Chapter 22

TAXATION OF PARTNERSHIPS AND PARTNERS

LEARNING OBJECTIVES

Upon completion of this chapter you will be able to:

- Define the terms *partner* and *partnership* for federal income tax purposes
- Distinguish between the entity theory and the aggregate theory of partnerships
- Analyze the tax consequences of forming a new partnership
- Determine the tax basis of a partnership interest
- Compute partnership taxable income or loss and identify any separately computed items of partnership income, gain, loss, deduction, or credit
- Explain how the tax consequences of partnership operations are reported on the tax returns of the partners and how the partners’ bases in their partnership interests are adjusted to reflect these tax consequences
- Identify the tax consequences of various transactions between a partner and a partnership
- Determine the tax consequences of both current and liquidating distributions from a partnership
- Analyze the tax consequences of a sale of a partnership interest to both the seller and purchaser
- Apply the family partnership rules to partnership interests created by gift
- Recognize a termination of a partnership and summarize the tax consequences of the termination to the partners
When two or more parties agree to go into business together, they must first decide which form of business to use. Should the business be incorporated or should it operate as a partnership? Although the corporate form predominates for large companies, it is certainly not appropriate for all businesses. Consequently, partnerships are widely used throughout the business world.

Partnerships come in a wide assortment of shapes and sizes. For example, two accountants may form a professional partnership through which to conduct their business, or a family may organize a partnership to manage real estate or operate a corner delicatessen. In contrast, two international corporations may form a partnership to develop a new product or to conduct research. Partnerships may also be used as investment vehicles. For instance, hundreds or thousands of people may invest in partnerships that drill for oil, construct office buildings, or make movies. For whatever reason, when two or more parties decide to pool their resources in order to carry on a profit-making activity, they often choose to do so as partners in a partnership.

The federal tax consequences of business activities that meet the statutory definition of a partnership are governed by the provisions of Subchapter K of the Internal Revenue Code (§§ 701 through 777). This chapter begins with an analysis of this definition and a brief introduction to several other important concepts that underlie Subchapter K. The chapter also includes discussions of the formation and operation of a partnership, the mechanics by which partnership income or loss is allocated to and taken into account by each partner, and the tax consequences of common transactions between partners and partnerships. The more advanced topics of current and liquidating partnership distributions and dispositions of partnership interests are also introduced.
DEFINITIONS

WHAT IS A PARTNERSHIP?

The Uniform Partnership Act defines a partnership quite simply as “an association of two or more persons to carry on a business for profit.”

This basic definition is expanded in the Code to include a syndicate, group, pool, joint venture, or any other unincorporated organization.

For an organization to constitute a partnership, it must have at least two partners. Note that there are no restrictions on either the maximum number of partners or on the type of entity that may be a partner. Individuals, corporations, trusts, estates, and even other partnerships may join together as partners to carry on a profit-making activity.

As a practical matter, determining whether an organization qualifies as a partnership is rarely a problem. For example, any organization formed under the Uniform Partnership Act or the Uniform Limited Partnership Act should expect to be treated as a partnership. However, as explained in Chapter 19, certain unincorporated organizations may or may not be treated as partnerships for tax purposes. Under the “check the box” regulations, all business entities incorporated under a state law providing for a separate corporation, a joint stock company, an insurance company, a bank, or certain foreign entities will be classified as corporations for federal tax purposes.

A foreign entity in which all owners have limited liability will be treated as a corporation. A foreign entity in which one or more owners have unlimited liability will be treated as a partnership unless it makes the election to be taxed as a corporation.

Other treasury regulations clarify that certain arrangements are not treated as partnerships for federal tax purposes. A joint undertaking is not a partnership if the only joint activity is the sharing of expenses. For example, if two adjacent property owners share the cost of a dam constructed to prevent flooding, no partnership exists. Similarly, joint ownership of property is not a partnership if the co-owners merely rent or lease the property and provide minimal services to the lessees. In such case, the co-owners are not actively conducting a trade or business. If, however, these co-owners provide substantial tenant services, they may elevate their passive co-ownership to active partnership status.

ELECTING OUT OF SUBCHAPTER K PARTNERSHIPS

Section 761(a) allows certain unincorporated organizations that potentially constitute partnerships for federal tax purposes to be excluded from the application of the statutory rules of Subchapter K. An organization may elect out of the statutory rules governing the taxation of partners and partnerships if it is formed for (1) investment purposes only and not for the active conduct of a business, or (2) the joint production,
extraction, or use of property. The members of such an organization must be able to compute their separate incomes without the necessity of computing partnership taxable income (i.e., income for the organization as a whole). The election is made by attaching a statement to a properly filed Form 1065 (U.S. Partnership Return of Income) for the first taxable year for which the organization desires exclusion from Subchapter K. The statement must identify all members of the organization and indicate their consent to the election.\(^7\)

**GENERAL AND LIMITED PARTNERSHIPS**

There are two types of partnerships: *general* partnerships and *limited* partnerships. The two differ primarily in the nature of the rights and obligations of the partners; the major differences can be summarized as follows.

1. General partnerships are owned solely by general partners, whereas limited partnerships must have at least one general partner and one or more limited partners.
2. General partners have *unlimited liability* for partnership debt, whereas limited partners are usually liable only to the extent of their capital contributions to the partnership.
3. General partners participate in the management and control of the partnership business, whereas limited partners are not allowed to participate in such business.\(^8\)
4. General partners are subject to self-employment taxes on partnership business earnings even if they do not perform services for the partnership, whereas limited partners are not.

Two other types of entities that are usually taxed as partnerships are limited liability companies (LLC) and limited liability partnerships (LLP). In an LLC, all members (i.e., owners) have limited liability. Generally, the partners in an LLP have better liability protection than general partners, but more liability exposure than limited partners. LLP partners usually have unlimited liability, except any particular partner is not personally liable for claims arising from a tort that was committed by a different partner. Nevertheless, the partner committing the tort is personally liable for the claims resulting from his or her actions.

All references throughout the text are to general partners and general partnerships unless otherwise stated.

**ENTITY AND AGGREGATE THEORIES**

Most rules governing the taxation of partnerships are based on either the entity or aggregate theory of partnerships.\(^9\) According to the *entity theory*, partnerships should be regarded as entities distinct and separate from their owners. As such, partnerships may enter into taxable transactions with partners, may hold title to property in their own names, are not legally liable for debts of partners, are required to file annual returns...
(Form 1065) that report the results of operations, and can make tax elections concerning partnership activities that apply to all partners.

In contrast, the aggregate theory views a partnership as a collection of specific partners, each of which indirectly owns an undivided interest in partnership assets. Under this theory, the partnership itself has no identity distinct from that of its partners. The fact that a partnership is a pass-through rather than a taxable entity, functioning only as a conduit of income to the partners, is a clear reflection of the aggregate theory. The aggregate theory also prevents the recognition of gain or loss on several types of transactions between partners and their partnerships.

The inconsistent application of the entity and aggregate theories throughout Subchapter K certainly complicates the taxation of partners and their partnerships. In extreme cases, a single Code section may contain elements of both theories. In spite of this confusion, taxpayers and their advisers who can determine which theory underlies a particular rule of partnership tax law will gain valuable insight into the proper application of that rule to a specific fact situation.

FORMING A PARTNERSHIP

The first step in the formation of any partnership is the drafting of a partnership agreement by the prospective partners. A partnership agreement is a legal contract stipulating the rights and obligations of the co-owners of the business. Ideally a partnership agreement should be drafted by a competent attorney, should be in writing, and should be signed by each partner. However, even oral partnership agreements between business associates have been respected as binding contracts by the courts.\(^\text{10}\)

A partner’s interest in a partnership is an intangible asset—an equity interest in the partnership business, the exact nature of which is defined in the partnership agreement. Under the typical agreement, each partner has a specified interest in partnership cash and property. The dollar amount of such interest at any time is reflected by the balance in each partner’s capital account in the equity section of the partnership balance sheet. In addition to his or her capital interest, each partner has an interest in any income or loss generated by the partnership’s activities. This interest is usually expressed as a profit-and-loss sharing ratio among the partners. If the partners consent, the terms of their agreement may be modified with respect to a particular taxable year at any time before the unextended due date by which the partnership return for such year must be filed.\(^\text{11}\)

Partners may certainly agree to share profits and losses in different ratios. They may also agree that these ratios will be independent of the relative amounts of capital to which the partners are entitled.

Example 1. Doctors J and K decide to form a general partnership to carry on a medical practice. Both individuals contribute $50,000 of cash to the partnership so that both have an initial capital account balance of $50,000. The partnership will use the cash to purchase equipment and supplies and to lease office space. Doctor J has been in local practice for several years and has an established reputation, while Doctor K recently graduated from medical school. Consequently, the partnership agreement provides that Doctor J will be allocated 65% of profits and losses, while Doctor K will be allocated 35%. The agreement stipulates that J and K will renegotiate this profit-and-loss sharing ratio after three years.

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\(^{10}\) See, for example, Elrod, 87 T.C. 1046 (1986).

\(^{11}\) § 761(c).
CONTRIBUTIONS OF PROPERTY

Partners may make initial contributions to partnership capital in the form of cash, property, or a combination of both. When a partner transfers property to a partnership in exchange for an ownership interest, § 721 provides that neither the partner nor the partnership recognizes any gain or loss on the exchange.\(^\text{12}\) The partner’s tax basis in the transferred property carries over to become the partnership’s basis in the property (i.e., a *carryover* basis).\(^\text{13}\) The tax basis in the transferring partner’s newly acquired partnership interest equals the basis of the transferred property plus any amount of cash contributed to the partnership (i.e., a *substituted* basis).\(^\text{14}\) Tax professionals who specialize in the partnership area have coined the term *inside basis* to refer to the tax basis of assets owned by a partnership. In contrast, the term *outside basis* refers to the tax basis of a partner’s interest in a partnership. Although neither term is used in the Code or Regulations, they provide a descriptive and easy way to differentiate between these two basis concepts.

The partnership’s holding period for contributed assets includes the holding period of the assets in the hands of the contributing partner.\(^\text{15}\) If the assets were either capital assets or § 1231 assets to the contributing partner, the partner’s holding period for these assets becomes the holding period for his new partnership interest.\(^\text{16}\) If the contributed assets were not capital or § 1231 assets, the partner’s holding period for his interest begins on the date the interest is acquired.

**Example 2.** A contributes § 1231 assets with a fair market value of $25,000 and an adjusted basis of $15,500, and B contributes $25,000 cash to the AB Partnership. The capital accounts on the partnership books are credited to reflect the equal $25,000 contributions of each partner. A does not recognize any gain on the exchange of the appreciated business assets for his interest in the AB Partnership. However, A’s initial outside basis in his partnership interest is only $15,500. A’s holding period for this interest includes the period of time for which A owned the contributed § 1231 assets. Even though the partnership recorded the contributed assets on its books at their $25,000 fair market value, the partnership’s inside basis in these assets is only $15,500. B’s initial tax basis in her partnership interest is $25,000, and her holding period for this interest begins on the date of contribution.

The above example illustrates two important points. First, a partner’s outside basis is not necessarily equal to the balance in his or her capital account on the partnership’s financial books and records. The partnership book capital accounts reflect the economic value of contributions to the partnership, while the partners’ outside bases in their partnership interests reflect the tax basis of their respective contributions. Second, the tax rules governing contributions to partnerships result in an initial equilibrium between the partners’ aggregate outside bases and the total inside basis of partnership assets. In *Example 2*, A and B have aggregate outside bases of $40,500. The AB Partnership has total inside basis in its assets of $40,500 ($25,000 cash + $15,500 carryover basis of its § 1231 assets). This equilibrium reflects the aggregate theory of partnerships under

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\(^\text{12}\) This nonrecognition rule does not apply to gain realized on transfer of appreciated stocks and securities to an investment partnership. § 721(b). Also, special rules—beyond the scope of this text—apply to transfers to partnerships with foreign persons and transfers of intangibles to foreign partnerships. See §§ 721(c) and 721(d).

\(^\text{13}\) § 723. If contributed property is depreciable, the partnership will continue to use the cost recovery method and life used by the contributing partner. § 168(i)(7).

\(^\text{14}\) § 722.

\(^\text{15}\) § 1223(2).

\(^\text{16}\) § 1223(1).
which A and B are considered to own indirect interests in AB’s assets. However, it is possible that during the partnership’s existence the aggregate outside basis will differ at times from the total inside basis.

A partner may have a divided holding period in his or her partnership interest in two circumstances. If a divided holding period occurs, the portion of a partnership interest to which a holding period relates is based on the relative fair market values of the properties contributed. This will occur if the partner acquired portions of the partnership interest at different times.

Example 3. R purchased a 10% interest in Z Partnership for $10,000 on January 1, 2006. She purchased another 5% interest in Z for $5,000 on November 1, 2006. As of January 1, 2007, R has a one-year holding period in two-thirds of her partnership interest ($10,000/$15,000), and a two-month holding period for one-third ($5,000/$15,000) of her interest.

A partner will also have a divided holding period in his or her partnership interest if the partner contributed more than one property for the partnership interest, and these properties had different holding periods in the hands of the partner.

Example 4. E contributes cash of $2,000 and a capital asset (basis = $1,000; value = $2,000) held for five years for a 25% interest in Partnership Y. The portion of E’s interest attributable to the cash, 50% [2,000/(2,000 + 2,000)], will have a holding period beginning the day after the contribution. The portion of his interest attributable to the capital asset (50%) has a five-year holding period.

EFFECT OF PARTNERSHIP LIABILITIES ON BASIS

When a partnership borrows money, the general partners typically have unlimited liability for repayment of the debt to the partnership’s creditors. If the partnership itself is unable to repay its debts, each partner must contribute personal funds to satisfy the unpaid balance. As a result, a partner’s economic investment in a partnership consists not only of the contribution of cash or property reflected in his or her capital account, but also of the share of partnership debt for which the partner might ultimately be held responsible.

Section 752(a) acknowledges this responsibility by providing that any increase in a partner’s share of the liabilities of a partnership or any assumption of a partnership debt by a partner is treated as a contribution of money to the partnership. This constructive cash contribution increases the partner’s outside basis in his or her partnership interest. Conversely, § 752(b) provides that any decrease in a partner’s share of the liabilities of a partnership or any assumption of a partner’s debt by a partnership is treated as a distribution of money from the partnership to the partner. This constructive cash distribution reduces the partner’s outside basis.

Example 5. M and N are equal partners in the M&N Partnership. On January 1 of the current year, both M and N had a $25,000 outside basis in their partnership interests, and the partnership had no debt on its balance sheet. On January 31, the partnership borrowed $15,000 from a local bank and used the funds to buy business assets. Because this transaction increased M and N’s respective shares of the

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17 Reg. § 1.1223-3(b)(1).
18 Reg. § 1.1223-2(a); for transfers of partnerships interests after September 20, 2000.
19 Reg. § 1.1223-3(a)(2).
20 § 733.
partnership’s liabilities by $7,500, each was considered to have contributed this amount of cash to the partnership. As a result, their outside bases as of January 31 increased to $32,500.

On June 1, the partnership repaid $6,000 of the outstanding debt. Because this payment decreased M and N’s respective shares of partnership debt, each was considered to have received a $3,000 cash distribution from the partnership. As a result, their outside bases as of June 1 decreased to $29,500.

<table>
<thead>
<tr>
<th></th>
<th>M</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1 outside basis</td>
<td>$25,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Plus: Increase in share of partnership debt on 1/31</td>
<td>7,500</td>
<td>7,500</td>
</tr>
<tr>
<td>Less: Decrease in share of partnership debt on 6/1</td>
<td>(3,000)</td>
<td>(3,000)</td>
</tr>
<tr>
<td>June 1 outside basis</td>
<td>$29,500</td>
<td>$29,500</td>
</tr>
</tbody>
</table>

Note that in the above example, the inclusion of partnership debt in the partners’ outside bases maintained the equilibrium between inside and outside basis. Between January 1 and June 1, M and N’s aggregate outside bases increased by a net amount of $9,000. During this same period, the basis of partnership assets also increased by $9,000 ($15,000 debt proceeds − $6,000 cash distribution).

