American Bar Association
Tax Section Webinar

Partnerships: The Fundamentals *Webinar*

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Principal Topics

- Forms of Business Entity and Entity Classification
- Outside v. Inside Basis
- Allocations of Income and Loss
- Sale of Partnership Interests
- Contributions of Property
- Distributions of Property

Forms of Business Entity and Entity Classification

Before Planning Begins

- Ascertain venture characteristics and objectives:
  - Income and cash distribution allocation
  - Decision making and management
  - Liability and debt protection
  - Best structure from a federal, state and local individual income or corporate taxation perspective
  - Family enterprise and succession plans
- Income tax perspective:
  - Profits (or the investment activity) either minimized or deferred
  - Tax losses (or investment losses) used to offset other income
  - Assets be transferred into and out of the entity
- Business (non-tax) perspective:
  - Liabilities limited to the assets of the business and protect owners personally
  - Efficient management structuring
  - Flexible future transferability of ownership

Three Basic Entity Classifications

- Corporation: Subject to double tax (corporate tax + tax on dividends)
  - However, corporations having special tax status, such as S Corporations, REITs and Regulated Investment Companies (mutual funds), may not be subject to corporate tax
- Pass-through: eliminates double taxation of income
  - Partnership:
    - Created through a contract for General Partnership *or* under state law for Limited Partnership
    - Taxable income & loss is allocated among members through "Partnership agreement"
    - To qualify, entity must have 2 or more partners
    - Partnerships tend to have legal personality in the U.S. so that they can own property and be sued
  - LLC:
    - Created under state law
    - Taxable income & loss is allocated among members through an "Operating agreement"
    - In the absence of an election, a domestic LLC is a pass-through for U.S. tax purposes
  - S Corporations:
    - Cannot have more than 100 shareholders
    - Shareholders can only be U.S. individuals, certain trusts and estates
    - Only one class of stock allowed
- Disregarded entity ("DRE"): A Delaware L.L.C. that has only one member
  - If no election, taxable income, gain, loss & foreign tax credits belong to its sole member for tax purposes, but not for other purposes
  - Valuable classification for operations abroad in reducing Controlled Foreign Corporation and other tax concerns

Check the Box ("C.T.B.") Rules: Flexibility under §7701 Regulations

- Default Rules for Most U.S. Entities:
  - If 2 or more members then partnership
    - LP, LLC, PLLC
  - If only 1 member then disregarded entity
- Per se U.S. corporations:
  - State law (e.g., Delaware) corporation
- Election to obtain different tax classification – Form 8832:
  - Generally within 75 days of effective date
  - Corrective late filing within an additional 3 years if –
    - Failure is due to reasonable cause,
    - All tax returns filed timely, &
    - All tax returns prepared as if an election were made
  - Changes
    - Can change initial classification on a prospective basis at any time
    - A non-initial classification election cannot be changed for 5 years

CTB for Foreign Entities

- Default Rules for Most Non-U.S. Entities:
  - If no owner is personally liable for debts of the entity, then classified as Corporation
  - If at least one member is liable for debts of the entity, then
    - If 2 or more members—partnership
    - If 1 member—disregarded entity
- Per se corporations:
  - For each foreign country, regulations designate entity that is always classified as a corporation. (e.g., in Canada, the SA or Canadian Corporation)
- In comparison to a domestic LLC, a foreign LLC defaults to corporate treatment for U.S. tax purposes

Inside v. Outside Basis

Outside Basis

<u>Outside basis</u> (section 722)– a partner's basis in his/her partnership interest

- The basis of property contributed, includes money
- Any gain under section 721(b) if the partnership is an investment company under section 351 (if a corporation)

Liabilities

- Increase in liabilities treated as contribution that increases outside basis (section 752(a))
  - Partner's share of liabilities or
  - Assumption of liability of partnership by a partner
- Decrease in liabilities treated as a distribution and decreases outside basis (section 752(b))
  - Partner's share of partnership liabilities
  - Partner's liability assumed by partnership
- When a partner contributes property subject to a liability, the allocation of that liability will depend on whether the liability is recourse or nonrecourse

Inside Basis

- **<u>Inside basis</u> (section 723)**– partnership’s basis in its assets
  - Partnership inside basis in an asset is initially equal to contributing partner’s basis in the property contributed
  - Adjusted for gain recognized by contributing partner under section 721(b)
- Inside and outside basis differences arise due to:
  - Sale of interests where the partnership does not have a section 754 election or substantial built-in-loss
  - Distribution of assets where the partnership does not have a section 754 election or substantial built-in-loss
  - Step-up in basis due to death of a partner

Allocations of Income and Loss

Partnership is <u>*not*</u> a taxpayer

- Partnership annually files Form 1065, Information Return with the IRS
- Partners are liable for tax on their *allocable* share of their partnership income
- Partners allocated losses from the partnership may be able to use those losses to offset other income (subject to limitations such as the passive activity loss rules)

Schedule K-1

- After year end, each Partner gets Schedule K-1 from the Partnership
- K-1 shows different types of taxable income, gain, loss & deductions allocated to each partner for the prior year
- <u>Question</u>: Will the IRS respect this allocation?
  - Partnership agreement becomes crucial

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☒ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) 2015

Department of the Treasury
Internal Revenue Service

For calendar year 2015, or tax year beginning ________, 2015 ending ________, 20 ____

Partner's Share of Income, Deductions, Credits, etc. ▶ See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
XX-XXXXXX

B Partnership's name, address, city, state, and ZIP code
ABC Properties, L.P.

