

**Chapter 11 – Partnership: Distributions,  
Transfers of Interest, and Termination (2012 edition)**

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## Learning Objectives:

- Determine the tax treatment of nonliquidating partnership distributions.
  - Describe the general concepts governing the tax treatment of disproportionate distributions.
  - Determine the tax treatment of liquidating partnership distributions.
  - Determine the tax treatment of income/property payments to a retiring or deceased partner.
  - Calculate the selling partner's amount & character of gain or loss on the sale of a partnership interest.
  - Outline the methods of terminating a partnership.
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***I. Distributions from a Partnership – In General***

A. All distributions of cash and property fall into two categories:

1. liquidating distributions
2. nonliquidating distributions

B. A liquidating distribution occurs when either:

1. the partnership itself liquidates and distributes all its property to all of its partners, or
2. an ongoing partnership redeems an interest of one of its partners (e.g., a partner retires or a partner dies)

C. A nonliquidating distribution is any distribution from a continuing partnership to a continuing partner; there are two types of nonliquidating distributions

1. a current distribution or draw – a distribution of partner's share of current or accumulated profits
2. partially liquidating distributions – reduce a partner's interest in partnership capital but does not liquidate partner's interest

D. Furthermore, distributions from a partnership may be either:

1. proportionate – partner receives his or her share of certain ordinary income-producing assets
2. disproportionate – partner's share of certain ordinary income-producing assets increases or decreases (disproportionate distributions involve Sec. 751 or "hot" assets)

## **II. Proportionate Nonliquidating Distributions**

### A. Partnership

1. general rule – no gain or loss is recognized by partnership

### B. Partner

1. general rule – no gain or loss is recognized by partner
2. partner usually takes a carryover basis in the assets distributed
3. distribution is treated as a nontaxable return of capital
4. basis in partnership interest is reduced by the amount of cash and the basis of property distributed (as of the last day of the partnership tax year)
5. partner continues to have a basis in partnership interest (in contrast to a liquidating distribution where basis in partnership interest must go to \$0)
6. exceptions:
  - money received > partner's basis in partnership interest
  - inside basis of property distributed > outside basis in partnership interest
  - property distributed with pre-contribution gain (distribution occurs within 7 years; two triggers)
  - disproportionate distributions of "hot assets" (Sec. 751)

### C. More on the exceptions

1. if money distributed exceeds partner's basis in partnership interest – then the partner recognizes a gain...
  - money received > partner's basis in partnership interest
  - money includes cash, fair value of marketable securities\*, reduction of partnership debt
  - gain = money received – basis in partnership interest

Note\*: May be less than fair value if marketable securities are appreciated.

Note: Partner cannot recognize a loss in a nonliquidating distribution.

2. partner takes a zero basis in any other property distributed

### C. More on the exceptions – continued

#### 2. inside basis of property distributed exceeds partner's outside basis in the partnership interest (outside basis shortfall)

- partner's reduction in basis is limited to pre-distribution basis in partnership
- partner's basis in partnership interest is reduced to zero (basis can never be negative)
- partner receives a substituted basis in assets (not a carryover basis)
- substituted basis in property received is lower than carryover basis
- if multiple assets are distributed, the outside basis shortfall is allocated using the following ordering rules:
  - (1) cash (also includes liability relief in *liquidating* distributions)
  - (2) unrealized receivables (A/R of cash basis taxpayer) and inventory (inventory = all assets except cash, capital assets, or Sec. 1231 property)
  - (3) all other property
- if “within class” allocation of outside basis shortfall is necessary, the following 3 step process is used – often called a “basis decrease formula”:

step one – each asset takes on a carryover basis

step two – assets are reduced to their lower fair values (as appropriate)

step three – remaining reduction in basis is allocated between the assets based on their respective bases (as computed in step two)

### C. more on the exceptions – continued

3. property distributed with a pre-contribution gain (a built-in gain when property was contributed to partnership) – two transactions can trigger the recognition of pre-contribution gain

(a) if the property is distributed to any other partner within 7 years (this exception involves one property and two partners)

- contributing partner recognizes remaining pre-contribution gain (“as if” sold by the partnership to outsiders)
- contributing partner’s basis in the partnership interest is increased by the recognized gain

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- the other partner’s basis in the partnership interest is reduced by the fair value of the property on the date it was contributed to the partnership (the partnership’s carryover basis in the property + contributing partner’s recognized gain)
  - basis of distributed property (in hands of other partner) is equal to the fair value of property on the date contributed to the partnership (the partnership’s carryover basis in the property + contributing partner’s recognized gain)

Note: The text book mentions only pre-contribution gains; however, Code Sec. 704 applies to pre-contribution gains and losses (for property distributed to any other partner within 7 years).