Partner’s Share of Partnership Liabilities. The combined result of § 752(a) and (b) is that on any particular date, a partner’s outside basis includes a share of the various debts reflected on the partnership balance sheet as of that date. The Treasury Regulations under § 752 provide a lengthy and complex set of rules for determining a partner’s share of partnership liabilities. Under these regulations, each partner’s share of any specific debt depends on the classification of the debt itself and whether the partner is a general or limited partner. All partnership debts are classified as either recourse or nonrecourse. A debt is recourse if the creditor can look to the personal assets of any general partner to satisfy the unpaid portion of the debt in the event the partnership does not have sufficient assets for repayment. A debt is nonrecourse if the creditor cannot look beyond the assets of the partnership for repayment.

A partner’s share of recourse debt equals the portion of such debt for which that partner bears the economic risk of loss. Because limited partners generally bear no responsibility for the repayment of partnership liabilities, they have no risk of loss with respect to partnership recourse debt. Consequently, no amount of such debt is apportioned to any limited partner. The extent to which general partners are deemed to bear the economic risk of loss for partnership recourse debt is generally determined by using the results from a hypothetical constructive liquidation scenario. The basic idea behind these rules is to consider which partners would have to actually satisfy these liabilities if the absolute worst scenario imaginable (i.e., all liabilities are due but all partnership assets are worthless) happened to the partnership. The following transactions are assumed to occur, simultaneously, at the end of the partnership’s taxable year:

1. All liabilities must be paid immediately in full.
2. All partnership assets, including cash, are assumed to have a fair market value of zero.

Reg. § 1.752-2(a).
Reg. § 1.752-2(b). In so-called straight-up partnerships in which the partners’ profit-and-loss sharing ratios correspond to the ratios of their respective capital account balances, the application of this analysis has the same result as an apportionment based on loss-sharing ratios.
3. All partnership assets are sold for no consideration, which results in a recognized loss for each asset equal to the asset’s adjusted basis.

4. These losses are allocated to the partners according to the loss sharing ratios in the partnership agreement.

5. The partners reduce their respective capital accounts by the amount of the losses.

6. The partnership liquidates. Consequently, any partner having a negative capital account after step five is deemed to make a cash contribution to the partnership, equal to this negative amount, so that his or her ending capital account will be zero.

7. The partnership is deemed to use this cash to pay off the recourse liabilities of the partnership.

8. Any remaining cash is deemed to be distributed to partners that have positive capital account balances.

The amount of cash that is deemed to be contributed to the partnership under step six is the partner’s share of the recourse liabilities.

**Example 6.** Individuals W and X are general partners and individuals Y and Z are limited partners in the WXYZ Partnership. Partnership losses are allocated 20% to W, 30% to X, and 25% respectively to Y and Z. As of December 31 of the current year, the partnership has $100,000 of recourse debt. The partnership’s balance sheet as of December 31 is as follows:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>75,000</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>75,000</td>
</tr>
<tr>
<td></td>
<td>$200,000</td>
</tr>
<tr>
<td>Recourse liabilities</td>
<td>$100,000</td>
</tr>
<tr>
<td>W, capital</td>
<td>20,000</td>
</tr>
<tr>
<td>X, capital</td>
<td>30,000</td>
</tr>
<tr>
<td>Y, capital</td>
<td>25,000</td>
</tr>
<tr>
<td>Z, capital</td>
<td>25,000</td>
</tr>
<tr>
<td></td>
<td>$200,000</td>
</tr>
<tr>
<td></td>
<td>$400,000</td>
</tr>
</tbody>
</table>

If the assets were worthless and sold for no consideration, a $200,000 loss would be recognized. In allocating this loss to the partners, the limited partners cannot have a negative capital account since they have limited liability. Therefore, whereas Y and Z would otherwise each be allocated $50,000 of loss ($200,000 × 25%), each is limited to a loss allocation of $25,000. The remaining $150,000 of loss is allocated to W and X based on their relative loss sharing ratios, as follows:

W: $150,000 × 20%/(20% + 30%) = $60,000

X: $150,000 × 30%/(20% + 30%) = $90,000
After allocation of these losses, the capital accounts are as follows:

<table>
<thead>
<tr>
<th></th>
<th>W</th>
<th>X</th>
<th>Y</th>
<th>Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital, 12/31</td>
<td>$20,000</td>
<td>$30,000</td>
<td>$25,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Loss allocation</td>
<td>(60,000)</td>
<td>(90,000)</td>
<td>(25,000)</td>
<td>(25,000)</td>
</tr>
<tr>
<td>$(40,000)</td>
<td>$(60,000)</td>
<td>-0-</td>
<td>-0-</td>
<td></td>
</tr>
</tbody>
</table>

The WXYZ Partnership is now assumed to liquidate. W and X must contribute $40,000 and $60,000 to the partnership, respectively, to restore their capital accounts to zero. This $100,000 is then used to pay the $100,000 recourse liability. Therefore, W and X are allocated $40,000 and $60,000 of the recourse liability, respectively, while Y and Z are not allocated any of the liability.

If a partnership defaults on the repayment of a nonrecourse debt and partnership assets are insufficient to satisfy the debt, the creditor cannot look to the personal assets of any partner for satisfaction. Therefore, no partner—general or limited—bears any economic risk of loss with regard to partnership nonrecourse debt. As a result, separate rules are provided for the allocation of nonrecourse debt. In general, the Regulations provide that nonrecourse debt is apportioned to all partners based on their profit-sharing ratios. However, an exception is provided to this rule if a partner has contributed property to the partnership encumbered with nonrecourse debt that has a built-in gain. In this case, the contributing partner is first allocated nonrecourse debt to the extent of the lower of 1) the built-in gain on the contributed property, or 2) the excess of the non-recourse debt over the adjusted basis of the contributed property. Any remaining gain is then allocated to all the partners based on their profit-sharing ratios. This apportionment rule reflects the fact that such debt will be repaid from partnership profits and that both general and limited partners alike will pay tax on their allocated shares of such profits.

**Example 7.** Individuals G and H are general partners and individuals I and J are limited partners in the GHIJ Partnership. Partnership profits are allocated 10% to G, 20% to H, and 35% respectively to I and J. As of December 31 of the current year, the partnership has $100,000 of nonrecourse debt. This $100,000 debt is attached to property that was contributed by G. At the time of contribution, the property had an adjusted basis to G of $80,000 and a fair market value of $120,000. The first $20,000 of the $100,000 debt is allocated to G as follows:

1. Lower of
   - the built-in gain on the property, $40,000 ($120,000 − $80,000),
   - or
2. the excess of the non-recourse debt over the adjusted basis of the contributed property, $20,000 ($100,000 − $80,000)

The remaining $80,000 of nonrecourse debt is allocated based on the profit sharing ratios. In summary, the $100,000 nonrecourse debt is allocated as follows:

<table>
<thead>
<tr>
<th></th>
<th>G</th>
<th>H</th>
<th>I</th>
<th>J</th>
</tr>
</thead>
<tbody>
<tr>
<td>Built-in gain</td>
<td>$20,000</td>
<td>$ 0</td>
<td>$ 0</td>
<td>$ 0</td>
</tr>
<tr>
<td>Profit ratio</td>
<td>8,000</td>
<td>16,000</td>
<td>28,000</td>
<td>28,000</td>
</tr>
<tr>
<td>$28,000</td>
<td>$16,000</td>
<td>$28,000</td>
<td>$28,000</td>
<td></td>
</tr>
</tbody>
</table>

23 Reg. § 1.752-3(a); these regulations also include the concept of minimum gain for allocations of nonrecourse debt, but that discussion is beyond the scope of this book.
Consequently, G, H, I, and J may include $28,000, $16,000, $28,000, and $28,000 of the debt respectively in the outside bases of their partnership interests.

**Liabilities Transferred to the Partnership.** A partner who contributes property to a partnership in exchange for an ownership interest may negotiate for the partnership to assume a recourse liability of the partner as part of the exchange transaction. Similarly, the property contributed to the partnership may be subject to a nonrecourse liability. In both cases, the rules of § 752 have an impact on the computation of the contributing partner’s outside basis.

Any debt from which the contributing partner is relieved of personal liability reduces that partner’s basis in his or her new partnership interest. However, this outside basis is also increased by any amount of such debt apportioned to the contributor in his or her capacity as partner. Because this decrease and increase occur simultaneously as the result of a single transaction, only the net increase or decrease is taken into account in computing the contributing partner’s basis. The net increase or decrease for the contributing partner’s basis can be computed as: amount of liability transferred / 0.100% \times \text{partner’s percentage share of debt}.

**Example 8.** Individual T contributes business assets with an adjusted basis of $50,000 to a partnership in exchange for a 25% general interest in partnership capital, profits, and losses. As part of the contribution, the partnership assumes $12,000 of T’s business recourse debt, relieving T of personal liability. The partnership has no other debts. Although T is relieved of the $12,000 debt in her individual capacity, she continues to bear the economic risk of loss for 25% of the debt in her capacity as general partner. Accordingly, T’s outside basis in her partnership interest immediately subsequent to her contribution is $41,000 ($50,000 basis of contributed property – $9,000 net relief of debt).

<table>
<thead>
<tr>
<th>Basis of contributed property</th>
<th>$50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Relief of personal liability</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Plus: Liability for debt as general partner</td>
<td>3,000</td>
</tr>
</tbody>
</table>

T’s outside basis in partnership interest \(=\) $41,000

A partnership’s assumption of a contributing partner’s debt has tax consequences not only to the contributor but to the other partners as well. The outside bases of the noncontributing partners will increase by the amount of newly assumed debt apportioned to them and decrease by the amount of existing partnership debt apportioned to the newly admitted partner.

**Example 9.** Individual L contributes business assets with a fair market value of $23,600 and adjusted basis of $10,000 to a partnership in exchange for a one-third general interest in partnership capital, profits, and losses. As part of the contribution, the partnership assumes $3,600 of L’s business recourse debt, relieving L of personal liability. Consequently, L’s contribution has a net value of $20,000 ($23,600 – $3,600) and a net basis of $6,400 ($10,000 – $3,600). The partnership has $6,000 of existing debt as of the date of contribution. Immediately after the contribution, the partnership has the following balance sheet:

\[\text{Basis of contributed property} = \$23,600\]
\[\text{Less: Relief of personal liability} = \$3,600\]
\[\text{Plus: Liability for debt as general partner} = \frac{1}{3} \times \$3,600\]

<table>
<thead>
<tr>
<th>Basis of contributed property</th>
<th>$23,600</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Relief of personal liability</td>
<td>(3,600)</td>
</tr>
<tr>
<td>Plus: Liability for debt as general partner</td>
<td>1,200</td>
</tr>
</tbody>
</table>

Immediately after the contribution, the partnership has a basis of $20,000 ($23,600 – $3,600) and a basis of $6,400 ($10,000 – $3,600) for the newly admitted partner.
L’s outside basis in his new partnership interest is $9,600 ($10,000 basis of contributed property – $2,400 ($3,600 × 66.7%) net relief of the assumed debt + $2,000 ($6,000 × 33.3%) assumption of one-third of existing partnership debt).

Prior to L’s admission to the partnership, partners M and N each had $15,000 of outside basis in his partnership interest. This basis number represented a one-half interest in the $24,000 net inside basis of existing partnership assets plus one-half of the $6,000 of existing partnership debt. Upon L’s admission, M and N are each apportioned $1,200 of the assumed debt. However, they are each relieved of $1,000 of existing debt. Subsequent to L’s admission, their outside bases have each increased to $15,200 ($15,000 + $200 net increase in share of partnership liabilities).

Note that in Example 9, the inclusion of $9,600 of total partnership debt in the partners’ outside bases maintains the equilibrium between the $40,000 aggregate outside basis (L’s $9,600 basis + M’s $15,200 basis + N’s $15,200 basis) and the $40,000 total inside basis of the partnership assets.

CONTRIBUTION OF SERVICES

The nonrecognition rule of § 721 does not apply when an incoming partner contributes personal services to a partnership in exchange for an ownership interest. The tax consequences of such an exchange to both parties depend on whether the service partner receives an interest in partnership capital or merely an interest in the future profits of the partnership business.

Receipt of a Capital Interest. If a service partner receives an interest in the existing capital of a partnership, the partner must recognize ordinary compensation income to the extent of the value of such interest. The amount of income recognized becomes the partner’s initial outside basis in the interest received.

Example 10. G agrees to perform services for the AB Partnership in exchange for a 20% interest in partnership capital, profits, and losses. On the date that C is admitted to the partnership, the net value of the partnership assets is $250,000. The value of C’s newly acquired interest is $50,000 (20% of $250,000), which equates to the value of the assets that C would receive if the partnership were to immediately liquidate and

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25 Reg. § 1.721-1(b)(1). The partnership can usually deduct the value of the capital interest given for services as an ordinary business expense. A complete analysis of the tax consequences of this payment by the partnership is beyond the scope of this chapter.

26 Reg. § 1.722-1.
distribute its assets to each partner based on their relative capital account balances. C must recognize $50,000 of compensation income on the exchange and will have a $50,000 outside basis in her partnership interest.

**Receipt of a Profits Interest.** The partners in an established partnership may be reluctant to give up any part of their equity in existing partnership assets (i.e., a capital interest) as compensation to a newly admitted service partner. These partners might be more willing to give the service partner an interest in the future profits of the business—profits partially attributable to the new partner’s efforts on behalf of the partnership.

**Example 11.** J agrees to perform services for the GHI Partnership in exchange for a 25% interest in future partnership profits and losses. On the date that J is admitted to the partnership, the net value of the partnership’s assets is $800,000. However, J is not given an initial capital account and has no legal interest in these assets. If the partnership were to immediately liquidate and distribute its assets to the partners based on their relative capital account balances, J would receive nothing. If the partnership generates income subsequent to J’s admission, J will be entitled to 25% of such income.

The tax consequences to a service partner who receives nothing more than an interest in future partnership profits have been the subject of heated debate among tax experts for many years. The courts have also struggled with this issue with confusing and inconclusive results. Currently, the uneasy consensus of opinion is that a service partner does not recognize current income upon the receipt of a profits interest because the interest has no immediate liquidation value. Consequently, the service partner’s initial basis in the interest is zero. The partner will, of course, recognize income to the extent of his or her share of future partnership profits.

### OPERATING THE PARTNERSHIP

Section 701, the first section in Subchapter K, states that “a partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities.” Even though partnerships are not taxable entities, they are required to file an annual information return, Form 1065 (U.S. Partnership Return of Income). Basically, this return shows the computation of partnership taxable income and how such income is allocated to each partner. Form 1065 is due by the 15th day of the fourth month following the close of the partnership taxable year.

In order to compute its annual taxable income, a newly formed partnership must make a number of initial elections, including the adoption of both an accounting method (or methods) by which to compute income and the partnership taxable year. The fact that these important elections are made by the partnership itself rather than by each partner is a very practical application of the entity theory of partnerships. As a general rule, partnerships are free to elect the cash receipts and disbursements method, the

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28 § 6031.

29 § 6072(a).

30 § 703(b).
accrual method, or a hybrid method of accounting for tax purposes.\textsuperscript{31} As explained in the next section of the chapter, they have much less flexibility in the choice of a taxable year.

\textbf{THE PARTNERSHIP'S TAXABLE YEAR}

Income generated by a partnership is included in the taxable income of a partner for the partner’s year in which the partnership’s taxable year ends.\textsuperscript{32} If partnerships had no restrictions as to their choice of taxable year, this simple timing rule could be used to achieve a significant deferral of income recognition.

\textbf{Example 12.} R and S, calendar year individuals, decide to operate a business as equal partners. The RS Partnership begins business on February 1, 2006. During its first year of operations the partnership generates $3,000 of taxable income each month. If the partnership could adopt a fiscal year ending January 31, its $36,000 of first-year income ($33,000 of which was earned in 2006) would be included in the partners’ 2007 tax returns because 2007 is the partners’ taxable year in which the partnership’s fiscal year ends. For each subsequent year that the RS Partnership remains in existence, eleven months of income earned in one calendar year would not be taxed at the partner level until the following calendar year.

Subchapter K contains a set of complex rules designed to minimize the potential for income deferral through use of a partnership. A partnership must adopt the taxable year used by one or more partners who own more than a 50 percent aggregate interest in partnership capital and profits. If no such \textit{majority interest taxable year} exists, the partnership must adopt the taxable year used by its principal partners (those partners owning at least a 5 percent interest in partnership capital or profits).\textsuperscript{33} If the principal partners use different taxable years, the partnership must adopt a taxable year resulting in the least aggregate deferral of income to the partners. The taxable year resulting from the application of these rules is known as the “required taxable year.”