New York, NY

C IRS Center where partnership filed return
Cincinnati, Ohio

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number
XXX-XX-XXXX

F Partner's name, address, city, state, and ZIP code
Donald T. Taxpayer

New York, NY

G ☐ General partner or LLC member-manager ☒ Limited partner or other LLC member

H ☐ Domestic partner ☐ Foreign partner

I1 What type of entity is this partner? Individual

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	10 %	10 %
Loss	10 %	10 %
Capital	10 %	10 %

K Partner's share of liabilities at year end:
Nonrecourse . . . . $
Qualified nonrecourse financing . $
Recourse . . . . $

L Partner's capital account analysis:

Beginning capital account . . .	$ $1,000
Capital contributed during the year	$
Current year increase (decrease) .	$ ($90)
Withdrawals & distributions . . .	$ ( )
Ending capital account	$ $910

☒ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

M Did the partner contribute property with a built-in gain or loss?
☐ Yes ☒ No
If "Yes," attach statement (see instructions).

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

No.	Item	Amount	No.	Item	Amount
1	Ordinary business income (loss)		15	Credits	
2	Net rental real estate income (loss)	($100)			
3	Other net rental income (loss)		16	Foreign transactions	
4	Guaranteed payments				
5	Interest income	$10			
6a	Ordinary dividends				
6b	Qualified dividends				
7	Royalties				
8	Net short-term capital gain (loss)				
9a	Net long-term capital gain (loss)		17	Alternative minimum tax (AMT) items	
9b	Collectibles (28%) gain (loss)				
9c	Unrecaptured section 1250 gain				
10	Net section 1231 gain (loss)		18	Tax-exempt income and nondeductible expenses	
11	Other income (loss)				
12	Section 179 deduction		19	Distributions	-0-
13	Other deductions		20	Other information	
14	Self-employment earnings (loss)				

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see Instructions for Form 1065. IRS.gov/form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2015

Code §704(b)

- Primary Rule:
  - Look at the partnership agreement
  - Determine if there is Substantial Economic Effect ("SEE")
- Default Rule:
  - If SEE is lacking *or* there is no Partnership Agreement
    - Then the IRS can reallocate the income/loss that matches the Partners' Interests in the Partnership ("PIP")

SEE: Three Part Test in Regulations

(1) Partnership maintains **Capital Accounts** for each partner

(2) Upon **Liquidation,** partners will receive only the amount in the Capital Accounts

(3) Partnership Agreement contains *either*:

  (1) Deficit Restoration Obligation *or*

  (2) Qualified Income Offset provision & loss restrictions

#1: Capital Account Maintenance

- Reflects partner's economic interest in the Partnership
  - Increased by (1) *cash* contributions to partnership & (2) share of taxable income & gain
  - Decreased by (1) *cash* distributions by partnership to partner & (2) share of taxable loss & deductions
  - Increased by FMV of *property* contributions (book value of property)
    - Related adjustments: For capital account purposes,
      - Each year, must re-compute depreciation deductions for that property based on its book value
      - When sell property, re-compute gain/loss based on book value

Capital Account Observation

- Capital account is <u>not</u> the same as the tax basis a partner has for their Partnership Interest
  - Money borrowed by the Partnership is not part of the Capital Account, but is part of the tax basis
    - Basis is similar to purchase price of property & when you buy property subject to debt, the tax basis includes the debt
      - Buy Building for $20 cash & assume $80 debt, tax basis = $100
    - Capital Account reflects your personal investment in the Partnership
      - The $20 cash investment in the Building
  - Use the FMV of Property contributions & distributions

#2: Liquidating Distributions

- Must equal the Capital Accounts
  - The tax allocations have an economic impact on the partner since it effects the cash partners get in liquidation
    - But Capital Accounts do not affect how regular cash distributions from operations are distributed
- Partner concern:
  - By following the capital account for liquidation purposes, a partner may not receive his percentage share of the business
    - Will discuss way to address this later

#3(a): Deficit Restoration Obligation

- On liquidation of the partnership, a partner must contribute cash to the partnership if that partner has a negative (or deficit) Capital Account balance
  - Partnership then distributes cash to partners whose Capital Accounts are positive
- No one uses this!
  - As a result, use alternate tests → →

#3(b): Restrict loss allocations & Qualified Income Offset ("QIO")

- PS Agreement prevents allocating loss to one partner that causes its Capital Account to go negative when another Partner has positive Capital Account
- QIO Provision-Backup:
  - If partner "unexpectedly" gets a distribution or allocation causing its Capital Account to go negative then allocate income to eliminate deficit.
  - QIO provision hardly used