(b) contributing partner receives other property with a fair value greater than his adjusted basis in partnership interest within 7 years (this exception involves one partner and two properties);

contributing partner must recognize a gain = lesser of:

- pre-contribution gain, or
  - fair value of property distributed – adjusted basis of partnership interest
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- basis in property distributed = a carryover basis
  - basis in partnership interest is increased by recognized gain and decreased by the carryover basis in the property distributed
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- basis of property (remaining in hands of partnership) is increased by the contributing partner's recognized gain

Note: Contributing partner does NOT recognize any of the pre-contribution gain if fair value of property distributed < basis in partnership interest.

4. disproportionate distribution of “hot assets” – see item III (below)

#### D. Other tax attributes of property received in distribution

1. holding period of property – includes holding period of partnership interest
2. character of the income
  - unrealized receivable – remains ordinary income to partner (always)
  - inventory – if sold within 5 years, ordinary; after 5 years, it depends on the use of the property in the hands of the partner
  - most other income is capital

### **III. Disproportionate Distributions**

A. Disproportionate distributions occur when a partnership distributes cash or property to a partner which increases or decreases the partner's share of ordinary income-producing assets (Sec. 751 assets or "hot" assets)

B. Hot assets include:

1. substantially appreciated inventory
  - inventory – includes all assets other than cash, capital assets and Sec. 1231 assets
  - substantially appreciated means aggregate fair value > 120% of partnership's aggregate basis in inventory
2. unrealized receivables
  - rights to receive future amounts that will result in ordinary income recognition (includes Sec. 1231 property with Sec. 1245 & Sec. 1250 ordinary income recapture)

C. Disproportionate distributions may result in gain recognition – intended to prevent unwarranted shift of ordinary income among partners

D. If partner receives either more or less than a proportionate share of hot assets, then the transaction is treated "as if":

1. partnership distributed some of the hot asset to the partner, and
2. the partner then sold these hot assets back to the partnership
3. partner recognizes ordinary income on the sale of the hot assets
4. the partnership's basis in the hot assets is "cost"

Note: These distributions will be described briefly, but can get extremely complex.

Note: Sec. 751 affects the character of the income, gain, or loss recognized; NOT the amount of the income, gain, or loss recognized.

#### IV. Liquidating Distributions

- A. Liquidating distribution (defined) – one of a series of distributions that completely terminates a partner's interest in the partnership
- B. May terminate one (or more) partner's interests, or the entire partnership
- C. Property distributions – in general:
1. no gain or loss is recognized by the partner
  2. no gain or loss is recognized by the partnership
  3. partner reduces basis in the partnership interest by basis in the property received at each level using the same ordering rules as nonliquidating distributions:
    - (a) cash (also includes liability relief in *liquidating* distributions)
    - (b) unrealized receivables (A/R of cash basis taxpayer) and inventory (inventory = all assets except cash, capital assets, or Sec. 1231 property)
    - (c) all other property
  4. partner's entire basis in the partnership interest will be absorbed by the distributed assets (partner's basis must be \$0 after the distribution)
  5. ex-partner receives a substituted basis in the distributed assets (defers the recognition of gain or loss until the assets are sold)

Note\*: If partner's remaining outside basis > basis in distributed assets (excess outside basis) a different "within class" allocation of the excess basis is necessary in the "all other property" class. A slightly different 3-step process is used (often called a "basis increase formula"):

step one – assets takes on a carryover basis

step two – assets are increased to their higher fair values (as appropriate)

step three – remaining increase in basis is allocated between assets based on their respective fair values

Note: This 3-step process is only used in the third or "all other property" class. Otherwise taxpayer will recognize a capital loss (See D – 2 on next page).

D. Distribution of cash & ordinary income property – in general:

1. capital gain is recognized by partner when
  - money received > basis in partnership interest
  - money = cash, fair value of marketable securities\*, reduction of partnership debt
  - gain = money received – basis in partnership interest

Note: Pre-contribution gain rules and disproportionate distribution rules still apply (some of the gain may be ordinary income)

2. capital loss is recognized by partner if:
  - distribution consists only of money, unrealized receivables, or inventory (i.e., ordinary income property)  
and
  - partner's basis in assets received < partner's basis in partnership interest

## ***V. More on Liquidating Distributions – Income vs. Property Payment***

A. When partnership does not liquidate (retirement or death of a partner) – amounts distributed must be classified as either an income payment or a property payment

1. income payment (Sec. 736(a))
  - payments made for partnership’s going-concern value
  - treated as distributive share of partnership income or guaranteed payment to partner
  - also includes certain “property” payments (payments for unrealized receivables & goodwill) if partnership is service-provider and retiring partner is a general partner

Note: Service provider (defined) – capital is NOT a material-income producing factor.