Under the \textit{least aggregate deferral method},\textsuperscript{34} all year-ends that any of the partners have must be tested, and the one that produces the least amount of deferral for the partners as a group is the required tax year. The deferral for each partner is computed as the time from the year-end being tested until the next year-end of the partner. The months of deferral are then weighted by each partner’s profits interest. The least aggregate deferral method is illustrated by the following example:

\textbf{Example 13.} M and N are equal corporate partners in the MN Partnership. M has a year-end of March 31 and N has a year-end of November 30. Since M and N each own 50% of the partnership, no partner, or group of partners, that have the same year-end own a more than 50% interest in the partnership. MN Partnership has two principal partners, but the principal partners do not have the same year end. Therefore, the least aggregate deferral method must be used. The two months that must be tested are March and November.

\textsuperscript{31} § 446(c). Section 448(a) limits the use of the cash method for a partnership that (1) is a tax shelter, or (2) has a C corporation as a partner. However, § 448(b) provides several important exceptions to this restrictive limitation.

\textsuperscript{32} § 706(a).

\textsuperscript{33} § 706(b)(1)(A).

\textsuperscript{34} Reg. § 1.706-1(b)(3).
Test of March 31 Year-End

<table>
<thead>
<tr>
<th>Partner</th>
<th>Year-End</th>
<th>Profit Interest</th>
<th>Months of Deferral</th>
<th>Weighted Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>M</td>
<td>3/31</td>
<td>50%</td>
<td>×</td>
<td>0.0</td>
</tr>
<tr>
<td>N</td>
<td>11/30</td>
<td>50%</td>
<td>×</td>
<td>4.0</td>
</tr>
</tbody>
</table>

Aggregate Deferral 4.0

Test of November 30 Year-End

<table>
<thead>
<tr>
<th>Partner</th>
<th>Year-End</th>
<th>Profit Interest</th>
<th>Months of Deferral</th>
<th>Weighted Deferral</th>
</tr>
</thead>
<tbody>
<tr>
<td>M</td>
<td>3/31</td>
<td>50%</td>
<td>×</td>
<td>2.0</td>
</tr>
<tr>
<td>N</td>
<td>11/30</td>
<td>50%</td>
<td>×</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Aggregate Deferral 2.0

Therefore, the required year end is November 30 since it produces the least amount of deferral for the partners as a group.

If the partners wish to use a year different from the “required tax year,” the Code offers relief from these mechanistic rules by allowing a partnership to adopt any taxable year (without reference to the taxable years of its partners) if it can convince the IRS that there is a valid business purpose for such year.35 The IRS will generally agree that a partnership has a business purpose for adopting a taxable year that conforms to its natural business year. For example, a partnership operating a ski resort might have a natural business year that ends on April 30. The IRS should allow this partnership to adopt this fiscal year for tax purposes, regardless of the taxable years used by the various partners. A partnership can also use a different year-end from its required year-end if it meets the 25 percent test. This test holds that a partnership may change its tax year if at least 25 percent of the taxpayer’s annual gross receipts are recognized in the last two months of the tax year to which the partnership wishes to change, and this 25 percent test is met for three consecutive years.36

ORIENTATION COSTS AND SYNDICATION FEES

Any costs incurred to organize a partnership, such as legal fees for drafting the partnership agreement and filing fees charged by the state in which the partnership is formed, must be capitalized and are not deductible as ordinary and necessary business expenses. The partnership may elect to expense up to $5,000 of these organization costs and to amortize the remainder over a period of 180 months, beginning with the month in which the partnership begins business.37 Any syndication fees connected with the issuance and marketing of partnership interests must also be capitalized. These fees may not be amortized and will remain as an intangible asset on the partnership books until the partnership is liquidated.38

35 § 706(b)(1)(B).
36 Rev. Proc. 2002-39, 2002-22 I.R.B. 1046, provides guidelines for changing from the required tax year because of the business purpose test and the 25 percent gross receipts test. Also see Rev. Rul. 87-57, 1987-2 C.B. 117 for other examples of circumstances that may or may not be considered valid business purposes.
37 § 709(b). The $5,000 amount to be expensed must be reduced (but not below zero) by the amount of organizational costs in excess of $50,000.
38 § 709(a).
COMPUTATION OF PARTNERSHIP TAXABLE INCOME

Partnership taxable income is computed in the same manner as the taxable income of an individual. However, a partnership must make a separate accounting of any item of income, gain, deduction, loss, or credit that is potentially subject to special treatment at the partner level. Separately stated items include capital gains and losses, § 1231 gains and losses, investment income and expenses, net rental income or loss, and charitable contributions. As a result, partnership taxable income is the net of all items that are not separately stated, which can be narrowly defined as gross receipts from services or gross profits from sales of inventory less deductible business expenses incurred by the partnership during the year. This net number is computed on page 1 of Form 1065 and is labeled *ordinary income (loss)*. In contrast, all separately stated items are listed as such on page 3, Schedule K of Form 1065. (Appendix contains a copy of Form 1065 and accompanying Schedule K.)

The character of any item of partnership income, gain, deduction, or loss is determined with reference to the activities of the partnership rather than the activities of the individual partners. For example, gain on the sale of land held by a partnership as an investment for two years is long-term capital gain. This characterization holds even if some of the partners to whom the gain will be taxed are real estate developers in whose hands the land would have been inventory. Similarly, the gain is long-term even if some of the partners have owned their partnership interests for less than one year.

Section 724 contains three exceptions to the general rule that tax characteristics are determined at the partnership level.

1. In the case of unrealized receivables contributed to the partnership by a partner, any gain or loss recognized when the partnership disposes of the receivables must be treated as ordinary gain or loss.

2. In the case of inventory contributed to the partnership by a partner, any gain or loss recognized on disposition within the five-year period subsequent to contribution must be treated as ordinary gain or loss.

3. In the case of a capital asset contributed to the partnership by a partner, any loss recognized on disposition within the five-year period subsequent to contribution must be treated as capital loss to the extent the basis of the asset exceeded its fair market value at date of contribution.

Example 14. Three years ago, D exchanged land that he held as an investment ($50,000 fair market value and $65,000 basis) and an inventory asset from his sole proprietorship ($20,000 fair market value and $18,000 basis) for an interest in the DEF Partnership. Both assets had a carryover basis to the partnership under § 723. Both contributed assets were used in the partnership business, and therefore were characterized as § 1231 assets at the partnership level. During the current year, the partnership sold both assets, realizing a $22,000 loss on the sale of the land and a $3,500 gain on the sale of the former inventory asset.

Because the sales took place within the five-year period subsequent to contribution, the partnership must recognize $15,000 of the loss on the land sale.

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39 § 703(a).
40 § 702(a). Reg. § 1.702-1(a)(8)(ii) explains that each partner must be able to take into account separately his or her distributive share of any partnership item that results in an income tax liability different from that which would result if the item were not accounted for separately.
41 § 702(b).
(excess of $65,000 contributed basis over $50,000 contributed value) as capital loss and the $7,000 remainder as § 1231 loss. The partnership must recognize the entire gain on the sale of the former inventory as ordinary income. If the sales had taken place after the expiration of the five-year period, both the recognized loss and gain would have been § 1231 in nature.\[43\]

### REPORTING OF PARTNERSHIP ITEMS BY PARTNERS

Partners must take into account their distributive shares of partnership taxable income and any separately stated partnership items in computing their taxable incomes.\[44\] This passthrough of partnership items to the partners is deemed to occur on the last day of the partnership’s taxable year. Consequently, the passthrough items are included in each partner’s return for the partner’s taxable year within which the partnership year ends.\[45\]

Each partner’s distributive share of every partnership item is reported on a Schedule K-1 for that partner. Partnerships must include a copy of each Schedule K-1 with the annual partnership return filed with the IRS. A second copy is transmitted to each partner. Upon receipt, partners must incorporate the information reported on the Schedule K-1 into their tax returns.

#### Example 15.

Individual A and Corporation B are calendar year taxpayers and equal partners in the AB Partnership, which uses a September 30 fiscal year end for tax purposes. During December 2006 each partner received a Schedule K-1 showing the following results of partnership operations from October 1, 2005 through September 30, 2006.

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income from business activities (partnership taxable income)</td>
<td>$42,300</td>
</tr>
<tr>
<td>Dividend income</td>
<td>2,300</td>
</tr>
<tr>
<td>Net long-term capital loss</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Investment interest expense</td>
<td>(5,500)</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>(1,900)</td>
</tr>
</tbody>
</table>

Individual A will include his $42,300 share of ordinary business income on Schedule E, his $2,300 share of dividend income on Schedule B, and his $4,000 share of the long-term capital loss on Schedule D of his 2006 Form 1040. Per § 163(d), A’s $5,500 share of investment interest expense is deductible only to the extent of his net investment income for 2006. Furthermore, the deductible portion of the interest expense and A’s $1,900 share of the charitable contribution must be reported as itemized deductions on Schedule A, Form 1040.

Corporation B will include both its $42,300 share of ordinary business income and its $5,500 share of investment interest expense on page 1, and its $4,000 share of long-term capital loss on Schedule D of its 2006 Form 1120. (Corporations are not subject to the § 163(d) limitation.) B will include its $2,300 share of dividend income on Schedule C (Dividends and Special Deductions) and will compute an appropriate dividends-received deduction. B’s $1,900 share of the charitable contribution may be deducted on page 1 of Form 1120 to the extent that the

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\[43\] § 704(c) also requires a special allocation of both loss and gain among the partners. This allocation rule is discussed in a later section of the chapter.

\[44\] § 702(a). Section 772(a) provides a simplified reporting system for certain electing large partnerships. Large nonservice partnerships with 100 or more members can elect to reduce the number of items that must be separately reported to their numerous partners. See §§ 771 through 777.

\[45\] § 706(a).
corporation’s total charitable contributions for 2006 do not exceed 10% of taxable income.

ADJUSTMENTS TO PARTNER’S BASIS

A partner’s distributive share of annual partnership income is determined without reference to actual cash distributions made by the partnership to its partners. If a partner’s share of annual partnership income exceeds any cash received from the partnership during the year, the undistributed income will be recorded as an increase in that partner’s capital account balance (his or her equity in the partnership) at year-end. On the other hand, in a year in which a partnership operates at a loss, a partner’s share of such loss will be recorded as a capital account decrease.

The fluctuating nature of a partnership investment is also reflected in the basis of the partner’s interest in the partnership. Outside basis is increased by a partner’s distributive share of both taxable and nontaxable partnership income. Outside basis is decreased by distributions made by the partnership to the partner and by the partner’s distributive share of partnership losses and nondeductible current expenditures. These basis adjustments are made in the above order at the end of the partnership taxable year. Even if cash distributions representing advances or draws against a partner’s share of current income are made at various dates throughout the year, the effect of these distributions on basis is determined as of the last day of the year.

Example 16. M owns a 40% interest in the capital, profits, and losses of the KLMN Partnership. Both M and KLMN use a calendar year for tax purposes. At the beginning of the current year, M’s outside basis in her partnership interest was $35,000. During the year, M received four cash distributions of $5,000 each as advances against her share of current-year income. At the end of the year, the partnership has $20,000 of nonrecourse debt. M’s Schedule K-1 for the current year showed the following distributive shares:

<table>
<thead>
<tr>
<th>Distribution</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income</td>
<td>$33,000</td>
</tr>
<tr>
<td>Tax-exempt interest income</td>
<td>4,000</td>
</tr>
<tr>
<td>Net long-term capital gain</td>
<td>8,100</td>
</tr>
<tr>
<td>Nondeductible penalty</td>
<td>(1,700)</td>
</tr>
<tr>
<td>Nondeductible 50% business meals and entertainment</td>
<td>(600)</td>
</tr>
</tbody>
</table>

As of the last day of the current year, M’s outside basis is increased by $8,000 ($20,000 × 40%) for her share of the debt and by $45,100 (her share of partnership taxable and tax-exempt income), decreased by the $20,000 of cash distributions made during the year, and decreased by $2,300 (her share of the partnership nondeductible current expenses). Consequently, M’s outside basis as of the first day of the next taxable year is $65,800.

PARTNERS’ DISTRIBUTIVE SHARES

The income or loss generated by a business conducted in partnership form is measured and characterized at the partnership level, then allocated to the various

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46 § 705(a)(1).
47 § 705(a)(2).
48 Reg. § 1.705-1(a).
49 Reg. § 1.731-1(a)(1)(ii).
partners for inclusion on their income tax returns. Each partner’s *distributive share* of any item of partnership income, gain, loss, deduction, or credit is determined by reference to the partnership agreement. Consequently, the partners themselves can decide exactly how the profits or losses from their business are to be shared. The sharing arrangement as specified in the partnership agreement can be an equal allocation of profits and losses to each partner or a more elaborate arrangement under which different items of gain or loss are shared in different ratios among different categories of partners.

Although partners certainly have a great deal of flexibility in determining the allocation of partnership income and loss, § 704(b) warns that such allocations must have *substantial economic effect* if they are to be respected by the Internal Revenue Service. If the IRS concludes that the allocation of any partnership item lacks substantial economic effect, it may reallocate the item among the partners. Such reallocation will be based upon the partners’ true economic interests in the partnership, as determined by the IRS upon examination of all relevant facts and circumstances.

**SUBSTANTIAL ECONOMIC EFFECT**

Treasury regulations provide an intricate set of rules for determining whether partnership allocations meet the substantial economic effect test of § 704(b). The basic objective of the regulations is to “ensure that any allocation is consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.” The economic benefit or burden of an allocation equates to the impact of the allocation on a partner’s interest in partnership capital. In other words, an allocation of income or loss for tax purposes must correspond to an allocation of dollars to or from a partner’s capital account on the partnership books.

The regulations attempt to ensure this correspondence through a three-pronged test for economic effect. Any allocation for tax purposes will have economic effect only if the following three conditions are met.

1. The allocation is reflected in the partners’ capital accounts for book purposes.
2. Upon liquidation of the partnership, liquidating distributions of cash and property are made to the partners based upon the balances in their capital accounts.
3. Partners with deficit balances in their capital accounts upon liquidation are unconditionally required to restore such deficit balance to the partnership. (This obligation may be expressly stated in the partnership agreement or imposed by state law.)

**Example 17.** The RST Partnership agreement provides that taxable income or loss will be allocated 50% to R and 25% respectively to S and T. The agreement provides that this allocation will be reflected in the partnership capital accounts, that liquidating distributions will be based on capital account balances, and that any partner with a deficit capital account balance must restore the deficit immediately prior to liquidation.

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50 § 704(a).
51 Reg. § 1.704-1(b)(2)(ii)(a).
52 The additional requirement that economic effect be *substantial* is discussed in Reg. § 1.704-1(b)(2)(ii). Any discussion of this difficult regulation is beyond the scope of an introductory text.
For the current year, the RST Partnership generated $48,000 taxable income, $24,000 of which was reported as R’s distributive share on his Schedule K-1 and $12,000 of which was reported as S and T’s respective distributive shares on their Schedules K-1. Each partner’s capital account was increased by the amount of income reported as his distributive share for tax purposes. Because the allocation meets the three-pronged test, it has economic effect and should be respected by the IRS.

Note that in the above example, the taxable income allocated to each partner matched the increase in each partner’s capital account balance for the year. Moreover, upon liquidation of the partnership, the partners will receive an amount of dollars (or property) equal to the balances in their capital accounts. Contrast this result with that in the following example.

Example 18. The XYZ partnership agreement provides that taxable income or loss will be allocated 50% to X and 25% respectively to Y and Z. The agreement states that for book purposes income will be allocated equally to each partner. For the current year, the XYZ Partnership generated $48,000 of taxable income, $24,000 of which was reported as X’s distributive share on his Schedule K-1 and $12,000 of which was reported as Y and Z’s respective distributive shares on their Schedules K-1. However, each partner’s capital account on the partnership books was increased by $16,000.

In this example, the allocation of taxable income fails to reflect the allocation of dollars to the partners. Because this tax allocation obviously lacks economic effect, the IRS can reallocate the taxable income to the partners based upon its determination of how the partners actually intend to share the economic benefit of the income. The facts of this simple example indicate that X, Y, and Z intend to share the dollars generated by their partnership business equally. Consequently, the IRS will allocate $16,000 of current-year taxable income to each partner.