Partners' Interests in the Partnership ("PIP")

- If SEE is lacking or there is no partnership agreement then the IRS re-allocates income/loss among the partners to reflect their PIP, which is based on:
  - Objective Test:
    - Complex test that looks to see what would happen if all partnership properties sold for their book value & partnership liquidates with cash distributed in accordance with capital account balances
  - Subjective Test:
    - If allocations do not meet Objective Test then based on all facts & circumstances (e.g., share of capital contributions, cash flow from partnership)

Alternative: Targeted Tax Allocations

- #1: Liquidating Distributions do *not* follow Capital Accounts
  - Liquidating distributions made in the same way as cash from a sale or another prescribed formula
- #2: Tax Allocations need to be determined to fit into this formula:
  - After the allocations are made & included in Capital Accounts then the Capital Accounts of each partner must equal the amount of cash each partner would get if
    - Partnership sold all its assets for their Book Value;
    - Partnership paid off all its liabilities; &
    - Partnership liquidates & distributes cash in accordance with Capital Account balances

Planning Tip

- Partner’s Obligation to Pay Tax: Partner is allocated taxable income & needs cash to pay their taxes
- Distributions: Under many PS Agreements, Managing Partner has *discretion* as to whether to make distributions to the partners & can decide to not distribute cash
- Tax Distribution Provision: *Requires* Managing Partner to distribute cash to partners so they have cash to pay their taxes

Sale of Partnership Interests

Sale of Partnership Interests

- Generally section 741 provides that the seller will recognize capital gain or loss: *amount realized* – *outside basis*
  - Buyer takes a basis equal to purchase price of interest
- However, the IRS is always looking for situations where “would be” ordinary gain is converted into capital gain
- Thus, section 751(a) provides for recapture, or re-characterization of gain as ordinary gain for certain types of assets referred to as “hot assets”

Sale of Partnership Interests

"Hot assets" include:

1. Inventory
2. Unrealized receivables- defined in section 751(c) and includes,
   - Goods delivered or to be delivered/services rendered or to be rendered- not yet taken into income
   - Recapture items- section 1245 property, section 1250 property, stock in a CFC subject to section 1248

Contribution of Property

AB Partnership Example

- **Formation**
  - A contributes $50 cash
  - B contributes Property with FMV = $50; AB = $10
    - Built-in Gain = $50 - $10 = $40
- **Distributions from Operations & Liquidation**
  - 50% to A & 50% to B
- **Tax Allocations**
  - 50% to A & 50% to B
- **What is the tax impact of B contributing Built-in Gain Property?**
  - Today: Tax impact to B or Partnership on contribution
  - Future: Tax impact on tax allocations

Property Contributions – Non-recognition

- Under § 721, no gain or loss is recognized by a partnership or the partners when contributing property in exchange for a partnership interest.
  - What is property?
  - Upon formation and throughout the partnership
  - No control requirements as in § 351

Tax Basis Impact

- Partnership
  - Carryover basis under §723
    - Inside basis of contributed property =
      - Tax basis of contributed property to contributing partner +
      - Gain, if any, recognized by contributing partner on comtribution
- Contributing Partner
  - Substituted basis under §722
    - Outside basis for partnership interest increased by
      - Amount of money contributed +
      - Tax basis of contributed property +
      - Gain, if any, recognized by contributing partner

§704(b) Capital Account Impact

- B's Capital Account = FMV of contributed property (also called §704(b) Book Value of property)
  - **Book-up** (or book down) capital account to match FMV
- **Tax/Book Disparity**
  - Outside TAX basis for partnership interest = AB of Contributed Property
  - Capital Account = FMV or book value of Property
  - *Requires keeping* 2 sets of books
    - Tax Depreciation & Tax Gain/Loss used to determine Income/Loss reported on K-1
    - Book Depreciation & Book Gain/Loss used for Cap. Acc't

Exceptions to Nonrecognition

- § 721(a) does not apply to:
  - contributions to a “partnership investment company” or
  - “disguised sales” of property under § 707(a) or
  - partnership interest given for services rendered

Exceptions to Nonrecognition

- If partnership ***assumes liability*** in connection with property contribution or property is ***subject to liability***, then partner may recognize gain
  - Gain = Excess of (A) Liability allocated to other partners under § 752, over (B) contributor's basis in her partnership interest. § 731(a)(1), § 741 and 752(b).
  - Gain is treated as gain from sale or exchange of partnership interest and is capital gain unless § 751(b) applies.

Section 704(c) – Introduction

- If basis of contributed property differs from its § 704(b) "book" value, § 704(c)(1)(A) requires income, gain, loss, and deduction with respect to such property to be allocated among partners "to take account of **variation between <u>basis</u> of property to partnership and its <u>FMV</u> at time of contribution**."
  - Regulations require "reasonable method that is consistent with purpose of § 704(c)."
    - § 704(c) principles also apply in context of § 704(b) revaluation, or "book-up," through so-called "reverse § 704(c)."

