PARTNERSHIP DISTRIBUTIONS, DISPOSITIONS OF PARTNERSHIP INTERESTS AND PARTNERSHIP TERMINATIONS

INTRODUCTION AND STUDY OBJECTIVES

Family businesses and tax shelters are frequently operated as partnerships because of their opportunities for tax reduction. Substantial opportunities for tax savings are possible where the partners are members of the same family. Tax shelters continue to be popular because of their unique opportunity for tax savings. Because the benefits provided to partners are so significant, special rules govern their operations.

Distributions of partnership assets and dispositions of partnership interest are also discussed. Generally, a distribution by a partnership has no tax consequences to the partnership or the partner except for its effect on basis. Gain or loss may be recognized in certain cases. Dispositions of partnership interests can generate both capital gains and losses as well as ordinary gain.

In studying the special rules dealing with partnership interest, the student should have these objectives:

1. To learn the characteristics and tax-saving opportunities in family partnerships and tax shelters.

2. To understand the rules for making partnership distributions, which include both proportionate and disproportionate distributions.

3. To become familiar with the effects of a disposition of a partnership interest, including the effects of § 751 assets.

STUDY HIGHLIGHTS

PARTNERSHIP DISTRIBUTIONS

1. A current distribution is one that does not liquidate a partner’s capital interest. Gain is recognized to the extent that money distributed exceeds the partner’s adjusted basis in the partnership interest.

2. The adjusted basis of assets received in a current distribution is as follows:

   - Cash—fair market value.
   - Unrealized receivables—the adjusted basis to the partnership.
   - Other property—the adjusted basis to the partnership before the distribution.

In no case can the basis of other assets exceed the partner’s adjusted basis in the partnership after reduction for cash and unrealized receivables.

Example. W, a partner in WX partnership, receives a distribution of land (nonliquidating). Before the distribution, the land has a basis to WX of $15,000 and cash of $9,000. If W’s adjusted basis is $21,000 (before the distribution), no gain is recognized. The cash received by W first reduces her basis in the partnership so that the remaining basis of $12,000 is allocated to the land. Her basis in the partnership is now zero.
3. When a partner contributes property to a partnership, unless it is a disguised sale, no gain or loss ensues. § 704(c)(1)(B), however, provides an exception. If (1) contributed property is distributed within a period 5 years prior to the distribution, AND (2) the property is distributed to a non-contributing partner, any built-in gain must be recognized by the contributing partner.

4. New § 737, added by the Energy Act of 1992, was enacted to prevent a tax-free contribution of appreciated property followed by a later tax-free distribution of property other than cash. This new provision triggers gain to a contributing partner that receives a distribution of property. The gain is the lesser of (1) the FMV of property over the outside basis, or (2) the net precontribution gain of the asset contributed by the partner.

5. Proportionate liquidating distributions are treated like current liquidations with one exception. In a case where a partner’s basis exceeds the partnership’s basis in the assets distributed, the excess must be allocated among the § 1231 and capital assets received.

6. When an interest in a partnership is liquidated with partnership cash, the recipient is considered to be a “retiring” partner. Income payments generally consist of payments for the partnership’s goodwill and unrealized receivables.

7. Section 736(b) payments are classified as payments in exchange for a partnership interest. These payments do not include unrealized receivables. Section 736(a) payments are classified as any other payments. These payments are treated as guaranteed income (ordinary).

8. The primary advantage of the partnership retiring a partner’s interest, compared with the remaining partners purchasing the interest, is the flexibility allowed for goodwill payments. Goodwill is included only to the extent provided in the partnership agreement.

9. When the basis of assets distributed to a partner is less than the basis in the hands of the partnership, there may be an “unused” basis situation. Section 754 permits the partnership to elect to adjust the basis of its remaining assets to take up this unused basis. This adjustment is for the benefit of the remaining partners.

10. Similarly, when a partner’s interest is sold or assumed by an estate, the partnership can elect to adjust the basis of its property to reflect the difference between the cost and the adjusted basis in the partnership property. This adjustment is for the benefit of the new partner.