ALLOCATIONS WITH RESPECT TO CONTRIBUTED PROPERTY

When a partner contributes property to a partnership and the value of such property is more or less than the contributing partner’s tax basis in the property, subsequent allocations of taxable income, gain, loss, and deduction with respect to the contributed property will lack substantial economic effect within the meaning of § 704(b).

Example 19. M contributed an asset (fair market value $20,000, adjusted basis $14,000) and N contributed $20,000 cash to M&N Partnership in exchange for a one-half interest in partnership capital, profits, and losses. The asset contributed by M was recorded on the partnership books at $20,000 but had a carryover tax basis to the partnership of $14,000. The capital accounts for both M and N were credited with the $20,000 values of their respective contributions. Three months after its formation, the partnership sold the contributed asset for $20,000. For tax purposes, the partnership recognized a $6,000 gain on sale. For book purposes, the partnership realized no gain and made no entry to either partner’s capital account.

Because of the initial difference between the contributed value and the contributed basis of the asset in the above example, the taxable gain on the sale is not equal to the gain realized for book purposes. Consequently, any allocation of the taxable gain to the partners does not have substantial economic effect because the allocation cannot be reflected in book capital accounts.
Section 704(c) solves this problem by mandating a special allocation rule for items of income, gain, loss, and deduction attributable to contributed assets. Essentially, any difference between the amount of the item for tax purposes and for book purposes at the time of contribution must be allocated to the contributing partner when the partnership disposes of the asset. The remainder of the item is allocated for both tax and book purposes according to the sharing ratios specified in the partnership agreement. The application of this special rule to the $6,000 taxable gain recognized in Example 19 results in an allocation of the entire $6,000 gain to contributing partner M. Note that this amount of gain equals the deferred gain that M was not required to recognize upon the contribution of the appreciated asset to the partnership.

Example 20. O contributed an asset (FMV $20,000, adjusted basis $26,000) and P contributed $20,000 cash to O&P Partnership in exchange for a one-half interest in partnership capital, profits, and losses. The asset contributed by O was recorded on the partnership books at $20,000 but had a carryover tax basis to the partnership of $26,000. The capital accounts for both O and P were credited with the $20,000 values of their respective contributions. Seven months after its formation, the partnership sold the contributed asset for $17,000. For tax purposes, the partnership recognized a $9,000 loss on sale, while for book purposes it realized only a $3,000 loss (the decline in the value of the asset subsequent to its contribution to the partnership). The first $6,000 of the tax loss must be allocated to contributing partner O. The remaining $3,000 loss is allocated equally between O and P.

Section 704(c) affects the allocation of depreciation deductions attributable to contributed property as well as allocations of gains and losses recognized by the partnership upon disposition of the property. These depreciation deductions are first allocated to the noncontributing partners in an amount equal to their allocable share of book depreciation (depreciation computed on the contributed value of the property). Any remaining tax depreciation is allocated to the partner who contributed the property.

Example 21. D contributed a depreciable asset (fair market value $60,000, adjusted basis $48,000) and E contributed $120,000 cash to DEF Partnership in exchange for a one-third and a two-thirds interest respectively in partnership capital, profits, and losses. The partnership will depreciate the asset over five years on a straight-line basis. In each year, tax depreciation on the contributed asset is $9,600 (20% of the $48,000 contributed basis), while book depreciation is $12,000 (20% of the $60,000 contributed value). One-third and two-thirds of the book depreciation is allocated to D and E respectively. Each year noncontributing partner E is allocated the first $8,000 of tax depreciation (her two-thirds share of the $12,000 book depreciation). The remaining $1,600 of the annual tax depreciation is allocated to contributing partner D.

RETROACTIVE ALLOCATIONS

In addition to the substantial economic effect requirement of § 704(b) and the special allocation rule of § 704(c), the determination of each partner’s annual distributive share of partnership income, gain, loss, deduction, or credit must take account of any change in the partner’s equity interest in the partnership during the year. This varying interest rule was enacted to prevent retroactive allocations of partnership items to new partners who were admitted to the partnership after the items were recognized or incurred.

54 § 706(d)(1).
Example 22. K and L have been equal partners in the calendar year cash basis K&L Partnership since 2001. On November 1 of the current year, M contributed $100,000 cash in exchange for a one-third interest in partnership capital. The partnership generated a $108,000 operating loss for the current taxable year. The maximum amount of this loss that can be allocated to M under the revised partnership agreement among K, L, and M is $18,049, the portion of the loss attributable to the last 61 days of the year during which M owned an interest in the partnership.

BASIS LIMITATION ON LOSS DEDUCTIBILITY

Under § 704(d), a partner’s distributive share of partnership loss is deductible only to the extent of the partner’s outside basis in his or her partnership interest as of the end of the partnership year in which the loss was incurred. Any nondeductible portion of a current year loss is carried forward indefinitely into future years and can be deducted if and when sufficient outside basis is restored. This loss limitation rule is applied only after a partner’s basis has been increased by any distributive share of current-year partnership income and decreased by any distributions made to the partner for the year.55

Example 23. F is a partner in the calendar year DEFG partnership. At the beginning of the current year, F’s outside basis in her partnership interest was $14,500. During the year, F received a $3,000 cash distribution from DEFG. At the close of the year, Schedule K-1 showed that her distributive share of the partnership’s current-year operating loss was $20,000, while her shares of current-year dividends and long-term capital gains were $3,400 and $1,300 respectively. F will increase her outside basis by $4,700 (her share of partnership income) and decrease it by the $3,000 cash distribution. Under § 704(d), F may deduct her allocated partnership loss only to the extent of her $16,200 remaining outside basis, thereby reducing her year-end basis to zero. The $3,800 nondeductible portion of F’s loss will carry forward into subsequent taxable years.

F’s January 1 outside basis .............................. $ 14,500
Plus: Allocated share of income ...................... 4,700
Less: Distributions ..................................... (3,000)
Deductible share of allocated loss ................... (16,200)

F’s December 31 outside basis ..................... -0-
F’s loss carryforward ................................. $ 3,800

If a partner is allocated a distributive share of more than one type of loss and the partner’s outside basis is insufficient to absorb the aggregate amount of losses, the § 704(d) limitation is applied proportionately to each type of loss.56

Example 24. Refer to the facts in Example 23, but assume that F is allocated a $6,000 § 1231 loss in addition to the $20,000 operating loss. F’s currently deductible amounts of each type of loss are computed as follows:

Operating loss: \((20,000 \div 26,000) \times 16,200 = 12,462\)

§ 1231 loss: \((6,000 \div 26,000) \times 16,200 = 3,738\)

55 Reg. § 1.704-1(d)(2).
56 Reg. § 1.704-1(d)(2).
The nondeductible $7,538 operating loss and $2,262 § 1231 loss are carried forward into subsequent years.

TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIPS

Under the entity theory, a partner and a partnership are separate and distinct entities that can transact with each other at arm’s length. This perspective is adopted in § 707(a), which states that “if a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.” Because of this general rule, a partner can assume the role of unrelated third party when dealing with the partnership. For example, a partner can lend money to or borrow money from a partnership, rent property to or from a partnership, buy property from or sell property to a partnership, or provide consulting services to a partnership as an independent contractor. The tax consequences of all the above transactions will be determined as if the partnership were dealing with a nonpartner.57

The major exception to the general rule of § 707(a) concerns partners who work in the partnership business on a regular and ongoing basis. The point was made earlier in the chapter that general partners are considered self-employed individuals, rather than employees of their partnership. Consequently, partners cannot be paid a salary or wage by the partnership, even if they perform exactly the same duties as nonpartner employees. However, partners who work in a partnership business certainly expect to be compensated for their time and effort. The tax consequences of compensatory payments made by partnerships to partners in their capacities as such are governed by § 707(c). The annual amounts of such payments are typically determined with reference to the extent and nature of the services performed, without regard to the income of the partnership for that year. Such guaranteed payments must be recognized as ordinary income by the recipient partner. The partnership will either deduct the guaranteed payment as a § 162 business expense or capitalize it to an appropriate asset account as required by § 263.58

Example 25. P has a one-third interest in the calendar year OPQ Partnership. Unlike partners O and Q, P works in the partnership business on a full-time basis. The partnership agreement provides that for the current year P will receive a monthly guaranteed payment of $4,000 from the partnership. The partnership business generates $175,000 of annual income before consideration of P’s guaranteed payment.

Based on the nature of the work performed by P, the partnership may claim a current deduction for the guaranteed payment; accordingly its net income for the year is $127,000 ($175,000 – $48,000 total guaranteed payments), and each partner’s one-third distributive share is $42,333. P will report total partnership income for the year of $90,333 ($48,000 guaranteed payment + $42,333 distributive

57 Under § 267(a)(2), a payment made by an accrual basis taxpayer to a cash basis related party may not be deducted by the payor until the taxable year in which the payee includes the payment in gross income. Per § 267(e), a partnership and any partner are related parties for purposes of this matching rule. The rule does not apply to § 707(c) guaranteed payments.

58 Guaranteed payments can also be made with respect to a partner’s capital account. Such payments are functionally equivalent to interest, always represent ordinary income to the recipient partner, and will be either deducted or capitalized by the partnership.
share), while O and Q will each report only their $42,333 distributive shares of income.

**Example 26.** Assume the same facts as in *Example 25*, except that the OPQ Partnership generates only $30,000 of annual income before consideration of P’s guaranteed payment. In this case, the deduction of the payment results in an $18,000 net loss of which each partner’s distributive share is $6,000. P will report total partnership income for the year of $42,000 ($48,000 guaranteed payment — $6,000 loss), while O and Q will each report only their $6,000 distributive shares of loss.

From an economic perspective, a guaranteed payment received by a partner is functionally equivalent to a salary received by an employee. Nonetheless, for tax purposes several important differences distinguish the two. An employer is required by law to withhold federal, state, and local income taxes and employee payroll taxes from an employee’s salary. Guaranteed payments are not subject to any similar withholding requirement. At the end of each calendar year, employees receive a Form W-2 on which gross annual compensation and various withheld amounts are summarized. Guaranteed payments are reported only as a line item on the recipient partner’s Schedule K-1 issued by the partnership. Finally, while cash basis employees must recognize salary payments as gross income in the year the payments are received, guaranteed payments are deemed to be paid to partners on the last day of the tax year, regardless of when they are actually paid during the year.\(^{59}\)

**Example 27.** Refer to the facts in *Example 26*, but assume the OPQ Partnership is on a fiscal year ending September 30. As a result, P actually received three $4,000 guaranteed payments in October, November, and December of the prior calendar year and only nine $4,000 payments during the current calendar year. Notwithstanding, P will report the entire $48,000 of guaranteed payments in the current year because all twelve months of guaranteed payments are deemed to be paid on September 30. Note that this result holds regardless of the amount of any renegotiated guaranteed payment that P may receive during the last three months of the current year.

**SALES BETWEEN PARTNERS AND CONTROLLED PARTNERSHIPS**

Section 707(b) defines two situations in which the general rule of § 707(a) is overridden and the tax consequences of transactions between partners and partnerships are not determined as if the transaction were negotiated at arm’s length between independent parties. Both situations involve a sale of property between (1) a partnership and any person owning more than a 50 percent interest in either partnership capital or profits, or (2) two partnerships in which the same persons own more than a 50 percent interest in either capital or profits.\(^{60}\) If such a sale results in a recognized loss to the seller, such loss is disallowed. If the purchaser of the property subsequently disposes of the property at a gain, the originally disallowed loss may be used to offset such gain.\(^{61}\)

**Example 28.** T owns a 60% interest in the TV Partnership. During the current year, T sells investment land to TV for $100,000; T’s basis in the land is $145,000.

\(^{59}\) Reg. § 1.707-1(c).

\(^{60}\) Percentage ownership is determined with reference to the constructive ownership rules of § 267(c) other than paragraph (3) of such section. § 707(b)(3).

\(^{61}\) § 707(b)(1). Note the similarity to the more general loss disallowance rule of § 267(a)(1).
T may not recognize his $45,000 loss realized on the sale, and TV will take a $100,000 cost basis in the land. If the partnership subsequently sells the land for more than $100,000, T’s $45,000 disallowed loss may be used to offset the amount of taxable gain the partnership must recognize. If the partnership sells the land for less than $100,000, T’s disallowed loss will have no effect on the amount of the taxable loss the partnership will recognize.

If a sale of property between a partner and a related partnership results in a recognized gain, and the property is not a capital asset in the hands of the purchaser, the gain must be characterized as ordinary income.\[62\]

Example 29. Refer to the facts in Example 28, but assume that T’s basis in the investment land was $70,000. If the TV Partnership uses the land in its trade or business, rather than holding it as a capital asset, T’s $30,000 recognized gain on the sale must be characterized as ordinary income.

PARTNERSHIP DISTRIBUTIONS

This next section of this chapter is an analysis of the broad set of rules applicable to partnership distributions to which the specialized provision of § 751(b) does not apply. (Any discussion of disproportionate distributions is beyond the scope of this chapter.) All partnership distributions can be classified as either current or liquidating. A current distribution reduces a partner’s interest in partnership capital but does not extinguish the interest. In other words, subsequent to the receipt of a current distribution, a partner is still a partner. In contrast, a liquidating distribution extinguishes the recipient partner’s entire equity interest in the partnership. An ongoing partnership may make liquidating distributions to any of its partners who terminates an interest. When a partnership itself terminates, it will make a final liquidating distribution to all its partners.

The aggregate theory of partnerships predominates in the sections of Subchapter K (§§ 731–737) devoted to distributions. Under this theory, a partner’s interest in a partnership represents an indirect ownership interest in partnership assets. Therefore, a partner who receives a distribution of cash or property is merely converting his or her indirect interest in partnership assets to direct ownership of the distributed assets. This change in ownership form should not be a taxable event and should have no effect on the tax basis of the distributed assets. This theoretical foundation is clearly discernible in the set of rules explained in the following paragraphs.

CURRENT DISTRIBUTIONS

Cash Distributions. Partners may withdraw cash from their partnerships at various times throughout the partnership’s taxable year in order to meet their personal short-term liquidity needs or as advance payments of their anticipated distributive shares of current-year partnership income. Partners may also receive periodic cash distributions as guaranteed payments for ongoing services rendered to the partnership. Finally, partners may receive constructive cash distributions in the form of reductions in their respective shares of partnership liabilities.\[63\]

Regardless of the nature of a current cash distribution, § 731(a) provides that the recipient partner does not recognize gain upon its receipt. The cash distribution is instead treated as a nontaxable return of capital that reduces the recipient’s outside basis in his or

\[62\] An almost identical (and therefore redundant) gain characterization rule can be found in § 1239(a).

\[63\] § 752(b).
her partnership interest. However, the basis of a partnership interest can never be reduced below zero. Consequently, a partner who receives a cash distribution in excess of outside basis must recognize the excess as gain derived from sale of the partnership interest.

Guaranteed payments and other cash distributions representing advances against the recipient’s share of current-year partnership income are taken into account as of the last day of the partnership year. This timing rule minimizes the possibility that distributions will trigger gain recognition at the partner level.

**Example 30.** Partnership WXYZ and 25% partner Z both use a calendar year for tax purposes. At the beginning of the current year, Z’s outside basis was $50,000, and partnership debt totaled $60,000 ($15,000 of which was properly included in Z’s outside basis). On July 7, the partnership made a $75,000 cash distribution to Z. As of the last day of the year, partnership debt totaled $80,000. Partnership income for the current year consisted of $109,000 ordinary income and a $5,600 capital loss. Z’s outside basis at the end of the year is computed as follows:

<table>
<thead>
<tr>
<th>Basis on January 1</th>
<th>$50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased by: 25% share of ordinary income</td>
<td>27,250</td>
</tr>
<tr>
<td>25% share of $20,000 increase in partnership debt</td>
<td>5,000</td>
</tr>
<tr>
<td>Decreased by: July 7 cash distribution</td>
<td>(75,000)</td>
</tr>
<tr>
<td>25% share of capital loss</td>
<td>(1,400)</td>
</tr>
<tr>
<td>Basis on December 31</td>
<td>$5,850</td>
</tr>
</tbody>
</table>

The effect of the July 7 distribution is determined as if the distribution had occurred on the last day of the partnership year. Because Z’s outside basis is first increased by his distributive share of partnership income and his share of WXYZ’s increased debt load, the distribution is treated as a nontaxable return of capital.