Interface of Sections 704(b) and (c) – Two Universes

- Purpose of § 704(b): Govern the **economics** - looks to fair market value upon contribution.
- Purpose of § 704(c): Prevent taxable gain or loss inherent in property at time of contribution from being shifted to another partner - looks to the difference between adjusted tax basis and fair market value upon contribution.
- § 704(c) tax allocations are determined after § 704(b) book allocations are determined.

Goal of §704(c)

- Non-contributing partner is generally hurt by the Partnership getting Carryover basis in Contributed Property, and not a FMV Basis
  - Operating Income/Loss:
    - Less depreciation may be allocated to non-contributing partner
  - Gain/loss from Sale
    - More gain (or lower loss) may be allocated to her or
- GOAL:
  - Put Non-contributing Partners in same place they would be in if tax basis of Contributed Property = FMV

If Contributed Property is Not Depreciable

- Only impact of §704(c) is on <u>SALE</u>
  - No impact on income/loss from operations
- In our example, Property = Land
  - Assume it is sold for $80, which results in Gain = $70 ($80 - $70)
  - How is that gain allocated?
    - 1st Apply §704(c) & allocate $40 of that gain (the built in gain) to B
    - 2nd Apply §704(b) for remaining gain of $30
      - Allocate that gain 50% to A & 50% to B
      - A gets $15 of that gain & B gets $15 of that gain
    - Total: $55 gain to B & $15 gain to A
    - Capital Account Increased by such amounts

If Contributed Property is Depreciable Property

- It gets very complex under §704(c) since affects income/loss from OPERATIONS and SALE of Property
  - Can change how you allocate depreciation.

Aside: §704(c)(1)(C) – Built-in Losses

- If § 704(c)(1)(A) property has a built-in loss—
  - such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner
    - Built-in Loss is personal to contributing partner: If Partner B sells partnership interest to Partner C, Partner C cannot share in the built-in loss of Asset X, even if no §754 election to step down basis in Asset X.
  - except as provided in regulations, in determining the amount of items allocated to other partners, the *basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value* at the time of contribution.

Section 704(c) Available Methods

- Big Three:
  - Traditional method.
  - Traditional method with curative allocations.
  - Remedial method.
- Other reasonable methods.

Choice of Method – Impact

- Method affects taxable income.
  - Partners have adverse interests – negotiate method up front.
  - Method chosen more important if property's depreciable tax basis less than noncontributing partner's aggregate share of book value (*i.e.*, ceiling rule).
  - If parties are in different tax positions, choice may result in aggregate tax savings to parties that may be shared (subject to anti-abuse rule).
- Partnership may retain flexibility by: (1) determining method on property-by-property basis; and (2) waiting until partnership must report § 704(c) item on tax return before choosing methods.

Mix and Match Rules

- Different methods allowed for different property.
- Different methods can apply for “forward” § 704(c) and to each layer of “reverse” § 704(c) in the same property.
- Must consistently apply method to item of property.
- Overall mix-and-match must be reasonable.

Traditional Method

- **Operative Rule – "Tax follows book."**
  - *1st Step:* ***Noncontributing*** *partner* receives tax allocations equal to its share of book items.
    - Focus on Tax depreciation & Book depreciation
  - *2nd Step: R*esidual tax allocations shared among **all** partners.
- **Ceiling limitation**.
  - If insufficient tax items, noncontributing partners may not receive tax allocations equal to their share of book items.
- Applies to gain or loss from sale of property and to depreciation and/or amortization; generally, does not apply to *income* from the § 704(c) property (e.g., rent).

Ceiling Rule

- The Rule: Total income, gain, loss or deduction allocated to noncontributing partners with respect to contributed property may not exceed total partnership income, gain, loss or deduction recognized by partnership with respect to that property for the taxable year (the ceiling rule).
- Impact: To the extent that tax items allocated to a noncontributing partner fall short of matching book items allocated to it, a portion of the built-in gain or loss is shifted to such partner.

Traditional Method Example

- Book Depreciation v. Tax (Actual) Depreciation
  - Book Dep. is $10 since *book* basis = $50 FMV
    - Non-contributing partner's (A's) 50% share = $5
  - Tax Dep. is $2 since *tax* basis = $10 (A's share = $1)
    - $2 of total dep. is ceiling on tax depreciation
- How do you allocate Tax Depreciation?
  - Absent §704(c): A only gets $1 dep. rather than $5
  - §704(c) Goal: Get A tax dep. = A's share of book dep. ($5)
    - Specially allocate all $2 dep. to A but A not made whole due to "ceiling" rule
      - $3 dep. shortfall to make A whole

Traditional Method With *Curative Allocations* – Addressing Ceiling Limitations

- Method is designed to help correct distortions created by ceiling rule.
  - Partnerships may make reasonable curative allocations to reduce or eliminate disparities between book and tax items of non-contributing partners.
    - Look to depreciation from other property to fix the problem
- Tax allocations affected only; book allocations are unaffected

Traditional Method With Curative Allocations – Addressing Ceiling Limitations

- Curative allocations must be *reasonable* in amount, timing, and type.
  - *Amount* - Curative allocation can't exceed ceiling distortion for that year (or prior years if cure is for ceiling limitation on disposition).
  - *Timing* - A curative allocation can offset ceiling distortions for prior years if allocation is made over economic life of the property and allocation is provided in partnership agreement at time of contribution.
  - *Type -* Curative allocation must be expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule. Expectation is generally tested at time the property is contributed and the curative allocation is made part of the partnership agreement.