11. If an election has been made under § 754, the partnership may have to decrease the basis of remaining assets in certain cases. A decrease would be required for the excess of the basis distributed over the basis that the partnership had for those assets. On a sale of a partner’s interest, a decrease would be required if the new partner paid less than the partnership’s basis in his pro rata share of assets.

**Example.** N has a partnership basis of $75,000 and receives a building having an adjusted basis to the partnership of $60,000, which terminates N’s interest. N’s basis in the building becomes $75,000 and the partnership reduces the basis of its remaining property by the $15,000 difference.

12. The 2004 Jobs Act provides that the §754 basis adjustments made under §743 are mandatory if the partnership has a substantial built-in loss after the transfer or distribution. For this new rule, a substantial built-in loss relating to a transfer of a partnership interest exists if the partnership’s aggregate adjusted basis in its property exceeds the aggregate fair market value of the property by more than $250,000.

**Example.** Partner S sells his 25% partnership interest to B for its FMV of $1,000,000 at a time the value of the partnership assets is $4,000,000 and the basis of the partnership assets is $4,300,000. Since the basis of the partnership assets exceeds the FMV of the partnership property by more than $250,000, the partnership’s basis in its assets must be adjusted even though the partnership does not file a §754 election. Thus, new partner B will recognize no gain or loss if the partnership were to sell its assets for their FMV.
13. Similar to the mandatory basis described in item 12. above, the new law also provides that a basis adjustment under §734(b) is required in the case of a distribution which causes the partner to make a substantial basis reduction in the distributed property. A substantial basis reduction means a downward adjustment of more than $250,000 that would be made to the basis of partnership assets if a §754 election were in effect.

DISPROPORTIONATE DISTRIBUTIONS

14. Unlike proportionate distributions, disproportionate distributions of partnership property generally result in taxable income. When a disproportionate distribution occurs, each partner determines his ordinary income and resulting basis using the following steps:

a. Pretend a proportionate distribution occurred.

b. Pretend the assets imaginarily received in excess of those actually received were sold for their fair market value.

c. The proceeds received from this imaginary sale were used to purchase the assets that were actually received minus those deemed received in the first step.

15. Gains or losses from partnership distributions, liquidations, or sales are generally capital gains or losses. However, any gains or losses attributable to unrealized receivables or inventory items are characterized as ordinary income.

Example. In December 2007, E receives a share of inventory items (basis of $20,000) in a nonliquidating distribution from a partnership. In February 2008, E sells the inventory for $30,000. Even though the inventory is a capital asset in E’s possession, the $10,000 gain is taxed to E as ordinary income.

16. Unrealized receivables are those amounts due from property or services previously provided but not yet included in income (for example, the accounts receivable of a cash basis taxpayer). Unrealized receivables also include depreciation recapture in the partnership assets.

17. The term inventory means all assets other than cash, capital assets, and § 1231 assets. To be included as ordinary income, before 2003, the inventory items must have been substantially appreciated. This means that the fair market value of the inventory items exceeds 120 percent of its basis to the partnership. Beginning in 2003, all inventory is treated as a “hot asset for purposes of a sale but not for purposes of a distribution.”

DISPOSITIONS OF PARTNERSHIP INTERESTS

18. When a partner sells all or part of a capital interest, two computations are required:

a. Determine the partner’s share of § 751 ordinary gain.

b. Determine the partner’s capital gain. This is done by subtracting the amount determined as § 751 ordinary gain from the realized gain.

19. Under the aggregate theory, a selling partner may be required to recapture investment tax credits.

20. A gift of a partnership interest may result in income recognition to the donor if the partnership has unrealized receivables.

21. Under the assignment of income doctrine, the IRS may reallocate income to prior partners when a cash basis partnership with unrealized receivables is incorporated.
22. The abandonment or forfeiture of a partnership interest can be a taxable event that generates income or loss.

23. As a result of the DRA of 1984, an exchange of partnership interest will not qualify as a like-kind exchange.

24. There is no taxable gain or loss, including ITC recapture, on the transfer of a partnership interest following the death of a partner. This is true even if the deceased partner’s share of liabilities exceeds his or her basis in the partnership.

