § 1.752-2 and -3 provide rules for allocating recourse and nonrecourse liabilities, respectively, among partners
- Recourse Liabilities
  - A deemed distribution of liability relief in respect of a recourse liability occurs when the distributee partner no longer bears the “economic risk of loss” for such recourse liability
  - Under Treas. Reg. § 1.752-2(b), a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership were constructively liquidated, the partner would be obligated to make a payment due without entitlement to reimbursement by another partner (or related person)
- Nonrecourse Liabilities
  - A deemed distribution of liability relief in respect of a nonrecourse liability occurs when the distributee partner no longer has a share in such nonrecourse liability as computed under Treas. Reg. § 1.752-3(a)
  - In brief, under such rules, a partner’s share of partnership nonrecourse liabilities is the sum of (1) the partner’s share of partnership section 704(b) minimum gain, (2) the amount of taxable gain allocated to the partner under section 704(c) if the partnership disposed of all of its property subject to a nonrecourse liability in a taxable transaction in full satisfaction of such liabilities; and (3) the partner’s share of “excess nonrecourse liabilities” of the partnership (based on its share of partnership profits)

# Distributions of Property Subject to Liabilities: Examples

*EXAMPLE: Liability Relief As Money*

## Facts:

- Partner O has a \$30,000 adjusted basis in Partnership W and is allocated \$20,000 of partnership liabilities of W.
- In liquidation of O's interest, W distributes to O \$10,000 in cash and O is relieved of its \$20,000 of partnership liabilities of W.

## Result:

- The total "money" distributed under section 752(b) is \$30,000, representing \$10,000 of cash plus \$20,000 of liability relief.
- O recognizes no gain or loss on the liquidating distribution since the total money distributed does not exceed O's outside basis in W.

*EXAMPLE: Distribution of Encumbered Property*

## Facts:

- Partnership ABC owns real property subject to a \$100,000 mortgage.
- Partner C is a 50% partner of ABC and has an adjusted basis in ABC of \$100,000.
- ABC distributes the real property subject to the mortgage to C in liquidation of C's interest.

## Result:

- Under section 732(b), the property takes a substitute basis equal to C's adjusted basis in ABC reduced by any money distributed.
- Under section 752(a), C's \$100,000 basis is increased by the assumption of the \$100,000 mortgage to \$200,000.
- C has a deemed distribution of \$50,000 (the reduction in C's 50% share of ABC's liabilities) under section 752(b), reducing the property's basis from \$200,000 to \$150,000.



# Nonrecognition Exception: Disguised Sales of Property

*Section 707*



# Disguised Sales of Property: Section 707

- Section 707(a)(2)(B) address “disguised sales” of property between a partner and partnership, which are generally not afforded such nonrecognition treatment under sections 721 and 731.
- A disguised sale occurs when a partner contributes money or property to a partnership and receives a distribution of money or other property in exchange, under circumstances that indicate that in substance, a sale or exchange has occurred between the partner and the partnership, (rather than a contribution to and a distribution from the partnership).
- The purpose of the disguised sale rules is to prevent partners from structuring otherwise taxable sales or exchanges with a partnership as purported contributions to and distributions from a partnership to inappropriately exploit the nonrecognition treatment of sections 721 and 731.
- Thus, if a liquidating distribution, when viewed together with a corresponding contribution to a partnership, is deemed to be a sale or exchange of property in substance, section 731 nonrecognition treatment does not apply and the transfer is treated as a taxable sale of property
- Partial disguised sales can occur based on the FMV of the property contributed relative to the amount of money received by the partner in the subsequent distribution.
  - A partner deemed to sell only a portion of certain property to the partnership in a disguised sale is considered as contributing the remaining portion under section 721 in a nonrecognition transaction (subject to other exceptions)

# Disguised Sales of Property: Section 707

- Disguised sale treatment is based the facts and circumstances of each set of transactions, and certain factors are considered under the rules, including whether:
  - Timing and amount of transfer to contributing partner are determinable with reasonable certainty;
  - Transferor partner has a legally enforceable right to the subsequent transfer by the partnership;
  - Right to receive the subsequent transfer of money/consideration by the partnership is secured; and
  - Transfer of money is disproportionately large relative to partner's continuing interest in partnership profits.
- Certain transactions are presumed by the rules to be a disguised sale
  - Transfer of property by partnership within two years of prior transfer to money to the partnership presumed to be disguised sale unless the facts and circumstances clearly establish otherwise
- Other transactions presumed *not* to be a disguised sale unless established otherwise, including:
  - Transfers occurring more than two years apart
  - Reasonable guaranteed payments
  - Reasonable preferred returns
  - Distributions of operating cash flow
  - Reimbursements of preformation capital expenditures
  - Debt-financed distributions

# Distributions of Property Subject to Liabilities: Examples

*EXAMPLE: Presumed Disguised Sale*

## Facts:

- Partner R contributes appreciated property to Partnership T and, several months later, R receives a distribution of other partnership property from T.

## Result:

- Because R's contribution and the T's distribution are within two years, the distribution of property is presumed to be a sale unless the facts and circumstances clearly establish otherwise.
- If so, the transaction is recharacterized as a sale, and R recognizes gain on the appreciated property.
- R may be able to rebut such presumption and avoid disguised sale treatment by showing, for example, that its contribution to T was made to supply permanent capital to meet a legitimate business need of the partnership


*EXAMPLE: Safe Harbor Exception to Disguised Sale*

## Facts:

- Partner S contributes property to Partnership U.
- One year later, S receives a distribution of cash from U because U has generated profit from its business operations.