Traditional with Curatives - Example

- Traditional method summary: PS specially allocated $2 tax dep. to A *but* did not get tax dep. = A's share of book dep. ($5)
  - A has $3 tax dep. shortfall
- Added fact: Use $50 cash to buy Other Property & Tax Dep. on Other Property = $10 (normally allocated 50% to each partner)
- Curative allocation: Specially allocate $3 tax dep. on Other Property to A so A now gets $5 tax dep.
  - Remaining depreciation on Other Property of $7 now allocated 50% to each partner

Remedial Method

- Allows partnership to create (*i.e.,* "fabricate") income and deduction items.
- Not dependent on adequacy of partnership items-thus completely prevents any ceiling rule limitations.
- Remedial items have no effect on book capital accounts.
- Calculation of book depreciation is different than traditional or curative method.

Book Depreciation – Remedial Method

- Book basis of asset is split into two components:
  - Tax amount which equals the actual tax basis, and
  - Book amount calculated as excess of book basis over tax basis.
- Amount of book basis equal to tax basis is recovered over remaining tax recovery period.
- Excess book basis treated as new asset and depreciated over applicable asset life.

General Rules for Planning – Which Method Best for You

- Generally, methods will only differ if ceiling rule will apply - otherwise reach same result using traditional method.
  - Remedial method is available even if there is not a current ceiling limitation as a protective measure for ceiling limited sale.
- If you are *property contributor* of <u>built-in gain</u> property –
  - Negotiate for traditional method (with potential for shifting tax consequences to money partner).
  - Generally don't want curatives - too fast burn-off of built-in gain with phantom income allocated to property contributor.
  - Compromise on remedials or curative with partial cure (e.g., gain on sale only).
    - Especially if big book-up and long lives.
    - Remedial stretches out realization of built-in gain.

General Rules for Planning (cont'd) – Which Method Best for You

- If you are *cash contributor* –
  - Negotiate for curatives (if adequate items) -
    - Fastest expensing of investment.
    - Especially if short remaining recovery cycle.
  - Don't want traditional method with exposure for shifting tax consequences.
  - Potential compromise on remedials.
  - Special considerations if § 197 anti-churning applies.
- Caveat – Always run the numbers before picking a method!

Special Rules Under Section 704(c)

- *15% De minimis exception* (capped at $20,000 per partner per year).
- *Account payable*: If a cash basis partner contributes accrued but unpaid accounts payable, this item is treated as § 704(c) property.
- *Transfers of partnership interest:* Transferee steps into shoes for § 704(c) purposes.

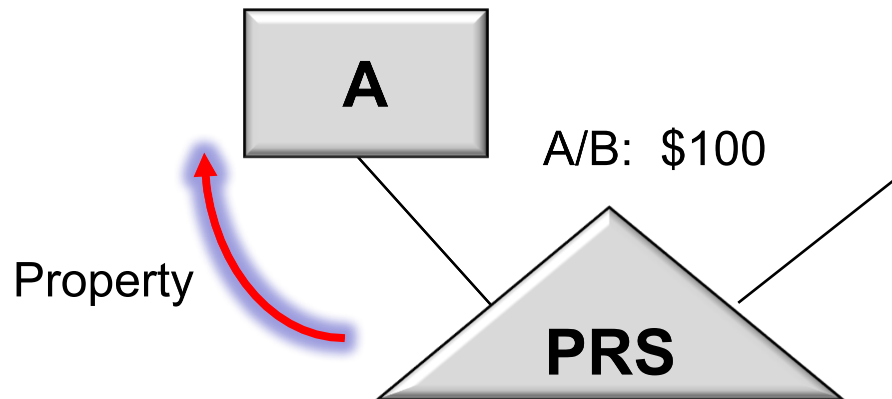
Distributions of Property

Current & Liquidating Distributions General Rules

- “Current Distributions” ⇨ distributions that do not completely terminate a partner’s interest in the partnership (including partial redemptions).

- “Liquidating Distributions” ⇨ one or more distributions that terminate a partner’s entire interest in the partnership.