25. A common device for splitting income among family members and avoiding the high tax brackets is the family partnership. A family member is recognized as a partner for income tax purposes if he owns a capital interest in which capital is a material income-producing factor. The validity of the partnership depends upon whether or not there has been an effective gift of the partnership interest.

26. If capital is not a material income-producing factor, a partnership resulting from a gift of an interest might be disregarded as an invalid attempt to assign income. If all the income is attributable to the personal efforts of the donor, he or she will be taxed on the entire amount of the income.

27. If a gift is a valid partnership interest, the following rules must be observed:

   The family member’s share must be determined with allowance of reasonable compensation for services rendered to the partnership by the donor.

   The share of the income allocated to the family member donee must not be proportionally greater than the share of the donor attributable to the donor’s capital.

   **Example.** The A & B partnership had a profit of $180,000 in the current year. A 50% interest is transferred by sale between Father and Son and is considered a gift. Capital is a material income-producing factor. Father performed services valued at $40,000 and Son did not perform any services. Under these conditions, the $40,000 should be allocated to Father as compensation, and of the remaining $140,000 income attributable to capital, at least 50%, or $70,000, must be allocated to Father.

28. The regulations require that the family member donee have control over the partnership; this includes authority to manage and have control over distributions.

**PARTNERSHIP TERMINATIONS**

29. Under Section 708(b), a partnership shall terminate for tax purposes only if:

   - It is a **natural termination**—No part of any business financial operation or venture is being conducted by the partnership, or
   
   - It is a **technical termination**—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.

30. When a partnership terminates, its tax year closes with respect to all partners. In a technical termination, under new regulations, the partnership is deemed to make a contribution of all of its assets to a new partnership. The new partnership, in turn, is deemed to distribute to all of the partners (including the new partner) an interest in the new partnership, who in turn, re-contribute the property back to a new partnership.

31. If two or more partnerships merge, the partnership whose partners own more than 50 percent of the new merged partnership will be deemed to survive. Conversely, if a partnership divides into two or more partnerships, the old partnership will be deemed to survive only if the old partners own more than 50 percent of one of the new partnership divisions. Partnerships that are not deemed to survive are considered to have terminated for tax purposes.
STUDY QUESTIONS

True or False

1. Pro rata distributions of property other than cash will not result in the recognition of gain to the distributee partner.
2. An election under § 754 is only binding for the current year and not for subsequent years.
3. The death of a partner will trigger gain or loss on the transfer of that interest to an heir.
4. At-risk rules were designed to prevent taxpayers from deducting investment losses against ordinary income on losses that were generated with nonrecourse liabilities.
5. Real estate activities are exempt from the at-risk rules.
6. A family member will be recognized as a valid partner only if he or she performs substantial services and if capital is a material income-producing factor.
7. Accounts receivable of an accrual basis taxpayer is classified as an unrealized receivable.
8. A gift of a partnership interest may trigger ordinary income to the donor partner.
9. To be considered “substantially appreciated,” the fair market value of inventory must exceed its basis to the partnership by 110 percent.
10. A disproportionate distribution occurs when a partner receives more or less than his pro rata share of unrealized receivables.
11. An exchange of one partnership interest for another partnership interest qualifies as a like-kind exchange, provided both interests are general partnership interests.
12. Payments to a retiring partner in liquidation of an interest that are not considered payments for the interest in partnership property are treated either as distributive shares or partnership income or as guaranteed payments, regardless of the time over which the payments are to be made.
13. W, a partner in a business consulting firm, received $25,000 in the firm’s dissolution as his share of accounts receivable. The partnership used the cash method. If the accounts receivable are later collected, or if W sells them, the amount received will be treated as ordinary income to him.
14. Recognition of gain will not occur with a liquidating distribution of property unless cash is received in excess of the partner’s basis.
15. The Walker partnership makes a distribution of all of its assets to partner L and all of its debt to partner S. A disproportionate distribution has occurred.
16. Amounts actually paid for unrealized receivables or goodwill will be included by the recipient as ordinary income under § 736(a) and will, accordingly, be deductible by the partnership.
17. A disproportionate distribution may result in capital gain treatment to one or some of the partners receiving the distributed assets.
18. The sale of a partnership interest will always result in capital gain treatment to the selling partnership as long as the partnership interest is a capital asset.