If the $75,000 distribution had not been a guaranteed payment or advance against income, its tax effect would have been determined on July 7. Assuming that the partnership debt on this date was still $60,000, Z must recognize a $25,000 capital gain equal to the excess of the distribution over his $50,000 basis. Subsequent to the distribution, Z’s outside basis would have been reduced to zero.

**Property Distributions.** As a general rule, a current distribution of partnership property to a partner does not cause gain or loss recognition at either the partnership or the partner level. The recipient partner simply takes a carryover basis in the distributed property and reduces the outside basis in her partnership interest by a corresponding amount.

**Example 31.** S receives a current distribution of property from the STUV Partnership. At date of distribution, the property has a fair market value of $14,000 and an inside basis to the partnership of $7,500. Immediately prior to the distribution, S’s outside basis in her partnership interest was $12,000. Neither the partnership nor...

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64 § 733.
65 § 731(a)(1). This gain is capital gain per § 741.
67 § 731(a) and (b). Section 731(c) provides that certain marketable securities are treated as money rather than property for purposes of § 731(a). Consequently, the distribution of such securities by a partnership may trigger gain recognition to the recipient partner. Discussion of this special rule is beyond the scope of this text.
68 §§ 732(a)(1) and 733.
S recognizes a gain on the distribution. S’s basis in the property becomes $7,500 and her outside basis is reduced to $4,500 ($12,000 − $7,500).

Note that in the above example, the $7,500 inside basis of the distributed property (i.e., the carryover basis) was preserved by shifting $7,500 of S’s outside basis to the property. If the recipient partner’s outside basis is less than the inside basis of the distributed property, the distribution is referred to as a substituted basis transaction. In such a situation, the basis of the distributed property in the hands of the partner is limited to his or her outside basis amount.⁶⁹

Example 32. Refer to the facts in Example 31. If S’s predistribution outside basis had been only $6,000, S’s basis in the distributed property would be $6,000 and her postdistribution outside basis would be zero ($6,000 − $6,000). Note that S simply substitutes her outside basis as the basis in the distributed asset.

If a partnership distribution consists of multiple assets and the recipient partner’s outside basis is less than the aggregate inside bases of the assets, the outside basis must first be reduced by any amount of cash included in the distribution. The remaining basis is allocated between two categories of noncash assets in the following order of priority:

1. To any unrealized receivables and inventory (Category 1) in an amount not to exceed the basis of these assets in the hands of the partnership.⁷⁰

2. To any other distributed properties (Category 2).

Basis is allocated to multiple assets within either of these two categories under a basis decrease formula. The basis decrease is first allocated to property with unrealized depreciation (i.e., inside basis greater than fair market value) to the extent of the unrealized depreciation in each property.⁷¹

Example 33. J receives a current distribution from the JKL Partnership consisting of the following:

<table>
<thead>
<tr>
<th>JKL Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$4,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>0</td>
</tr>
<tr>
<td>Inventory</td>
<td>2,000</td>
</tr>
<tr>
<td>Capital asset 1</td>
<td>1,000</td>
</tr>
<tr>
<td>Capital asset 2</td>
<td>3,000</td>
</tr>
</tbody>
</table>

Immediately prior to the distribution, J’s outside basis in his partnership interest was $8,000. This basis must first be reduced by the $4,000 cash distribution. The $4,000 remaining basis is allocated to the Category 1 assets in an amount not to exceed JKL’s inside basis:

<table>
<thead>
<tr>
<th>Partner J’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized receivables</td>
</tr>
<tr>
<td>Inventory</td>
</tr>
</tbody>
</table>

---

⁶⁹ § 732(a)(2).
⁷⁰ An unrealized receivable is any right to payment for goods or services provided to customers in the ordinary course of business that has not been recognized by the partnership as ordinary income. Reg. § 1.732-1(c)(1) and § 751(c).
⁷¹ § 732(c)(3)(A).
Because J’s $2,000 remaining outside basis is less than the aggregate inside bases of the Category 2 assets distributed, the basis decrease formula must be used to allocate this amount to the two capital assets received. First, the amount of the basis decrease is computed to be $2,000 by subtracting J’s remaining outside basis amount ($2,000) from the aggregate inside bases ($1,000 + $3,000 = $4,000) of these assets. The $2,000 basis decrease is then allocated to any of these assets with unrealized depreciation; in this case only Capital asset 2. Thus J’s basis in Capital asset 2 is $1,000 ($3,000 − $2,000). J’s resulting basis in each of these assets is reflected below:

<table>
<thead>
<tr>
<th>Inside Basis</th>
<th>FMV</th>
<th>Unrealized Depreciation</th>
<th>Partner J’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital asset 1</td>
<td>$1,000</td>
<td>$1,500</td>
<td>$0</td>
</tr>
<tr>
<td>Capital asset 2</td>
<td>3,000</td>
<td>1,000</td>
<td>2,000</td>
</tr>
</tbody>
</table>

Subsequent to this distribution, J’s outside basis in his partnership interest has been reduced to zero.

If more than one of the distributed assets from the same category has depreciated in value, the basis decrease is allocated based on relative depreciation.

**Example 34.** Assume the same facts in Example 33 above, except that the fair market value of Capital asset 1 is $500 instead of $1,500. In this case, the basis decrease is allocated between the two capital assets based on relative depreciation. J’s basis in each of these assets is determined as follows:

<table>
<thead>
<tr>
<th>Inside Basis</th>
<th>FMV</th>
<th>Unrealized Depreciation</th>
<th>J’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital asset 1</td>
<td>$1,000</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>Capital asset 2</td>
<td>3,000</td>
<td>1,000</td>
<td>2,000</td>
</tr>
</tbody>
</table>

Capital asset 1:

$1,000 carryover basis – $400 ([($500/2,500) × $2,000 basis decrease] = $600

Capital asset 2:

$3,000 carryover basis – $1,600 ([($2,000/2,500) × $2,000 basis decrease] = 1,400

Finally, if the required basis decrease exceeds the unrealized depreciation of the assets, any further decrease is allocated in proportion to the assets relative bases (as previously adjusted).

**Example 35.** Assume the same facts as in Example 34 above, except that the total amount of the required basis decrease is $2,800 instead of $2,500. In this case, the bases of Capital assets 1 and 2 would first be reduced by the existing depreciated amount to $500 and $1,000, respectively. The $300 remaining basis decrease would be allocated between these assets in proportion to these reduced bases. J’s basis in each of the capital assets would be computed as follows:

<table>
<thead>
<tr>
<th>JKL Basis</th>
<th>Depreciation</th>
<th>Reduced Basis</th>
<th>$300 Basis Decrease</th>
<th>J’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital asset 1</td>
<td>$1,000</td>
<td>$500</td>
<td>$500</td>
<td>$100 ([($500/$1,500) × $300] = 400</td>
</tr>
<tr>
<td>Capital asset 2</td>
<td>3,000</td>
<td>2,000</td>
<td>1,000</td>
<td>200 ([($1,000/$1,500) × $300] = 800</td>
</tr>
</tbody>
</table>

72 § 732(c)(3)(B).
LIQUIDATING DISTRIBUTIONS

Cash Distributions. When a partner’s entire interest in a partnership is extinguished upon receipt of a liquidating cash distribution, the partner will recognize capital gain to the extent of any amount of cash in excess of the outside basis in his partnership interest. Conversely, if the cash distribution is less than outside basis, the partner may recognize the amount of unrecovered basis as capital loss.

Example 36. C receives a liquidating distribution of $20,000 cash from the ABC Partnership. (This distribution equals the $20,000 value of C’s capital account as of the date of distribution.) Because she is no longer a partner, C is relieved of $13,000 of partnership debt. C’s total cash distribution is $33,000 ($20,000 actual cash + $13,000 constructive cash in the form of debt relief).

If C’s outside basis immediately prior to distribution is $24,500, she must recognize a $8,500 capital gain equal to the excess of the $33,000 cash distribution over this basis.

If C’s outside basis immediately prior to distribution is $35,000, she may recognize a $2,000 capital loss equal to the excess of this basis over the $33,000 cash distribution.

Property Distributions. Liquidating distributions of property generally do not result in gain or loss recognition to either partnership or partner. When a partnership distributes property as a liquidating distribution, the recipient partner’s outside basis (reduced by any amount of cash included in the distribution) is allocated to the distributed property. In most cases, this substituted basis rule defers the recognition of any economic gain or loss realized by the partner upon liquidation.

Example 37. M receives a liquidating distribution of $6,000 cash and a partnership § 1231 asset with a fair market value of $25,000 and a $14,600 inside basis to the partnership.

Assume M’s predistribution outside basis is $40,000. This basis is reduced by the $6,000 cash distribution and the remaining $34,000 basis is substituted as the basis of the distributed asset to M. Neither M nor the partnership recognizes gain or loss because of the distribution.

Assume M’s predistribution outside basis is $9,000. This basis is reduced by the $6,000 cash distribution and the remaining $3,000 basis is substituted as the basis of the distributed asset to M. Neither M nor the partnership recognizes gain or loss because of the distribution.

Assume M’s predistribution outside basis is only $4,000. M must recognize the $2,000 cash distribution in excess of basis as capital gain. The distributed asset will have a zero basis to M.

If a liquidating distribution includes multiple assets, the recipient partner’s outside basis (reduced by any cash distributed) is allocated between two categories of noncash assets in the following order of priority:

1. To any unrealized receivables and inventory (Category 1) in an amount not to exceed the basis of these assets in the hands of the partnership.

2. To any other distributed properties (Category 2).

See Footnote 67, supra.

§ 732(b).
Unlike the current (nonliquidating) distribution rules that limit the distributee partner’s bases in any assets to the distributing partnership’s inside basis (i.e., a carryover basis), only the bases of unrealized receivables or inventory (Category 1 assets) are subject to this rule in a liquidating distribution. If the distributee partner’s outside basis exceeds the partnership’s inside basis of any unrealized receivables or inventory distributed, the remaining outside basis must be assigned to any asset received from Category 2.\(^{75}\) If the partner does not receive any Category 2 assets, then the excess of the outside basis over the inside basis of the Category 1 assets is recognized as a loss by the partner.\(^ {76}\) However, if Category 2 assets are received, the partner can never recognize a loss.

**Example 38.** R receives a liquidating distribution from the RST Partnership that consists of the following:

<table>
<thead>
<tr>
<th></th>
<th>RST Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$2,500</td>
<td>$2,500</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>0</td>
<td>2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>3,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Capital asset</td>
<td>5,000</td>
<td>9,000</td>
</tr>
</tbody>
</table>

R’s predistribution outside basis in his partnership interest was $12,000. This basis must first be reduced by the $2,500 cash distribution. The $9,500 remaining basis is allocated to the Category 1 assets in an amount not to exceed RST’s inside basis:

<table>
<thead>
<tr>
<th></th>
<th>Partner R’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized receivables</td>
<td>0</td>
</tr>
<tr>
<td>Inventory</td>
<td>3,000</td>
</tr>
</tbody>
</table>

The $6,500 remaining basis is allocated to the capital asset (Category 2 asset), even though this substituted basis exceeds the RST Partnership’s $5,000 inside basis. In addition, neither R nor the RST Partnership recognizes gain or loss because of the distribution.

**Example 39.** N receives a liquidating distribution from the MNOP Partnership that consists of the following:

<table>
<thead>
<tr>
<th></th>
<th>MNOP Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$700</td>
<td>$700</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>0</td>
<td>800</td>
</tr>
<tr>
<td>Inventory asset 1</td>
<td>1,000</td>
<td>1,300</td>
</tr>
<tr>
<td>Inventory asset 2</td>
<td>2,100</td>
<td>2,500</td>
</tr>
</tbody>
</table>

Immediately prior to the distribution, N’s outside basis is $4,000. This basis must first be reduced by the $700 cash distribution. Only $3,100 of the $3,300 remaining basis is allocable to the Category 1 assets.

<table>
<thead>
<tr>
<th></th>
<th>Partner N’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealized receivables</td>
<td>$-0-</td>
</tr>
<tr>
<td>Inventory asset 1</td>
<td>1,000</td>
</tr>
<tr>
<td>Inventory asset 2</td>
<td>2,100</td>
</tr>
</tbody>
</table>

N may recognize her $200 unrecovered outside basis as a capital loss.

\(^ {75}\) § 732(c).

\(^ {76}\) § 731(a)(2).
Note that in Example 39 partner N received a liquidating distribution with a total fair market value of $5,300 so that she realized an economic gain upon termination of her partnership interest. The Subchapter K rules governing the tax consequences of partnership property distributions ensure that a partner’s economic gain or loss with respect to the distribution is deferred until subsequent disposition of the property.

**Example 40.** Refer to the facts in Example 39. Although N recognized a $200 tax loss upon receipt of the liquidating distribution, she realized a $1,300 economic gain ($5,300 value of assets received in excess of $4,000 basis in N’s liquidated partnership interest). However, N’s basis in the distributed assets is only $3,100. If N were to sell the unrealized receivables and inventory for their aggregate value of $4,600, she would recognize a $1,500 taxable gain.

This result is consistent with the aggregate theory of partnerships under which N has not severed her interest in the MNOP Partnership until she no longer owns any interest in partnership assets. When N finally sells the distributed MNOP assets, her $1,500 recognized gain on sale netted against her $200 recognized loss upon distribution equates to her $1,300 economic gain attributable to the termination of her partnership interest.

Finally, when a partner receives more than one Category 2 asset in a liquidating distribution, his or her remaining outside basis must be allocated between the assets using one of the following:

1. **Basis decrease formula**—where the sum of the bases of the distributed Category 2 assets exceeds the distributee partner’s outside basis remaining after reduction for any cash received and basis allocated to any unrealized receivables or inventory (Category 1 assets).

2. **Basis increase formula**—where the sum of the bases of the distributed Category 2 assets is less than the distributee partner’s outside basis remaining after reduction for any cash received and basis allocated to any unrealized receivables or inventory (Category 1 assets).

**Example 41.** After reduction for a distribution of cash and the required allocation of basis to unrealized receivables and inventory received in a liquidating distribution from the RST Partnership, partner T’s remaining outside basis of $25,000 must be allocated to the following capital assets:

<table>
<thead>
<tr>
<th>RST’s Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital asset 1</td>
<td>$10,000</td>
</tr>
<tr>
<td>Capital asset 2</td>
<td>30,000</td>
</tr>
</tbody>
</table>

Because T’s $25,000 remaining outside basis is less than the aggregate bases of the Category 2 assets, the basis decrease formula must be used. First, the amount of the basis decrease is computed to be $15,000 by subtracting T’s outside basis amount ($25,000) from the aggregate inside bases ($40,000) of these assets. The $15,000 basis decrease is then allocated to any of the assets with unrealized depreciation; in this case only Capital asset 2. T’s basis in each of these assets is reflected below:

<table>
<thead>
<tr>
<th>Inside Basis</th>
<th>FMV</th>
<th>Unrealized Depreciation</th>
<th>Partner T’s Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital asset 1</td>
<td>$10,000</td>
<td>$20,000</td>
<td>$0</td>
</tr>
<tr>
<td>Capital asset 2</td>
<td>30,000</td>
<td>10,000</td>
<td>20,000</td>
</tr>
</tbody>
</table>
Note that even though the depreciation in value of Capital asset 2 is $20,000, the total basis decrease is only $15,000. Thus, the $30,000 inside basis in that asset is reduced to $15,000 in T’s hands.

If more than one of the distributed assets from the same category has depreciated in value, the basis decrease is allocated based on relative depreciation.