Current Distributions
Example 1



- A has a $100 basis in partnership PRS:
  - *If PRS distributes to A property with a basis to PRS of $75, what basis will A take in the property?*
  - *If PRS distributes to A property with a basis to PRS of $125, what basis will A take in the property?*

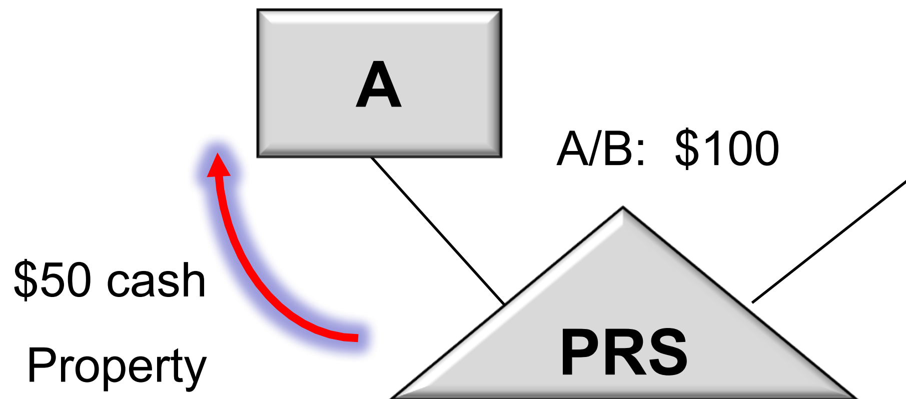
Current & Liquidating Distributions

- General nonrecognition treatment:
  - No gain or loss to partnership.
  - No gain to distributee unless money distributed > basis in partnership interest.
  - Losses
    - Current distributions -- no loss to distributee for current distributions
    - Liquidating distributions -- no loss to distributee *unless* only money, unrealized receivables, or inventory is distributed and the basis of such assets to the partnership is less than the distributee partner's basis in the partnership interest
  - Gain or loss is generally treated as from sale of partnership interest.
- Carryover basis, generally, limited to distributee's basis in its partnership interest (after reduction for any money distributed or deemed distributed).
- BUT…..

Current & Liquidating Distributions Basis Allocation

- Allocate outside basis to the assets received in the following order:
  - Amount of cash distributed.
  - Ordinary income assets (“Hot Assets”) distributed, based on inside basis.
    - If limited, basis is allocated in the following order:
      - » To “hot assets” with unrealized depreciation;
      - » To all “hot assets” based on the relative tax bases.
  - “Other Assets” distributed, based on inside basis.
    - If limited, basis is allocated in the following order:
      - » To “other assets” with unrealized depreciation;
      - » To all “other assets” based on the relative tax bases.
    - If not limited in a liquidating distribution, excess is allocated in the following order:
      - » To “other assets” based on relative appreciation.
      - » To “other assets” based on relative fair market value.

Liquidating Distribution Example 2

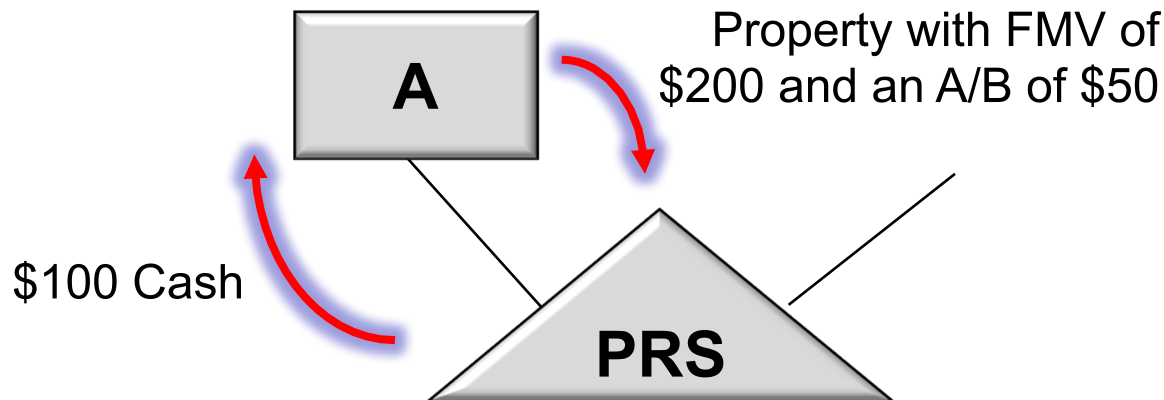


- If A has a $100 basis in partnership PRS:
  - *PRS distributes money and property with a basis to PRS of $75, what basis will A take in the property?*
  - *PRS distributes money and property with a basis to PRS of $125, what basis will A take in the property?*
  - *Role of a section 754 election?*
  - *What if A's basis in the partnership is $200?*

Exceptions to the No Gain or Loss Rule on Distributions

- Section 707(a)(2)(B)
  - Disguised sales.
- Section 751(b)
  - Disproportionate distributions.
- Section 731(c)
  - Distribution of marketable securities.
- Section 704(c)(1)(B)
  - Distributions of previously contributed property.
- Section 737
  - Distributions to contributing partner.
- Section 721(c)
  - Distributions to non-contributing partner by partnership subject to gain deferral method
- 732(f)
  - Distributions of stock to corporate partner.

Disguised Sale?
Example 3



- A contributes property to PRS in 2016 and receives cash as a distribution from PRS in ?. Is this a sale to the partnership or a tax free contribution? If so, how much of the property is sold?
- What if the property is subject to debt of $100 and there is no cash distribution?
  - Impact of section 752(a) and (b).

Disguised Sales

- Disguised sale rules of § 707(a)(2)(B) override the general rules.
- Components of a disguised sale:
  - Transfer to partnership – "Contribution."
  - Transfer to partner – "Distribution."
  - When viewed together, the two are more properly viewed as a sale.
- Substance over form.