Multiple Choice

1. L, M, and N formed an equal partnership in 2009, each contributing $1,000 cash. The partnership is engaged in a computer leasing activity and uses the cash method of accounting. The partnership purchased a computer for $100,000, paying $3,000 in cash and giving a $97,000 nonrecourse note for which none of the partners is personally liable. For 2009, the partnership incurred an operating loss of $15,000. What is each partner’s deductible share of the loss?
   a. $0.
   b. $1,000.
   c. $4,000.
   d. $5,000.
   e. $6,000.

2. K owned a 50 percent interest in K&L Partnership, which reports income on the accrual basis. On April 1, 2009, the partnership was dissolved and it distributed to K half of all partnership assets. The following assets were distributed to K:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$5,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$10,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$8,000</td>
</tr>
<tr>
<td>Land</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

   K’s basis in the partnership was $43,000. As of December 31, 2009, K had sold the inventory for $10,000 and collected all accounts receivable. What gain will K report in 2009?
   a. $0.
   b. $2,000 capital gain.
   c. $2,000 ordinary income.
   d. $32,000 capital gain.
   e. $32,000 ordinary income.

3. The adjusted basis of X’s partnership interest is $30,000. X receives $5,000 cash and a current nonliquidating distribution of property with an adjusted basis of $45,000 to the partnership. What is X’s basis for the property received in the distribution?
   a. $15,000.
   b. $20,000.
   c. $25,000.
   d. $35,000.
   e. $45,000.
4. A had an adjusted basis of $11,000 for her interest in the A and D Partnership on December 1, 2009. On this date A received from the partnership, in complete liquidation of her interest, $10,000 cash and land with a basis to the partnership of $2,000 and a fair market value of $3,000. What is A’s basis in the land distributed to her?

   a. $0.
   b. $1,000.
   c. $1,833.
   d. $2,000.
   e. $3,000.

5. N’s adjusted basis in his partnership is $3,000. The partnership went out of business and N received $11,000 in cash and land with an adjusted basis of $15,000. What is N’s basis in the property received?

   a. $0.
   b. $3,000.
   c. $8,000.
   d. $11,000.
   e. $15,000.

6. A partnership in which the father sold a 50 percent interest to his son had a profit of $60,000 for 2009. Capital is a material income-producing factor. The father performed services for which $24,000 was considered to be reasonable compensation, and the son performed no services. The $24,000 must be allocated to the father as compensation. The son’s share of the partnership income cannot exceed what amount?

   a. $12,000.
   b. $18,000.
   c. $24,000.
   d. $30,000.
   e. $36,000.

7. During 2009, W sold the interest she had held for five years in the WX Partnership for $15,000 cash. The buyer also assumed W’s $2,000 share of the partnership liabilities. W’s tax basis in the partnership was $11,000. There were no unrealized receivables or appreciated inventories involved in this transaction. What is W’s gain on the sale of her partnership interest in WX?

   a. $2,000 ordinary gain.
   b. $2,000 long-term capital gain.
   c. $4,000 long-term capital gain.
   d. $6,000 long-term capital gain.
   e. None of the above.
8. C, an individual, is a partner in ABC Partnership. The adjusted basis of C’s interest at the end of 2009 is zero. C’s proportionate share of partnership liabilities is $20,000 and his share of ordinary income potential in partnership depreciable property is $5,000. The partnership has no other liabilities, unrealized receivables, or substantially appreciated inventory items. C sells his interest in the partnership for $15,000 in cash. Calculate C’s gain or loss on the disposition.