**Example 42.** Assume the same facts in Example 41 above, except that the fair market value of Capital asset 1 is $5,000 instead of $20,000. In this case, the $15,000 total basis decrease is allocated between the two capital assets based on relative depreciation as follows:

\[
\text{J's Basis} = \frac{\text{Carryover Basis}}{\text{FMV}} \times \text{Basis Decrease}.
\]

- **Capital asset 1:**
  \[
  \text{J's Basis} = \frac{10,000}{20,000} \times 15,000 = 7,500
  \]
- **Capital asset 2:**
  \[
  \text{J's Basis} = \frac{30,000}{25,000} \times 15,000 = 18,000
  \]

**Example 43.** After reduction for a distribution of cash and the required allocation of basis to unrealized receivables and inventory received in a liquidating distribution from the RST Partnership, partner T’s remaining outside basis of $25,000 must be allocated to the following capital assets:

<table>
<thead>
<tr>
<th>Capital asset 1</th>
<th>RST's Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$10,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Capital asset 2</td>
<td>5,000</td>
<td>25,000</td>
</tr>
</tbody>
</table>

Because the aggregate bases of the Category 2 assets is less than T’s remaining outside basis, the basis *increase* formula must be used. First, the amount of the basis increase is computed to be $10,000 by subtracting the aggregate inside bases ($15,000) of these assets from T’s outside basis amount ($25,000). The $10,000 basis increase is then allocated to the assets based on relative unrealized appreciation. T’s basis in each of these assets is reflected below:

<table>
<thead>
<tr>
<th>Inside Basis</th>
<th>FMV</th>
<th>Unrealized Appreciation</th>
<th>Basis Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital asset 1</td>
<td>$10,000</td>
<td>$20,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Capital asset 2</td>
<td>5,000</td>
<td>25,000</td>
<td>20,000</td>
</tr>
</tbody>
</table>

T’s basis in Capital asset 1 will be $13,333 ($10,000 carryover basis + $3,333 basis increase) and his basis in Capital asset 2 will be $11,667 ($5,000 carryover basis + $6,667 basis increase). Note that the total of T’s bases in these assets ($13,333 + $11,667 = $25,000) equals his $25,000 remaining predistribution outside basis.

If only one of the assets in Example 43 above had unrealized appreciation, it would have been allocated all of the basis increase up to its total fair market value. In the event that the basis increase exceeded the unrealized appreciation, any remaining basis increase amount would be allocated between the assets based on relative fair market values.

**Closing of Partnership Year.** When a partner’s entire interest in a partnership is liquidated, the partnership taxable year closes with respect to that partner. As a result, the partner may have to include a proportionate share of more or less than 12 months of partnership income in his or her taxable year in which the liquidation occurs.

---

77 § 706(c)(2)(A)(ii).
Example 44. The BCD Partnership and partner B both use a calendar year for tax purposes. On September 30, 2006 B received a liquidating distribution from BCD that terminated his interest in the partnership. BCD’s taxable year closed with respect to B on September 30. As a result, B will include his proportionate share of BCD’s income from January 1 through September 30 (nine months) in his 2006 tax return. BCD’s taxable year does not close with respect to the remaining partners, who will include their proportionate shares of BCD’s income for the full calendar year on their respective returns.

Example 45. Refer to the facts in Example 44. If BCD uses a fiscal year ending May 31 for tax purposes, two partnership years (June 1, 2005 through May 31, 2006 and the short year June 1, 2006 through September 30, 2006) ended within partner B’s 2006 taxable year. As a result, B will include his proportionate share of BCD’s income from June 1, 2005 through May 31, 2006 (12 months) and from June 1, 2006 through September 30, 2006 (four months) in his 2006 tax return.

In Example 44 and Example 45, B’s outside basis in his partnership interest immediately prior to the receipt of his liquidating distribution should reflect his distributive share of BCD’s income or loss through September 30, 2006. Therefore, B cannot determine the tax consequences of the distribution itself until he receives his final Schedule K-1 from the BCD Partnership.

SECTION 736 PAYMENTS

The amount of a liquidating distribution paid to a partner who is terminating an interest in an ongoing partnership should theoretically equal the partner’s proportionate interest in the value of the partnership assets. In reality, partners may negotiate for and partnerships may agree to pay liquidating distributions in excess of such amount. In such case, § 736 provides that only the portion of the total distribution attributable to the partner’s interest in partnership assets is subject to the statutory rules dealing with partnership distributions. The remainder of the distribution (labeled a § 736(a) payment) is not subject to the normal distribution rules. Instead, § 736(a) payments that are determined without regard to the income of the partnership are classified as guaranteed payments. Section 736(a) payments determined with reference to partnership income are classified as distributive shares of such income.

Example 46. R, a 20% general partner in the RSTU Partnership, retired from the partnership business during the current year. As of the date of R’s retirement, the partnership had the following balance sheet.

<table>
<thead>
<tr>
<th>Inside Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Business assets</td>
<td>65,000</td>
</tr>
<tr>
<td>Debt</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Capital: R</td>
<td>22,000</td>
</tr>
<tr>
<td>Other partners</td>
<td>88,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$115,000</strong></td>
</tr>
</tbody>
</table>

78 § 705(a).
Even though R’s capital account balance was only $27,000, the other partners agreed to pay R $40,000 cash in complete liquidation of his equity interest. The additional $13,000 payment was in grateful recognition of R’s long years of faithful service to the business.

The total liquidating payment to R consisted of $41,000 ($40,000 actual cash + $1,000 relief of 20% of the partnership debt). R’s 20% interest in the value of partnership assets was $28,000 (as evidenced by the $27,000 value of his capital account and 20% share of the partnership debt). Therefore, only $28,000 of the liquidating payment is treated as a distribution. If R’s outside basis in his partnership interest was $23,000, R must recognize a $5,000 capital gain equal to the excess of the cash distribution over this basis.

The $13,000 § 736(a) payment to R was determined without regard to partnership income. Consequently, it is classified as a guaranteed payment, which R must recognize as ordinary income and the partnership may deduct as a current expense.

Payments for Unrealized Receivables and Unspecified Goodwill. Section 736 contains a special rule concerning liquidating payments made with respect to a partner’s interest in certain partnership assets. Payments made with respect to unrealized receivables must be considered § 736(a) payments rather than distributions. Payments made with respect to goodwill are similarly classified unless the partnership agreement specifies that a withdrawing partner will be paid for his or her share of goodwill. Prior to the enactment of the Revenue Reconciliation Act of 1993, this special rule applied to liquidating payments made to any partner by any partnership. The 1993 Act limited its application to payments made to general partners by partnerships in which capital is not a material income-producing factor.

Example 47. E is a 10% general partner in the Beta Partnership, a professional service partnership in which capital is not a material income-producing factor. During the current year, E had a serious disagreement with the other partners and decided to withdraw from the partnership. As of the date of E’s withdrawal, the partnership had the following balance sheet:

<table>
<thead>
<tr>
<th>Inside Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$35,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>0</td>
</tr>
<tr>
<td>Business assets</td>
<td>100,000</td>
</tr>
<tr>
<td>Debt</td>
<td>$15,000</td>
</tr>
<tr>
<td>Capital: E</td>
<td>12,000</td>
</tr>
<tr>
<td>Other partners</td>
<td>108,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$135,000</strong></td>
</tr>
</tbody>
</table>

---

79 § 751(c) provides that, for § 736 purposes, the term unrealized receivables includes only zero basis accounts receivable and not § 1245, § 1250, or other types of ordinary income recapture.

80 § 736(b)(3). Capital is not a material income-producing factor if substantially all of the partnership’s income consists of fees, commissions, or other compensation for personal or professional services performed by individuals.
After considerable negotiation, the other partners agreed to pay E $20,000 cash in complete liquidation of her equity interest. The partners determined that this was a fair price for E’s 10% capital interest because the partnership business has considerable goodwill and going concern value that is not recorded as an asset on its balance sheet. The Beta Partnership agreement does not provide for specific payments with respect to partnership goodwill.

The total liquidating payment to E consisted of $21,500 ($20,000 actual cash + $1,500 relief of 10% of the partnership debt). E’s 10% interest in the value of the recorded partnership assets was $20,400 (as evidenced by the value of her $18,900 capital account and 10% share of the partnership debt). However, the $2,400 payment made with respect to E’s 10% interest in Beta’s unrealized receivables must be classified as a § 736(a) payment. Consequently, only $18,000 of the liquidating payment ($20,400 − $2,400) is treated as a distribution. If E’s outside basis in her partnership interest was $13,500, E must recognize a $4,500 capital gain equal to the excess of the cash distribution over this basis.

The $3,500 § 736(a) payment to E represents the value of her 10% interest in Beta’s accounts receivable and unspecified goodwill. Because the payment was determined without regard to partnership income, it is classified as a guaranteed payment, which E must recognize as ordinary income and Beta may deduct as a current expense.

DISPOSITIONS OF DISTRIBUTED PROPERTY

If a partner who received either a current or liquidating distribution of partnership unrealized receivables subsequently collects the receivables or disposes of them in a taxable transaction, that partner must recognize the excess of the amount realized over the zero basis in the receivables as ordinary income.\(^81\) Similarly, if a partner sells inventory distributed from a partnership within five years of the date of distribution, any gain or loss recognized must be characterized as ordinary gain or loss.\(^82\) A partnership’s holding period for a distributed asset is included in the recipient partner’s holding period.\(^83\)

**Example 48.** Two years ago, G received a current distribution of land from the EFG Partnership, which operates a real estate development business. The land was an inventory asset to EFG and took a carryover basis of $140,000 in G’s hands. G held the land as an investment and sold it in the current year for $200,000. Because she sold the land within five years of the date of its distribution by EFG, G must recognize her gain as ordinary income, even though the land was a capital asset in her hands.

BASIS ADJUSTMENTS TO PARTNERSHIP PROPERTY

Under the general rules governing the tax consequences of partnership distributions, no gain or loss is recognized at either the partnership or the partner level and distributed assets simply take a carryover basis in the hands of the recipient partner. However, in certain circumstances, a partner may be required to recognize either capital gain or loss

\(^81\) § 735(a)(1). This paragraph provides that both gain or loss realized on a partner’s disposition of partnership unrealized receivables is characterized as ordinary gain or loss. Except in unusual circumstances, such receivables will have a zero basis in the hands of a distributee partner; consequently, their disposition can only trigger gain recognition.

\(^82\) § 735(a)(2).

\(^83\) § 735(b).
because of a distribution. In other cases, the inside basis of a distributed partnership asset does not carry over to the recipient partner.

These exceptions to the general rules can be viewed as anomalies that violate the aggregate theory of partnerships. Subchapter K provides a mechanism to correct these anomalies in the form of an adjustment to the inside basis of undistributed partnership property. Specifically, if a partnership has a § 754 election in effect, it is allowed to increase the basis of partnership property by (1) any amount of gain recognized by a partner as the result of a distribution, or (2) any reduction of the inside basis of a distributed partnership asset in the hands of the recipient partner.84

Example 49. Partner L received a current distribution from the LMNO Partnership that consisted of $5,000 cash and partnership inventory with an inside basis of $1,500. Because L’s predistribution outside basis was only $3,600, L recognized a $1,400 capital gain and took a zero basis in the distributed inventory. If LMNO has a § 754 election in effect, it may increase the inside basis in its remaining assets by $2,900 ($1,400 gain recognized by L + $1,500 reduction in the basis of the distributed inventory).

In Example 49, $1,400 of the positive basis adjustment counterbalances the current gain recognized at the partner level by decreasing the amount of future gain the partnership will recognize on a sale of assets (a $1,400 basis increase is equivalent to a $1,400 decrease in gain potential). The remaining $1,500 positive basis adjustment to LMNO’s assets compensates for the $1,500 lost basis in the distributed inventory.85

A partnership with a § 754 election in effect is required to decrease the basis of partnership property by (1) any amount of loss recognized by a partner as the result of a distribution, or (2) any increase in the basis of a distributed partnership asset in the hands of the recipient partner.86

Example 50. Partner E received a liquidating distribution of $5,000 cash from the EFGH Partnership. Because E’s predistribution outside basis was $7,000, E recognized a $2,000 capital loss. Partner F received a liquidating distribution from EFGH consisting of a capital asset with an inside basis of $10,000. Because F’s predistribution outside basis was $14,500, F took a $14,500 substituted basis in the distributed asset.

If EFGH has a § 754 election in effect, it must decrease the basis in its remaining assets by $6,500 ($2,000 loss recognized by E + $4,500 increase in the basis of the distributed capital asset).

In Example 50, $2,000 of the negative basis adjustment counterbalances the current loss recognized at the partner level by decreasing the amount of future loss the partnership will recognize on a sale of assets (a $1,400 basis decrease is equivalent to a $1,400 decrease in loss potential). The remaining $4,500 negative basis adjustment to EFGH’s assets compensates for the $4,500 additional basis in the distributed capital asset.

The optional basis adjustment is allocated to the same asset class in which the distributed property falls. For purposes of this adjustment, the partnership’s assets are divided into two property classes:

1. Capital assets and § 1231 property (i.e., capital gain property), and
2. All other assets (i.e., ordinary income property).

84 § 734(b)(1).
85 The rules for allocating a § 734(b) basis adjustment to specific partnership assets are found in § 755 and the regulations thereunder.
86 § 734(b)(2).
However, any loss resulting from the distribution of cash, unrealized receivables, and inventory, must be allocated to the partnership’s capital gain property. Further, any gain recognized from the distribution of cash must also be allocated to the capital gain property.

For allocations of increases in basis within a class, the increase must be allocated first to any properties in that class with unrealized appreciation. If more than one property has unrealized appreciation, the increase is allocated in proportion to each asset’s unrealized appreciation. However, in no case can the allocated increase for an asset exceed that asset’s unrealized appreciation. If any increase remains after this allocation, it is allocated to properties within that class in proportion to their fair market values.

The rules are similar for a decrease in basis. The decrease must be allocated first to any properties in that class with unrealized depreciation. If more than one property has unrealized depreciation, the decrease is allocated in proportion to each asset’s unrealized depreciation. However, in no case can the allocated decrease for an asset exceed that asset’s unrealized depreciation. If any decrease remains after this allocation, it is allocated to properties within that class in proportion to their adjusted bases. The adjusted bases used for this allocation include any adjustments already made as part of the overall allocation process. In no case can the adjusted basis for an asset be reduced below zero. If the bases of all assets within a class have been reduced to zero, any remaining decreases are suspended until the partnership acquires property in that class.

It is important to note that the rules for increases and decreases are similar, except that any remaining adjustment after the initial allocations are based on relative fair market values for increases, but on relative adjusted bases for decreases.

Example 51. Refer to the facts in Example 49. The § 734 adjustment was $2,900: $1,400 for the gain from the cash distribution and $1,500 due to the reduction in basis for the distributed inventory. The $1,400 for the gain must be allocated to capital gain property. Since inventory is an ordinary asset, the $1,500 for the inventory basis must be allocated to the ordinary income class.

Assume that LMNO Partnership owns the following two capital assets:

<table>
<thead>
<tr>
<th>Adjusted Basis</th>
<th>FMV</th>
<th>Unrealized Appreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Asset A</td>
<td>$1,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Capital Asset B</td>
<td>1,000</td>
<td>1,000</td>
</tr>
</tbody>
</table>

Since the only capital asset with unrealized appreciation is asset A, its basis is increased by $1,400 to $2,400.

Alternatively, assume that LMNO Partnership owns the following two capital assets:

<table>
<thead>
<tr>
<th>Adjusted Basis</th>
<th>FMV</th>
<th>Unrealized Appreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Asset A</td>
<td>$1,000</td>
<td>$2,200</td>
</tr>
<tr>
<td>Capital Asset B</td>
<td>1,000</td>
<td>1,800</td>
</tr>
</tbody>
</table>

The $1,400 basis increase is allocated to the assets based on the relative unrealized appreciation. Therefore, asset A receives a basis increase of $840 ($1,200/$2,000 × $1,400). Asset B receives a basis increase of $560 ($800/$2,000 × $1,400). Note that these basis increases are allowed because neither exceeds the unrealized

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87 Reg. § 1.755-1(c)(2).
88 Reg. § 1.755-1(c)(4).
appreciation for the respective asset. Asset A’s basis is increased from $1,000 to $1,840, and asset B’s basis is increased from $1,000 to $1,560.

Example 52. Refer to the facts in Example 50. The § 734 adjustment was $6,500: $2,000 for the loss recognized and $4,500 for the increase in basis of the capital asset. This results in a $6,500 decrease in the basis of capital assets, because all losses due to distributions are allocated to capital assets, as are adjustments due to the distribution of capital assets.

Assume that LMNO Partnership owns the following two capital assets:

<table>
<thead>
<tr>
<th>Capital Asset</th>
<th>Adjusted Basis</th>
<th>FMV</th>
<th>Unrealized Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Asset A</td>
<td>$12,000</td>
<td>$4,000</td>
<td>$8,000</td>
</tr>
<tr>
<td>Capital Asset B</td>
<td>10,000</td>
<td>12,000</td>
<td>0</td>
</tr>
</tbody>
</table>

Since the only capital asset with unrealized depreciation is asset A, its basis is decreased by $6,500 to $5,500.