## Result:

- Under the operating cash flow distribution presumption of Treas. Reg. § 1.707-4(b), the distribution may not be treated as a disguised sale unless the facts and circumstances clearly establish otherwise.



# Nonrecognition Exception: Distributions to Corporate Partners

*Section 732(f)*

# Distributions to Corporate Partners: Section 732(f)

- A distributee partner that is a corporation may recognize gain under the rules of section 732(f) if such partner receives, in a partnership distribution, stock of another corporation and such corporate partner controls (within the meaning of section 1504(a)(2)) such distributed corporation after the partnership distribution
- In in such case, if the partnership's adjusted basis in the stock of the distributed corporation exceeds the corporate partner's adjusted basis in the same stock, then the basis of the distributed corporation's property is reduced (with certain limitations)
  - If such reduction exceeds the aggregate adjusted bases of the property of the distributed corporation, then the corporate partner:
    - Recognizes such excess as long-term capital gain, and
    - Increases its adjusted basis in the stock of the distributed corporation by the amount of such excess.
- A distributee corporate partner may also recognize gain under the rules of section 337(d) if such corporate partner receives its own stock in a distribution by a partnership

# Distributions to Corporate Partners: Examples

*EXAMPLE: Distribution of Stock to Corporate Partner*

## Facts:

- Partnership L has two partners, M, an individual, and N, a corporation.
- N's adjusted basis in L is \$100,000.
- L owns, among other assets, stock of corporation O with inside basis to L of \$150,000. O's basis in its own assets is \$40,000.
- L distributes its O stock to N in liquidation of N's partnership interest, and after the distribution N owns 100% of O.

## Result:

- Section 732(f) applies because N controls O after the liquidating distribution.
- L's inside basis in O exceeds N's carryover basis in the O stock (i.e., its own adjusted basis of \$100,000) by \$50,000.
- Therefore, the basis of O's assets are reduced by \$40,000 (the total amount of O's basis) to zero, and N recognizes the remaining \$10,000 (\$50,000 – \$40,000) in excess of basis as capital gain.
- N increases its adjusted basis of its O stock by the \$10,000 excess.

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# Alternative Nonrecognition Exit Strategies

# Alternative #1: Leveraged Distributions

- A leveraged distribution (or debt-financed distribution) by a partnership can be used as an alternative to a taxable distribution to a partner
  - This can be effective, for example, where a partner does not have sufficient outside basis to absorb a liquidating cash distribution under section 731(a)
- When properly structured, a leveraged distribution permits a partnership to distribute cash proceeds of a loan to a partner tax-free
  - This allows the distributee partner to unlock the value of their partnership interest without recognizing gain
- In a leveraged distribution, a partnership assumes debt and distributes the proceeds to a partner, with such distributee partner personally guaranteeing the debt
  - This allows the partner to unlock the value of their partnership interest without recognizing any gain in the partnership's assets



# Leveraged Distributions: Example

## Facts:

- Partner A and Partner B form Partnership AB. A contributes appreciated assets with basis of \$1,000 and FMV of \$10,000 for a 50% interest in AB. B contributes cash of \$10,000 for other 50% interest in AB.
- A wishes to unlock the value of the appreciated assets it contributed without taking a distribution from or triggering the disguised sale rules. A and AB can accomplish this through a leveraged distribution.

## Leveraged Distribution Steps:

- AB obtains a nonrecourse loan in the amount of \$10,000. A guarantees the full amount of the loan, which increases A's basis in AB by \$10,000 (the amount of the guarantee).
- AB distributes the \$10,000 proceeds of the loan to A, decreasing A's basis in AB by \$10,000. If made within 90 days and traceable to the loan proceeds, this distribution is tax free to A under the debt-financed distribution exception to the disguised sale rules.

## Result:

- A now has loan proceeds to use for A's own purposes without having to recognize the gain from the appreciated asset A contributed to AB.
- Any principal payments AB makes on the loan are deemed distributions to A in the amount of the corresponding debt reduction of such payment. This would further reduce A's basis in AB.

# Alternative #2: Direct Property Purchase/Distribution by Partnership

- Available where a partner seeking redemption has identified the asset or property that it ultimately seeks to acquire with the proceeds of the liquidating distribution.
- Steps:
  - Prior to the liquidating distribution, partner identifies ultimate property it wishes to obtain
  - Partnership purchases property directly and distributes it to the partner in liquidation
  - Partner transfers its outside basis in its partnership interest over to the new property rather than recognizing gain (which would reduce the proceeds available to purchase the property)
- Caveats:
  - This asset cannot be a marketable security subject to section 731(c).
  - IRS has disclaimed this strategy under certain facts in at least one Chief Counsel Advisory
    - “A carryover basis is not appropriate for a unique parcel of residential property that was apparently selected by the distributee, acquired by the partnership immediately before the distribution, solely for the purpose of the distribution, and was unrelated to the partnership's business activities.” IRS CCA 200650014
    - But, IRS also noted here the partnership was likely never the true owner for USFIT purposes, since a large portion of purchase price was borrowed by partnership and immediately repaid by the partner.

# QUESTIONS?



A low-angle, upward-looking photograph of a cable-stayed bridge. The bridge's concrete deck and steel cables are visible, extending from the bottom towards the top of the frame. A large, solid blue rectangle is positioned on the left side of the image, partially obscuring the bridge structure. Inside this rectangle, the words "Thank you!" are written in a white, sans-serif font.

Thank you!



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