<table>
<thead>
<tr>
<th>Ordinary Income</th>
<th>Capital Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. $0</td>
<td>$0</td>
</tr>
<tr>
<td>b. $15,000</td>
<td>$0</td>
</tr>
<tr>
<td>c. $0</td>
<td>$15,000</td>
</tr>
<tr>
<td>d. $35,000</td>
<td>$0</td>
</tr>
<tr>
<td>e. $5,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

9. Partner A wishes to sell her interest in a partnership to an outside individual. She and three others hold equal shares, and all allocations are based on these holdings. Her adjusted basis at the date of disposition is $15,000. The partnership property is valued as follows:

<table>
<thead>
<tr>
<th></th>
<th>Book Value</th>
<th>Fair Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$48,000</td>
<td>$48,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$0</td>
<td>$36,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$75,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Land</td>
<td>$50,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$10,000</td>
<td>$12,000</td>
</tr>
</tbody>
</table>

NOTE: If the equipment is sold at the fair market value, the realized gain would be ordinary income—§ 1245 gain.

What would partner A’s realized gain or loss be?

a. $10,500.
b. $33,750.
c. $45,750.
d. $54,000.
e. $69,000.

10. Using the same facts given in the previous question, what portion of the gain is ordinary income?

a. $15,250.
b. $15,750.
c. $21,500.
d. $27,750.
e. $35,250.
11. In 2008, Corporation C contributed land (FMV $100,000 and basis $60,000) to Beta Partnership in exchange for a 25% interest in Beta. In 2009, Beta distributed the land to individual partner P, thereby terminating P’s 30% interest in Beta. Immediately prior to distribution, the land was worth $110,000 and P’s outside basis in his interest was $200,000. Which of the following is the correct set of tax consequences of the distribution?

a. There are no consequences to Corporation C. P takes a $200,000 basis in the land.
b. There are no consequences to Corporation C. P takes a $110,000 basis in the land.
c. There are no consequences to Corporation C. P takes a $100,000 basis in the land.
d. Corporation C must recognize a $50,000 gain and increase the basis in its partnership interest by $50,000. P takes a $200,000 basis in the land.
e. Corporation C must recognize a $40,000 gain and increase the basis in its partnership interest by $40,000. P takes a $200,000 basis in the land.

12. Partner L received a $55,000 cash distribution from the KLM Partnership in liquidation of his 25% interest. Immediately prior to distribution, L’s outside basis was $48,000. KLM had the following balance sheet:

<table>
<thead>
<tr>
<th>Inside Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$57,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>45,000</td>
</tr>
<tr>
<td>§ 1231 and capital assets</td>
<td>90,000</td>
</tr>
<tr>
<td><strong>$192,000</strong></td>
<td><strong>$232,000</strong></td>
</tr>
<tr>
<td>Debt</td>
<td>$32,000</td>
</tr>
<tr>
<td>Capital:</td>
<td></td>
</tr>
<tr>
<td>Partner L</td>
<td>40,000</td>
</tr>
<tr>
<td>Other Partners</td>
<td>120,000</td>
</tr>
<tr>
<td><strong>$192,000</strong></td>
<td><strong>$232,000</strong></td>
</tr>
</tbody>
</table>

Because of the distribution, L should recognize:

a. $15,000 capital gain.
b. $10,000 capital gain and $5,000 ordinary income.
c. $8,000 capital gain and $7,000 ordinary income.
d. $10,000 capital gain.
e. $8,000 capital gain and $2,000 ordinary income.

13. Partner E is retiring from the EFGH Partnership. The partnership agreement provides that E will be paid $64,000 for his 15% net interest in partnership property (excluding goodwill) plus an additional $36,000 retirement bonus. In addition, E will be immediately relieved of any personal liability for partnership debts. The $100,000 cash will be paid to E in ten annual $10,000 installments, beginning in the current year. Immediately prior to his retirement, E’s outside basis in his partnership interest is $28,000; this basis includes $20,000 of EFGH’s debt. In the current year, E will:

a. Recognize ordinary income of $9,000 and no capital gain.
b. Recognize ordinary income of $3,600 and no capital gain.
c. Recognize capital gain of $2,000.
d. Recognize ordinary income of $3,600 and capital gain of $6,400.
e. Recognize ordinary income of $9,000 and capital gain of $21,000.
14. A partnership is owned by a mother (60%) and her son (40%). Their capital accounts are maintained in the same ratio. The son received his ownership interest as a gift from his mother several years ago. Partnership income for the current year was $50,000. Although the mother performed services valued at $10,000, there was no entry on the partnership books and she received no cash for her services. To avoid a reallocation by the IRS, what amount of current year income should be allocated to the mother?