Disguised Sales (Cont'd)

- 2-year presumption
  - Transfers between a partnership and a partner that are made within two years of each other are presumed to be a sale.
  - Transfers made more than two years apart are presumed not to be a sale.
  - Rebuttable presumption.
- Tax consequences of a disguised sale:
  - Part sale/part contribution.
  - **Sale for all purposes of the Code.**
  - **Sale as of the date of contribution.**

Exceptions to Disguised Sale Treatment and to the Two-Year Presumption

1. Reimbursements for certain preformation expenditures.
   - Only exception not excepted from two-year presumption (i.e., disclosure required).
2. Reasonable guaranteed payments.
3. Reasonable preferred returns.
4. Operating cash flow distributions.
5. Qualifying debt-financed distributions.
   - Significantly restricted by newly issued temporary and final regulations.

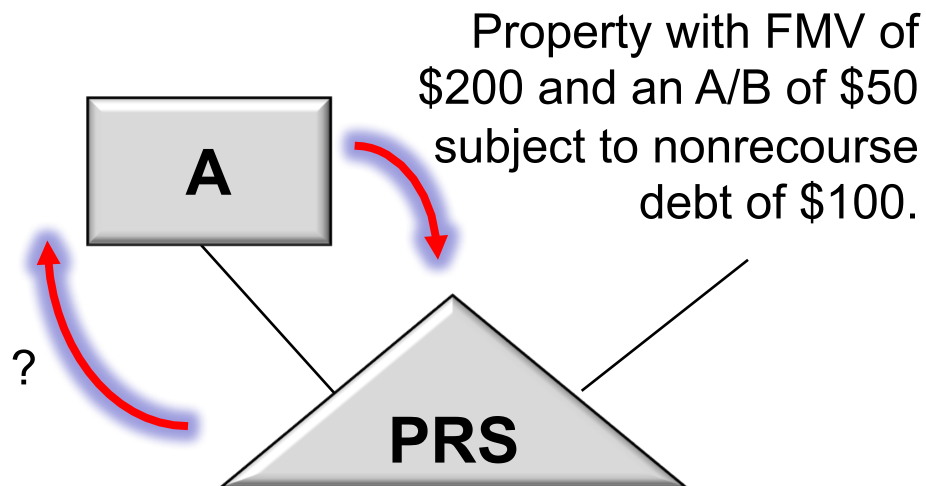
Impact of Liabilities

- Can the assumption of liabilities create consideration in a disguised sale?
  - Depends on whether the liability is "Qualified" or "Non-qualified" and the partner's share of the liability as provided in the disguised sale rules.
- Qualified liabilities create consideration only if the transaction is otherwise a disguised sale. Note change in regulations for de minimis shifts of qualified liabilities.
- Non-qualified liabilities create consideration if the liability exceeds the partner's share of the liability, as determined under the disguised sale rules.
  - Only tier-3 allocation of nonrecourse liabilities based on interest in profits may be used.

Allocation of Liabilities – Section 752

- Recourse versus nonrecourse liabilities
- Recourse allocated to partner with economic risk of loss
- Nonrecourse allocated in 3 tiers
  - Tier 1: Partnership minimum gain
  - Tier 2: Section 704(c) minimum gain
  - Tier 3: Excess nonrecourse liabilities -
    - For disguised sale purposes only as share profits.
    - For other purposes – in accordance with deductions, a significant item, built-in gain.

Disguised Sale? Example 4



- A contributes property to PRS in exchange for a 25% interest in PRS profits. A borrowed the $100 in 2015 and used the proceeds for ?.
- Is there a sale?. What facts do we need?

Distributions Subject to Section 751(b)

- Transactions generally subject to section 751(b)
  - Distributions by partnerships holding hot assets and other assets, and
  - Distributee's interest in the value of one class of partnership property is increased, and his interest in the value of the other class is decreased ("disproportionate distribution").

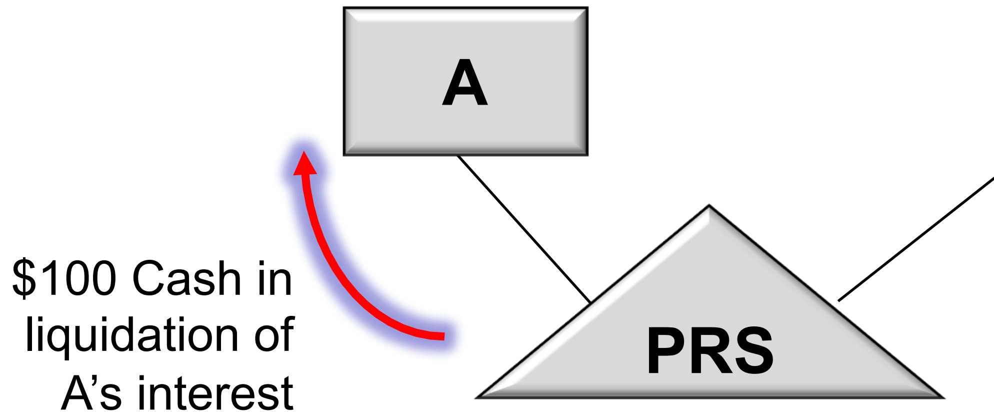
Disproportionate Distributions
"Hot Assets"