The Section 754 Election. A partnership will adjust the inside basis of its assets as the result of a distribution to a partner only if it has a § 754 election in effect for the year of the distribution. A partnership makes a § 754 election simply by attaching a statement to that effect to its Form 1065 for the first taxable year for which the election is to be effective. Once made, the election applies for all subsequent years unless the Internal Revenue Service agrees to its revocation.\(^{89}\)

Substantial Basis Reduction. Even if a § 754 election is not in effect, the rules discussed above will apply if there is a substantial basis reduction to partnership property as the result of a distribution. A substantial basis reduction occurs if the sum of 1) the partner’s loss on the distribution, and 2) the basis increase to the distributed properties is more than $250,000.\(^{90}\)

Example 53. Partner B has a basis of $4,000,000 in her partnership interest in Partnership AB. Partnership AB does not have a § 754 election in effect. She receives a liquidating distribution of land from the partnership having a fair market value of $3,500,000 and a basis of $1,800,000. She will recognize no gain or loss on the distribution. Her basis in the land will be $4,000,000 and the basis in her partnership interest will be reduced to zero. Since the basis of the land has increased by more than $250,000 (by $2,200,000, from $1,800,000 to $4,000,000) a substantial basis reduction has occurred. Therefore, Partnership AB will have to reduce the basis of its other properties by $2,200,000 according to the rule § 755.

DISPOSITIONS OF PARTNERSHIP INTERESTS

The most common way for a partner to dispose of a partnership interest is through a liquidating distribution from the partnership itself. There are, however, a number of other types of dispositions, each of which has a unique set of tax consequences to both partner and partnership.

\(^{89}\) Reg. § 1.754-1.

\(^{90}\) See § 734(d)(1). These rules apply for distributions made after October 22, 2004
SALES OF PARTNERSHIP INTERESTS

Partnership agreements typically place restrictions on the partners’ right to sell their equity interests in the partnership to third parties. For example, an agreement might provide that a partner must offer his or her interest to the partnership itself or to the existing partners before offering it to a third-party purchaser. The agreement may also provide that a prospective purchaser must be approved by the general partners or by a majority of all partners. Because of such limits on transferability, partnership interests are considered illiquid assets.

When a partner sells his or her entire interest in a partnership, the partnership’s taxable year closes with respect to that partner. The selling partner’s outside basis in the partnership interest immediately prior to sale includes his or her distributive share of partnership income or loss through date of sale. The tax consequences of the sales transaction itself to both seller and purchaser are governed by specific rules in Subchapter K.

**Tax Consequences to Seller.** Upon sale of a partnership interest, the seller recognizes gain or loss to the extent the amount realized exceeds or is less than the outside basis of the interest. Section 741 contains a general rule that such gain or loss is capital in nature. This rule reflects the entity theory under which a partnership interest represents the partner’s equity in the partnership as a whole rather than a proportionate interest in each specific asset owned by the partnership. Literally in mid sentence, § 741 shifts to the aggregate theory by cautioning that the general rule is inapplicable to the extent provided in § 751(a). This subsection applies only if the partnership owns unrealized receivables or inventory, which for convenience’ sake tax practitioners have simply labeled **hot assets**.

**Hot Assets.** The term **unrealized receivables** includes zero basis trade accounts receivables generated by a cash basis partnership. The term also includes the § 1245 and § 1250 ordinary income recapture potential inherent in depreciable partnership assets. All partnership unrealized receivables are deemed to have a zero tax basis. The term **inventory** includes not only stock in trade and property held primarily for sale to customers in the ordinary course of business, but also any other property that is not a capital asset or a § 1231 asset to the partnership.

**Example 54.** The accrual basis MNO Partnership owns the following assets:

<table>
<thead>
<tr>
<th></th>
<th><strong>Tax Basis</strong></th>
<th><strong>FMV</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$7,000</td>
<td>$7,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>29,000</td>
<td>27,000</td>
</tr>
<tr>
<td>Stock in trade</td>
<td>330,000</td>
<td>410,000</td>
</tr>
<tr>
<td>Equipment cost</td>
<td>$100,000</td>
<td></td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(30,000)</td>
<td>70,000</td>
</tr>
<tr>
<td>Other 1231 assets</td>
<td>250,000</td>
<td>390,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$686,000</strong></td>
<td><strong>$914,000</strong></td>
</tr>
</tbody>
</table>

---

91 § 706(c)(2)(A)(i). Refer to the discussion of the closing of a partnership year with respect to a partner at 77, supra.
92 § 751(c). The term **unrealized receivables** also includes many esoteric types of ordinary income recapture potential, such as § 1254 recapture of intangible drilling and development costs of oil and gas wells and mining development and exploration expenditures.
93 Reg. § 1.751-1(c)(5).
94 § 751 inventory also includes any partnership property that is a § 1231 asset to the partnership.
If MNO were to sell its equipment for market value, it would recognize a $10,000 gain, all of which would be recaptured as § 1245 ordinary income. Consequently, the partnership has $10,000 of unrealized receivables.

Both MNO’s accounts receivable and stock in trade are inventory assets because accounts receivable are not a capital or § 1231 asset to the partnership.\textsuperscript{95}

Under § 751 (a) the amount of gain or loss for the hot assets (unrealized receivables and inventory) is determined by assuming that these assets are sold by the partnership in a fully taxable transaction for cash in an amount equal to the fair market value of the properties. The partner selling his partnership interest is allocated the portion of the ordinary income that would have been allocated to him if these assets had actually been sold by the partnership.\textsuperscript{96}

**Example 55.** K sold her 10% interest in the KLM Partnership to P for $45,000 cash. KLM used the cash method of accounting and had the following balance sheet as of the date K sold her interest. K’s outside basis in her interest was $35,500.

\begin{align*}
\text{Inside Basis} & \quad \text{FMV} \\
\text{Cash} & \quad \$40,000 \quad \$40,000 \\
\text{Accounts receivable} & \quad 0 \quad 30,000 \\
\text{Stock in trade} & \quad 90,000 \quad 100,000 \\
\text{Section 1231 assets (no recapture)} & \quad 225,000 \quad 300,000 \\
\text{Debt} & \quad 20,000 \quad 20,000 \\
\text{Capital: K} & \quad 33,500 \quad 45,000 \\
\text{Other partners} & \quad 301,500 \quad 405,000 \\
\text{Total} & \quad 355,000 \quad 470,000
\end{align*}

At date of sale, the partnership had both unrealized receivables of $30,000 (zero basis accounts receivable) and $100,000 of inventory.

If the hot assets were sold by the partnership at fair market value the partnership would recognize $40,000 of ordinary income ($130,000 fair market value − $90,000 basis). Ten percent of this income, or $4,000, would be allocated to K. Therefore, on the sale of her partnership interest K must recognize $4,000 of ordinary income under § 751(a).

Subsequent to the application of § 751(a), the amount realized on the sale of K’s partnership interest has been reduced to $34,000 ($47,000 total amount realized − $13,000 attributable to hot assets). K’s outside basis in her partnership interest has been reduced to $26,500 ($35,500 predistribution basis − $9,000 basis allocated to hot assets). Under the general rule of § 741, K recognizes a $7,500 capital gain on the sale of her partnership interest.

These computations can be summarized as follows:

\begin{align*}
\text{Total} & \quad \text{Hot Assets} & \quad \text{Other (§ 741)} \\
\text{Amount realized} & \quad \$47,000 & \quad \$13,000 \quad \$34,000 \\
\text{Adjusted basis} & \quad (35,500) & \quad (9,000) \quad (26,500) \\
\text{Recognized gain/loss} & \quad \$12,500 & \quad \$4,000 \quad \$7,500 \\
\text{Ordinary Income} & & \text{Capital Gain}
\end{align*}

\textsuperscript{95} Accounts receivable of a cash basis partnership are both an unrealized receivable and an inventory item for purposes of § 751.

\textsuperscript{96} Reg. § 1.751-1(a)(2).
In addition to the recognition of ordinary income if the partnership has hot assets, the seller of a partnership interest may also have special tax treatment in three other situations: collectibles gain, § 1250 capital gain, and residual long-term capital gain or loss.

First, if at the time of the sale of a partnership interest (which has been held for more than one year) the partnership holds collectibles with unrealized appreciation, the gain attributable to this appreciation is taxed at 28 percent.\(^\text{97}\) A collectible includes any work of art, rug, antique, metal, gem, stamp, coin, or alcoholic beverage.\(^\text{98}\)

**Example 56.** H and G are individuals that have been equal partners in HG for the last three years. The partnership owns gems that qualify as collectibles that have an adjusted basis of $500 and a fair market value of $1,100. H sells her interest in HG to I. As a result, $300 of H’s gain from the sale will be characterized as collectibles gain (50% of the $600 gain that HG would have realized if it sold its collectibles in a fully taxable transaction).

Second, unrecaptured § 1250 gain is taxed at a 25 percent maximum rate. Unrecaptured § 1250 gain is the capital gain that would be treated as ordinary income if § 1250(b)(1) required all depreciation to be recaptured as ordinary income. If a partner sells an interest in a partnership, and the partnership has unrecaptured § 1250 gain, then the partner must take into account his or her portion of that gain in computing the tax results.\(^\text{99}\)

**Example 57.** Assume in Example 56 above that HG also owns residential rental property. At the time of H’s sale, the property had a fair market value of $110,000 and adjusted basis of $60,000. The property’s original cost basis was $100,000. Straight-line depreciation of $40,000 had been claimed on the property. At the time of H’s sale, one must compute what H’s share of unrecaptured § 1250 gain would be if the property was sold. Since the property is realty and straight-line depreciation was used there would be no § 1250 recapture. Consequently, the entire gain ($50,000) would be a § 1231 gain. However, the § 1231 gain would be treated as a 25% gain to the extent of any straight-line depreciation claimed ($40,000). H’s share of the 25% gain is $20,000. Consequently, of the total gain recognized by H on the sale of his partnership interest, $20,000 will be 25% gain due to the § 1250 unrecaptured gain.

The collectibles gain and § 1250 unrecaptured gain that are allocable to a partner that has sold his or her partnership interest are together known as the look-through capital gain.\(^\text{100}\) The residual long-term capital gain or loss is computed as follows:

\[
\text{Residual long-term capital gain/loss} = \\
\frac{\text{§ 741 long-term capital gain or loss (after application of § 751)}}{\text{Look-through capital gain or loss}}
\]

**Example 58.** G and H are individuals that have been equal partners in Partnership B for the last two years. B owns collectibles with a basis and fair market value of

\(^{97}\) § 1(h)(6)(B).

\(^{98}\) § 408 (m)(3).

\(^{99}\) Reg. § 1.1(h)-1(b)(3)(ii).

\(^{100}\) § 1(b)(1)(D); Reg. § 1.1(h)-1(b)(1).
$3,000 and $5,000, respectively. G sells his interest in partnership B to R and has a total recognized gain of $500. After the application of the § 751 hot assets rules, assume that G recognizes ordinary income of $2,000 and § 741 long-term capital loss of $1,500 (i.e., the pre-look through long-term capital loss). G’s share of the collectibles gain (i.e., the look-through capital gain) is $1,000 \([\frac{5,000 - 3,000}{2} \times 50\%]\).

<table>
<thead>
<tr>
<th>Total gain</th>
<th>$500</th>
</tr>
</thead>
<tbody>
<tr>
<td>§ 751 Hot asset ordinary income</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Pre-look through long-term capital loss</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Gain from collectibles</td>
<td>1,000</td>
</tr>
<tr>
<td>Residual long-term capital loss</td>
<td>$(2,500)</td>
</tr>
</tbody>
</table>

To summarize, G has $2,000 of ordinary income, $1,000 collectibles gain taxed at 28%, and a $2,500 capital loss.

**Tax Consequences to Purchaser.** Section 742 states that the basis of a partnership interest acquired other than by contribution shall be determined under the normal basis rules provided in §§ 1011 and following. Thus, the purchaser of a partnership interest takes a *cost* basis in the interest. The *cost basis* includes the amount of cash and the value of any noncash property paid to the seller plus the amount of any partnership liabilities assumed by the purchaser in his or her role as a new partner.

The fact that a purchaser is given a cost basis in the partnership interest rather than in a proportionate share of partnership assets reflects the entity theory of partnerships. Section 743(a) reinforces this perspective by specifying that the basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership by sale or exchange. This general rule typically results in an imbalance between a purchasing partner’s outside basis and the inside basis of his or her proportionate share of partnership assets.

**Example 59.** P purchased a 10% interest in the accrual basis KLM Partnership from K for $45,000 cash. As of the date of sale, the partnership had the following balance sheet:

<table>
<thead>
<tr>
<th>Inside Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$40,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>30,000</td>
</tr>
<tr>
<td>Stock in trade</td>
<td>90,000</td>
</tr>
<tr>
<td>Depreciable assets</td>
<td>225,000</td>
</tr>
<tr>
<td>$385,000</td>
<td>$470,000</td>
</tr>
<tr>
<td>Debt</td>
<td>$20,000</td>
</tr>
<tr>
<td>Capital: K (replaced by P)</td>
<td>36,500</td>
</tr>
<tr>
<td>Other partners</td>
<td>328,500</td>
</tr>
<tr>
<td>$385,000</td>
<td>$470,000</td>
</tr>
</tbody>
</table>

P’s cost basis in his new partnership interest is $47,000 ($45,000 cash + 10% of KLM’s debt). The transaction between P and K had no effect on the basis of the partnership assets, so that P’s aggregate inside basis in 10% of KLM’s assets is only $38,500.
The imbalance between P’s outside and inside bases in Example 59 has several negative implications for P. If the partnership sells its entire stock in trade for $100,000, P will be allocated $1,000 of ordinary income (the excess of the $10,000 value of 10 percent of the stock in trade over its $9,000 basis), even though P indirectly paid $10,000 to acquire his share of this asset. Similarly, P will be allocated tax depreciation computed on the $22,500 inside basis of 10 percent of KLM’s depreciable assets, even though P indirectly paid $30,000 to acquire his share of these assets.

**Special Basis Adjustment for Purchaser.** Strict adherence to the entity theory is relaxed if a purchaser acquires an interest in a partnership with a § 754 election in effect.\(^\text{101}\) In this case, § 743(b) provides that any excess of the purchaser’s outside basis over the inside basis of his or her proportionate share of partnership assets becomes a *positive* adjustment to that partner’s inside basis.\(^\text{102}\) Conversely, any excess of a purchaser’s inside basis in his or her proportionate share of partnership assets over outside basis becomes a *negative* adjustment to that partner’s inside basis.

Any positive or negative adjustment to the inside basis of the partnership property must be allocated to specific assets in such a manner as to reduce the difference between the fair market value and the tax basis of the asset. For purposes of this adjustment, the partnership’s assets are divided into two property classes:\(^\text{103}\)

1. Capital assets and § 1231 property (i.e., capital gain property), and
2. All other assets (i.e., ordinary income property).

The allocation of the optional basis adjustment between these two classes is based on the gain or loss that would be allocated to the transferee partner based on a hypothetical sale of all the partnership’s assets. Therefore, it is possible that a positive adjustment could be made to the capital assets and a negative adjustment to the other assets, or vice-versa.

The adjustment to the ordinary income class is the amount of income, gain, or loss allocated to the transferee partner from the hypothetical sale of all ordinary income property at fair market value for cash. The adjustment to the capital asset class is then the difference in the total adjustment less the adjustment to the ordinary income class. However, any decrease in basis adjustment for the capital asset class cannot reduce the basis of the capital assets below zero. Once the basis of the capital assets is reduced to zero, any remaining negative adjustment must be used to reduce the basis of ordinary income property.\(^\text{104}\)

The adjustment to each class must then be allocated to assets within that class. Generally, the adjustment to each item of ordinary income property equals the amount of income, gain, or loss allocated to the transferee partner in a hypothetical sale of the item. The adjustment for each item in the ordinary income class is determined as shown below.

**Example 60.** G sells his 25% interest in the JJG Partnership to D on March 15, 2006. JJG Partnership previously made a § 754 election. D paid $50,000 to G and assumed G’s share of partnership liabilities. JJG’s balance sheet at the date of sale is as follows:

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\(^\text{101}\) The § 754 election is discussed at Footnote 87, *supra*.