a. $20,000.
b. $30,000.
c. $34,000.
d. $40,000.
e. $50,000.

15. Which of the following statements concerning § 751(b) disproportionate distributions is accurate?

a. Both the distributing partnership and the recipient partner may recognize taxable gain because of a disproportionate distribution.
b. A disproportionate distribution can trigger the recognition of either ordinary gain or loss to the recipient partner.
c. A disproportionate distribution can only occur if the partnership has failed to make a valid § 754 election.
d. The disproportionate distribution rules of § 751(b) reflect the entity theory of partnerships.
e. None of the above is accurate.

Fill In the Blanks

1. A ________ partnership is a common device for splitting income among family members.

2. A gift of a partnership interest is treated as part ________ and part ________.

3. ________ and ________ are expressly excluded from the at-risk rules of § 465.

4. Loss cannot be recognized on a ________ distribution.

5. An account receivable held by a cash basis partnership is classified as an ________ ________.

6. In order to have substantially appreciated inventory, the value of the inventory must exceed ________ percent of its basis.

7. When a partnership is sold it will be taxed as a ________ ________ except to the extent of ________ ________ ________ or ________ ________.

8. The optional adjustment under § 754 is for the benefit of the ________ partner(s).
Code Section Recognition

For each of the following Code sections, try to match the response that most properly identifies the underlying provision.

1. § 704  a. payments to retiring partner
2. § 731  b. special allocations
3. § 751  c. election to step-up/down basis
4. § 736  d. substantially appreciated inventory
5. § 754  e. effect of partnership distributions
SOLUTIONS TO STUDY QUESTIONS

True or False

1. True.
2. False. The election applies to all subsequent years.
3. False. The estate or heirs take the interest in a nontaxable transaction.
4. True.
5. True.
6. False. Capital need not be a material income-producing factor.
7. False. Unrealized accounts receivable only apply to cash basis T/Ps.
8. True.
9. False. Fair market value needs to exceed 120 percent of basis.
10. True.
11. False. This change was added by the Deficit Reduction Act of 1984.
12. True.
13. True.
14. True.
15. True. One partner has received more than his or her share of assets.
16. True.
17. True. Under § 751 a disproportionate distribution is treated as a sale of certain assets that for some partners could be their interest in the capital assets.
18. False. Section 751 overrides the application of § 741 and the sale of a partnership interest to the extent that hot assets exist.

Multiple Choice

1. b. At-risk limits the loss to $1,000.
2. c. $2,000 of inventory.
3. c. $30,000 - $5,000.

4. b. $11,000 - $10,000.

5. a.

6. b. ($60,000 - $24,000) \times 50%.

7. d. $17,000 - $11,000.

8. e. $35,000 realized gain - $5,000 ordinary income.

9. d. $69,000 - $15,000.

10. b. Acct. rec. of $9,000 + inventory of $6,250 + equipment of $500.

11. e.

12. b.

13. a. $84,000 § 736(b) payment and $36,000 § 736(a) payment. In the current year a receives (30% of $30,000) = $9,000.

14. c. $10,000 + (60% of $40,000) = $34,000.

15. a.

Fill In the Blanks

1. Family.

2. Sale; contribution.

3. Real estate; leasing.


5. Unrealized receivable.

6. 120.

7. Capital gain; substantially appreciated inventory; unrealized receivable.

8. Remaining.
10-14  Partnership Distributions, Dispositions of Partnership Interests, etc.

Code Section Recognition

1.  b.

2.  e.

3.  d.

4.  a.

5.  c.