- Unrealized receivables – section 751(c)
  - Rights to payment for services rendered or to be rendered, not previously included in income.
  - Rights to payment for goods delivered or to be delivered to extent the proceeds were not previously included in income and will not qualify for capital gain treatment.
  - Includes recapture items (sections 1245, 1250, 1252, 617(d), 995(c), 1248(a), 1254(a)).
  - Other ordinary income provisions (sections 1253(a), 1276, 1283).

Disproportionate Distributions "Hot Assets" (cont.)

- Inventory Items
  - Section 751(b) -- Substantially appreciated inventory items
    - FMV partnership inventory items > 120% A/B
    - Excludes property acquired to avoid purposes of section 751(b)
  - Includes section 1221(a)(1) inventory, assets other than capital assets or section 1231 property, unrealized receivables
    - Determined by reference to partnership or the distributee partner
  - Compare Section 751(a) inventory items

Disproportionate Distributions Example 5



- A was a 25% partner with a 25% share in PRS and is liquidated with a distribution of cash.
- If, immediately before the distribution, PRS has the following assets, is there a section 751(b) issue?

	A/B	FMV
Cash	100	100
Accounts Receivable	0	100
Capital Asset	50	200

Distributions of Marketable Securities – Section 731(c)

- General Rule – Fair market value of distributed marketable securities is treated as money.
- Distributee partner recognizes gain to extent money distributed exceeds outside basis.
- Provision has multiple exceptions.

"Mixing Bowl" – Section 704(c)(1)(B)

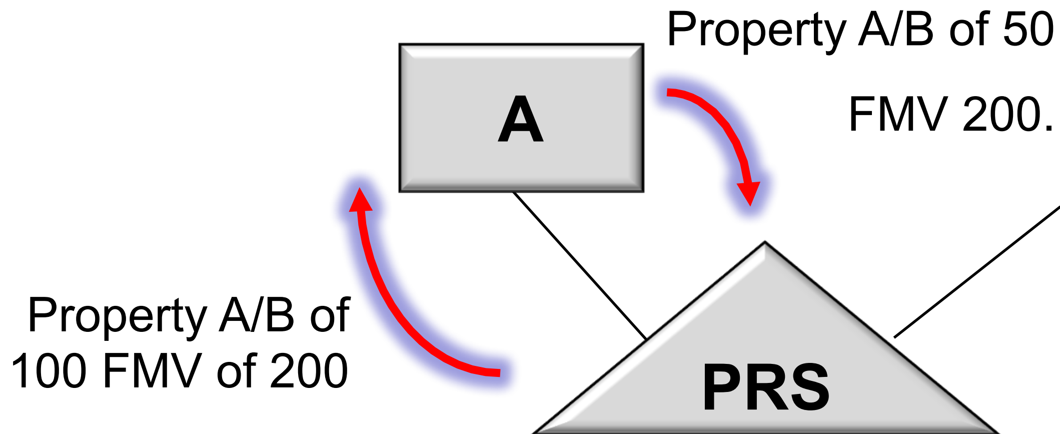
- Applies if contributed section 704(c) property (property with a FMV that differs from its adjusted tax basis at the time of contribution) is distributed to a partner other than the contributor within 7 years of the contribution.

- Contributor recognizes gain or loss to the extent of its remaining forward section 704(c) amount as if the property were sold at its FMV at the time of the distribution.

"Mixing Bowl" – Section 737

- If property other than the contributed property is distributed to the Contributor Partner within seven years of contribution, Contributor Partner recognizes gain under section 737.
- Gain triggered is equal to the lesser of Contributor Partner's:
  - Net precontribution gain; or
  - Excess distribution (FMV of the distributed property – Contributor Partner's outside basis).
- Exception
  - Any property distributee contributed to PRS can be distributed back to Contributor Partner.

Mixing Bowl
Example 6



- A contributes property to PRS in exchange for a 25% interest in PRS profits in 2010.
- PRS distributes other property to A in 2016.
- Gain? How much?

Section 732(f) – Overview

- Section 732(f)(1) provides that if:
  - (A) a corporation ("corporate partner") receives a distribution from a partnership of stock in another corporation ("distributed corporation"),
  - (B) the corporate partner has control of the distributed corporation immediately after the distribution or at any time thereafter, and
  - (C) the partnership's adjusted basis in the stock immediately before the distribution exceeded the corporate partner's adjusted basis in the stock immediately after the distribution, then an amount equal to the excess shall be applied to reduce (in accordance with section 732(c)) the basis of property held by the distributed corporation at such time (or, if the corporate partner does not control the distributed corporation at such time, at the time the corporate partner first has control).
- If the excess exceeds the basis of the corporation's assets, the corporate partner shall recognize capital gain.

Concluding Remarks