\(^\text{102}\) § 743(b)(1).

\(^\text{103}\) § 755.

\(^\text{104}\) Reg. § 1.755-1(b).
Since the JJJG Partnership has a § 754 election in effect, D is entitled to a $9,500 basis adjustment [the excess of his $57,500 outside basis over the $48,000 inside basis of his 25% share of JJJG’s assets ($192,000 \times 25\%)]

Note that his outside basis is computed as the $50,000 cash payment plus 25% of the partnership’s debt. The $9,500 is labeled as a § 743(b) adjustment.

The § 743(b) adjustment is allocated between classes and among properties based on the allocations of income, gain, or loss that the transferee partner would receive from a hypothetical sale of all partnership assets.

**Allocation Between Classes:**

<table>
<thead>
<tr>
<th>Ordinary Income Property</th>
<th>Adjusted Basis</th>
<th>FMV</th>
<th>Gain/(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts receivable</td>
<td>$5,000</td>
<td>$3,750</td>
<td>$(1,250)</td>
</tr>
<tr>
<td>Inventory</td>
<td>10,500</td>
<td>12,500</td>
<td>2,000</td>
</tr>
<tr>
<td>Total</td>
<td>$15,500</td>
<td>$16,250</td>
<td>$750</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Capital Gain Property</th>
<th>Adjusted Basis</th>
<th>FMV</th>
<th>Gain/(Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building</td>
<td>$17,500</td>
<td>$21,250</td>
<td>$3,750</td>
</tr>
<tr>
<td>Land</td>
<td>5,000</td>
<td>10,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Total</td>
<td>$22,500</td>
<td>$31,250</td>
<td>$8,750</td>
</tr>
</tbody>
</table>

Therefore, the § 743(b) adjustment is allocated $750 to the ordinary income property and $8,750 to the capital gain property.

**Allocation Within Classes:**

If a hypothetical sale occurred, D would be allocated a loss of $1,250 from the sale of the receivables and a gain of $2,000 from the sale of the inventory. D would also be allocated a gain of $3,750 for the building and a gain of $5,000 for the land. Therefore, these amounts are D’s basis adjustment for each of these assets.

To summarize, D’s allocation of the inside basis of JJJG’s assets is as follows:

<table>
<thead>
<tr>
<th>Inside Basis</th>
<th>25% of Basis</th>
<th>§ 743(b) Adjustment</th>
<th>Adjusted Inside Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$40,000</td>
<td>$10,000</td>
<td>$0</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>20,000</td>
<td>5,000</td>
<td>(1,250)</td>
</tr>
<tr>
<td>Inventory</td>
<td>42,000</td>
<td>10,500</td>
<td>2,000</td>
</tr>
<tr>
<td>Building</td>
<td>70,000</td>
<td>17,500</td>
<td>3,750</td>
</tr>
<tr>
<td>Land</td>
<td>20,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

$57,500
Note that D’s total outside basis of $57,500 is now equal to his allocation of the inside basis of the partnership’s assets.

**Effect of the Adjustment.** A § 743(b) special basis adjustment belongs only to the purchasing partner and has no effect on the other partners. Although any benefit of a § 743(b) basis adjustment accrues only to the purchasing partner, the burden of record keeping for the adjustment falls upon the partnership. This disparity is one reason partnerships may be reluctant to make the § 754 election necessary to activate § 743(b). If a partner has a special basis adjustment with respect to an asset disposed of by the partnership in a taxable transaction, the adjustment will be taken into account in calculating that partner’s distributive share of gain or loss.

**Example 61.** If the JJJ Partnership in the previous example sells its inventory for $50,000 and recognizes $8,000 of ordinary income, D’s 25% share of that is $2,000. However, D’s $2,000 special basis adjustment in the inventory reduces his distributive share of the partnership ordinary income to zero.

If a partner has a special basis adjustment with respect to a depreciable or amortizable asset, the adjustment will generate an additional cost recovery deduction for that partner. Therefore, D can depreciate the $3,750 step-up in basis for the building in Example 60.

**Substantial Built-in Loss.** Even if a § 754 election is not in effect, the rules discussed above will apply if there is a substantial built-in loss to the partnership immediately after the transfer of the partnership interest. A substantial built-in loss occurs if the partnership’s basis in its assets exceeds the fair market value of those assets by more than $250,000.

**Example 62.** Partner M sells his partnership interest for $500,000 at a time when the MN partnership has a basis and fair market value in its assets of $3,000,000 and $2,500,000, respectively. Since the basis of the partnership’s assets exceeds the fair market value by more than $250,000 ([by $500,000 ([$3,000,000 — $2,500,000])], a substantial built-in loss exists. Therefore, even if Partnership MN does not have a § 754 election in effect, the partnership must reduce the basis of its properties by $500,000 according §755.

**Special Rule for Built-in-Losses.** If the seller of a partnership interest had previously contributed built-in-loss property to the partnership, special rules apply. As explained earlier, if a partner contributes property with built-in losses, §704(c) requires that when the property is sold, any recognized loss must be allocated to that contributing partner to the extent of the built-in loss, with any remaining loss allocated per the partnership agreement. However, §704(c)(1)(C) requires that in determining the amount of items allocated to other (non-contributing partners), the basis of the property is assumed to be its fair market value at the time of contribution.

**Example 63.** Partner L contributes land to equal partnership LO with a basis of $100 and a fair market value of $80. Therefore, the land has a built-in loss of $20. If the partnership sold the land for $80, the $20 loss would be allocated to L.

Assume that L sells his partnership interest to M for $80. L would recognize a loss of $20 from the sale of his partnership interest. Under previous law, M would “step
into the shoes’’ of L and the first $20 loss from the future sale of the land would be allocated to M. Section 704(c)(1)(C) now requires that the basis of the land be treated as $80 (its fair market value on the date of contribution) for purposes of allocating any tax items to partners M and O. Thus, if the land was later sold by the partnership for $70, the basis of the land would be $80 (not $100). The sale would create a $10 loss ($70 amount realized less $80 basis), none of which is a built-in loss. The $10 loss would be allocated equally to partners M and O.

The purpose of this rule is to prevent the partners from benefiting from a double loss. If L recognizes a loss of $20 on the sale of the partnership interest and M could recognize another loss of $20 when the land was sold, a double benefit would be created.

GIFTS OF PARTNERSHIP INTERESTS AND FAMILY PARTNERSHIPS

Dispositions of partnership interests by gift generally have no income tax consequences to either donor or donee, although the donor may be liable for a gift tax on the transfer. The donee will take a basis in the partnership interest as determined under § 1015.

Transfers of partnership interests by gift usually involve donors and donees who are members of the same family, and therefore often result in the creation of family partnerships. Such partnerships can be an effective way to divide the income from a family business among various family members. To the extent the income can be allocated and taxed to individuals in the lower marginal tax brackets, family partnerships can also achieve a significant tax savings.

Not surprisingly, the tax laws restrict the use of family partnerships as income shifting devices. If the income earned by a partnership is primarily attributable to the individual efforts and talents of its partners, any allocation of that income to nonproductive partners would be an unwarranted assignment of earned income. Accordingly, a family member generally cannot be a partner in a personal or professional service business unless he or she is capable of performing the type of services offered to the partnership’s clientele.108

A family member can be a partner in a business in which capital is a material income-producing factor.109 In contrast to a service partnership, the mere ownership of an equity interest in a capital intensive partnership entitles a partner to a share of partnership income. Under the general rules of § 704, a partner’s allocable share of income does not have to be in proportion to his or her interest in partnership capital as long as the allocation has substantial economic effect. However, § 704(e)(2) provides that in the case of any partnership capital interest created by gift, the income allocable to such interest cannot be proportionally greater than the income allocated to the donor’s capital.

Example 64. M creates a partnership with his son S and daughter D by giving each child an equity interest in his business. M is in the highest marginal tax bracket, while his children are in the 15% marginal tax bracket. The initial MSD Partnership balance sheet appears as follows:

<table>
<thead>
<tr>
<th>Contributed business assets</th>
<th>$300,000</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Capital</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>M</td>
<td>$200,000</td>
</tr>
<tr>
<td>S</td>
<td>50,000</td>
</tr>
<tr>
<td>D</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$300,000</strong></td>
</tr>
</tbody>
</table>

109 § 704(e)(1). Capital is a material income-producing factor if the operation of the partnership business requires substantial inventories or a substantial investment in plant, machinery, or equipment. Reg. § 1.704-1(e)(1)(v).
If S and D’s interests had not been created by gift, the partnership agreement could allocate any amount of partnership income to S and D as long as the allocation had substantial economic effect. Because the interests were created by gift, the maximum percentage of income allocable to S and D respectively is 16.7% ($50,000 donee’s capital ÷ $300,000 total capital of both donor and donees).

Section 704(e)(2) also requires that any allocation of income with respect to donor and donee partners take into account the value of services rendered to the partnership by the donor. This statutory requirement prevents a donor partner from forgoing reasonable compensation from the partnership in order to maximize the amount of income shifted to the donee partners.

**Example 65.** Refer to the facts in *Example 64*. If M performs services for MSD during its first taxable year that are reasonably worth $25,000, he must be compensated for the services before any amount of partnership income may be allocated to S and D. If the partnership earns $145,000 of operating income during its first year, the maximum amount of such income allocable to S and D respectively is $20,000 [16.7% of ($145,000 operating income — $25,000 compensation to M)].

Note that the restrictions illustrated in *Example 64* and *Example 65* technically apply to any partnership interest created by gift, regardless of any familial relationship between donor and donee. Realistically, these restrictions most frequently apply to family partnerships. In order to prevent families from circumventing these restrictions, the statute states that a partnership interest purchased from a family member is considered to have been acquired by gift.\(^{110}\)

**DEATH OF A PARTNER**

When an individual partner dies, his or her partnership interest passes to a *successor in interest* in the partnership.\(^{111}\) The partner’s gross estate for federal estate tax purposes includes the fair market value of the partnership interest at date of death, and the decedent’s successor takes an outside basis in the interest equal to such fair market value.\(^{112}\) Because the death of a partner causes a closing of the partnership’s tax year with respect to that partner, items of income, gain, loss, deduction, or credit attributable to the deceased partner’s interest up to date of death will be included on the final tax return of the decedent. Any amounts for the remainder of the partnership’s tax year must be reported by the deceased partner’s successor in interest.\(^{113}\)

**Example 66.** Individual Z, who owned a 40% interest in the capital, profits, and loss of the calendar year XYZ Partnership, died on November 3 of the current year. Under the terms of Z’s will, all his assets (including his interest in XYZ) passed to his estate. Because the partnership’s tax year closes with respect to Z on the date of his death, XYZ’s income or loss attributable to this interest from January 1 to November 3 will be included in Z’s final tax return. Income or loss attributable to this 40% interest for

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\(^{110}\) Section 704(e)(3). For purposes of this rule, a partner’s family members include a spouse, ancestors, and lineal descendants.

\(^{111}\) The successor in interest is named under the decedent partner’s will or determined by reference to state intestacy laws if the decedent died without a will.

\(^{112}\) Section 1014(a). Any imbalance between a successor in interest’s outside basis and inside basis in the partnership assets is remedied if the partnership has a § 754 election in effect. In such case § 743(b) permits a special adjustment with respect to the inside basis of the partnership assets.

\(^{113}\) Section 706(c)(2)(A)(ii). Prior to 1998, the death of a partner did not cause the partnership’s tax year to close with respect to the deceased partner. As a result, income or loss attributable to the interest for the entire year was usually included on the tax return of the successor in interest.
the remainder of the year must be included in the first fiduciary income tax return filed on behalf of Z’s estate.

PARTNERSHIP TERMINATION

One of the important legal characteristics of the partnership form of business is *limited life*. Under state law, a partnership is dissolved whenever any partner ceases to be associated in the carrying on of the partnership business.\(^{114}\) From a legal perspective, a partnership’s identity, and therefore its existence, is dependent upon the continued association of a particular group of partners. This perspective is consistent with the aggregate theory of partnerships. Nevertheless, it would be totally impractical to require a partnership to close its taxable year and make a final accounting of its business activities every time an existing partner left or a new partner joined the partnership.

Section 708(a) adopts the entity theory by providing that a partnership does not terminate for tax purposes simply because it may be dissolved under state law. In other words, a partnership shall continue in existence as an entity for purposes of Subchapter K even if the association of partners changes. Section 708(b) provides that a partnership shall terminate for tax purposes *only if*:

1. No part of any business, financial operation, or venture is being conducted by the partnership (*natural termination*), or
2. Within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits (*technical termination*).

TECHNICAL TERMINATIONS

When a partnership ceases to conduct any type of economic activity, its termination for federal tax purposes marks the natural end of its life as a business entity. In contrast, a partnership that is terminated because of a sale or exchange of more than a 50 percent interest may be conducting a vital, ongoing business. Moreover, the partners who were not involved in the sale or exchange may be unaware that the terminating transaction even occurred!

Only sales or exchanges of partnership interests can trigger a technical termination. Other types of dispositions, such as gifts or transfers at death, are ignored. Similarly, changes in the relative ownership interests of partners because of contributions to or distributions from a partnership cannot result in termination. Sales or exchanges will not cause termination unless *at least* a 50 percent cumulative interest in both capital and profits changes hands within a 12-month period.

**Example 67.** Partners A, B, and C have owned equal interests in the capital and profits of the ABC Partnership since 1996.

- On January 12, 2005, A sold her one-third interest to new partner D.
- On July 8, 2005, B sold 10% of his interest to new partner E.
- On November 22, 2005, C gave his one-third interest to new partner F.
- On January 9, 2006, F exchanged this interest for stock in a new corporation; the exchange was nontaxable under § 351.

The January 12 sale did not terminate the ABC Partnership because only a 33.3% interest in capital and profits was sold. The July 8 sale did not terminate the

\(^{114}\) Uniform Partnership Act, § 29.
partnership because at that point in time only a 43.3% cumulative interest in capital and profits had been sold within a 12-month period. The November 22 gift did not enter into the termination calculation. The January 9 exchange did result in a termination of the ABC Partnership; within the 12-month period beginning on January 12, 2005, a cumulative 76.6% interest in the partnership was sold or exchanged. If F had delayed his exchange until after January 11, 2006, the transaction would have not triggered a termination.

In determining whether a cumulative 50 percent interest has been sold or exchanged within the crucial 12-month time period, multiple transfers of the same interest are counted only once.\textsuperscript{115} In Example 67, if D (rather than F) had exchanged his one-third interest for corporate stock on January 9, 2006, the exchange would not have resulted in a technical termination.

**EFFECT OF TERMINATION**

Upon termination, a partnership’s taxable year closes with respect to all its partners. If the partnership and any partner use different taxable years, a bunching of more than 12 months of income may occur.

**Example 68.** The QRS Partnership uses a calendar year for tax purposes, while corporate partner A uses a fiscal year ending June 30. The partnership terminated on March 31, 2006 and closed its taxable year on that date. Because two partnership years (calendar year 2005 and the short taxable year from January 1–March 31, 2006) ended within its fiscal year ending June 30, 2006, Q must include its distributive share of 15 months of partnership income in its taxable income for the year.

Pursuant to a natural termination, a partnership typically will wind up its affairs and distribute all remaining cash and assets to the partners in complete liquidation of their interests.\textsuperscript{116} In a technical termination, the partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership. The terminated partnership then distributes interests in the new partnership to the purchasing partner and all other remaining partners.\textsuperscript{117} The result of the application of these rules is that the technical termination does not automatically result in adjustments to the bases of the partnership assets because no assets are treated as being distributed.\textsuperscript{118}

**PROBLEM MATERIALS**

**DISCUSSION QUESTIONS**

22-1  *Partnership versus Corporation.* List both tax and nontax advantages or disadvantages of operating a business as a partnership rather than as a corporation.

22-2  *General versus Limited Partners.* Distinguish between the legal rights and responsibilities of a general partner and a limited partner.

\textsuperscript{115} Reg. § 1.708-1(b)(2).

\textsuperscript{116} Reg. § 1.708-1(b)(1).

\textsuperscript{117} Reg. § 1.708-1(b)(1)(iv).

\textsuperscript{118} A complete analysis of the potential tax consequences of technical terminations is beyond the scope of an introductory text.