2. property payment (Sec. 736(b))
  - payments made for liquidated partner’s share of partnership’s assets
  - does not include certain “property” payments (payments for unrealized receivables & goodwill) if partnership is service-provider and retiring partner is a general partner

B. Tax treatment – income payment

1. partner has:
  - ordinary income (guaranteed payment), or
  - distributive share of income (character flows through to partner)
2. partnership has:
  - guaranteed payment (deductible) if determined without regard to partnership profits
  - distributive share if based on profits

C. Tax treatment – property payment

1. are taxed under the liquidating distribution rules
2. disproportionate distribution to extent of partner’s share in hot assets
3. nontaxable return of basis
4. capital gain (loss) for remainder
5. partnership may not deduct property payments

## **VI. Sale of a Partnership Interest**

### A. Tax treatment – in general

1. results in gain or loss recognition by selling partner
2. treated as the sale of a capital asset
3. gain(loss) = amount realized less partner's basis in partnership interest
4. partnership liabilities assumed by purchasing partner are treated as part of consideration paid for the partnership interest (because they are assumed/acquired by the purchaser)
5. basis calculation for income/loss and liabilities needs to be made up to the date of sale

### B. Effect of hot assets

1. must allocate sales price of partnership interest between "hot" (ordinary income) assets and "nonhot" (capital gain) components
2. gain or loss is calculated separately for the hot assets (creates ordinary income/loss) and non-hot asset (creates capital gain/loss) portions of the transaction

### C. Partnership tax year closes for selling partner on sale date

1. partner's share of income through sale date is calculated
  - can prorate annual income, or
  - can use interim closing of the books
2. income is taxed to selling partner and increases basis in partnership interest

### D. Optional adjustments to property basis (partnership's Sec. 754 election)

1. adjust partnership's basis in assets to reflect:
  - the amount paid by the purchasing partner in excess of his share of the inside basis of partnership assets
  - the gain or loss recognized by partner receiving distribution from partnership (the exiting partner)
  - only the purchasing partner receives benefit from the election
  - will result in special allocations of income/deduction to the purchasing partner in the future
  - because of the additional record keeping the partnership may not want to make a Sec. 754 election
  - once made, the election remains in effect for all future years unless election revoked with IRS consent
2. it is now required if partnership has a "substantial" built-in loss (greater than \$250,000)

## ***VII. Termination of the Partnership***

A. Partnership terminates when either of the following events occur

1. no part of the business continues to be carried on by any partners
2. within a 12-month period, 50% or more of the partnership's capital and profits interests are sold or exchanged
3. one partner in a two-party partnership buys out the other partner (i.e. must have at least TWO partners to have a partnership)
4. the partnership incorporates

B. If a partner completely liquidates (including retirement or death), the partnership tax year closes for that partner only.

Note: The tax code and state laws treat this issue very differently.

## ***VIII. Other Dispositions of Partnership Interests***

### **A. Transfer of a partnership interest to a controlled corporation**

1. tax free if Sec. 351 requirements are met
2. if 50% or more of the total interest in capital and profits of the partnership are transferred, the partnership terminates

### **B. Incorporating a partnership (at least three methods available)**

1. transfer each partner's interest to the corporation in exchange for stock
  - partnership terminates
  - corporation becomes owner of all partnership assets
  - corporation has substituted basis in assets; old partners have substituted basis in stock
2. transfer partnership assets to corporation in exchange for stock and assumption of partnership liabilities
  - partnership distributes stock to partners in liquidating distribution
  - corporation has carryover basis in assets; old partners have substituted basis in stock
3. partnership distributes all assets and liabilities pro rata to partners in complete liquidation of partnership
  - partners transfer assets and liabilities to corporation in exchange for stock under Section 351
  - corporation has substituted basis for assets; partners have substituted basis for stock

Note: All three methods of incorporating a partnership are tax-free (exception: if liabilities of partnership exceed basis of transferred assets)

### **C. Nontaxable like-kind exchange rules do not apply to the exchange of interests in different partnerships**

### **D. Gift of a partnership interest**

1. generally, the gift of a partnership interest is tax-free
2. partnership income, loss, etc. is prorated between donor and donee

### **E. Death of a partner**

1. taxable year of partnership closes with respect to that partner on date of death
2. compute deceased partner's share of partnership income or loss to that date and report on partner's final Form 1040

## ***IX. Limited Liability Companies & Partnerships***

A. Limited liability companies – a LLC with 2 or more owners is taxed as a partnership

1. LLC members are not personally liable for debts of the entity – effectively treated as a limited partnership with no general partners
2. LLCs are relatively new so there is no established body of case law available (makes tax planning difficult)

B. Limited liability partnerships

1. partners are not personally liable for the malpractice and torts of their partners
2. taxable as a partnership
3. conversion of a general partnership into a LLP is not taxable if all of the general partners become LLP partners and hold the same proportionate interest