Partnership Basis and Distributions: Navigating Sections 731-737, 751(b) and 755

TUESDAY, SEPTEMBER 9, 2014, 1:00-2:50 pm Eastern

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Partnership Basis and Distributions

Sept 9, 2014

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PARTNERSHIP DISTRIBUTIONS: TAX OUTLINE

L. Andrew Immerman
Alston & Bird LLP
September 9, 2014
INTRODUCTION:

What is a Distribution?
What is a “Distribution”?  

• The term “distribution” is not formally defined in the Code, but under Code § 731 generally includes:  
  – Transfer of money to a partner with respect to the partner’s equity interest in the partnership.  
  – Transfer of other property to a partner with respect to the partner’s equity interest in the partnership.  
    • The rules on distributing “other property” to partners are somewhat different from the rules on transferring money, as discussed later.  
  – So-called “redemption” of a partner’s interest.  
    • “Redemptions” are simply distributions.  
    • However, distributions in liquidation of a partner’s interest are treated somewhat differently than current distributions, as explained below.  
  – So-called “dividends.”  
    • “Dividend” is not strictly speaking a partnership (or LLC) concept.  
    • When people talk about partnership “dividends,” they are thinking of transactions that the Code calls distributions.
What is a “Distribution”? 
– So-called “tax distributions.”
  • Tax distributions are distributions that are designed to give the partners the cash they need to pay taxes on income allocated to them by the partnership.
  • Tax distributions are just distributions that happen to be made with one particular purpose in mind.
  • They are important and often heavily negotiated.
    – Without a “tax distribution” a partner may have to pay tax on its share of partnership income without receiving any cash from the partnership.
  • However, under the tax rules, tax distributions are *not* a distinct category of distributions; they have the same status and are subject to the same rules as any other distributions.
    – If the partnership made cash distributions to the partners to enable them to buy refrigerators the tax rules would treat refrigerator-purchase distributions the same as tax distributions.
What is a “Distribution”?

– Decrease in the share of partnership liabilities allocated to a partner. Code § 752(c).
  • Partnership liabilities are included in the tax basis of the partners.
  • When a partner’s share of liabilities increases, the partner is treated as making a contribution.
  • When a partner’s share of liabilities decreases, the partner is treated as receiving a distribution.
Liability Share Decrease: Example

- Partners A, B and C contribute $100 each to Partnership, and each receives a 1/3 interest in Partnership.
- Partnership borrows $600 on a nonrecourse basis and A’s share of the debt is $200 (i.e., $200 of the debt is included in A’s basis under Code § 752).
  - Rules governing allocation of debt are extremely complex.
  - Here we simply assume that $200 of the debt is allocated to A.
- A’s basis in Partnership is $300 ($100 contribution plus $200 share of debt).
- Suppose that D contributes $300 for a 50% interest in Partnership, and D is allocated half of the total debt (i.e., D’s basis includes $300 of debt).
- Debt allocation to D reduces the debt allocated to A, B, and C.
  - A’s share of the debt might be reduced from $200 (1/3 of the total) to $100 (1/6 of the total).
Liability Share Decrease: Example

- A is treated as receiving a distribution of $100 even though nothing happened other than D’s acquisition of an interest in Partnership.
- Admission of a new partner to a partnership often creates a deemed distribution to the original partners, even if the new partner pays full fair market value.
- In our example, the deemed distribution reduces A’s basis from $300 to $200.
  - As explained below, distributions are generally not taxable unless the partner receives cash in excess of basis.
  - If we had varied the facts of our example, so that A’s basis had been reduced to $100 before D joined Partnership, the $100 deemed distribution would have been fully taxable to A.
  - Deemed distributions caused by a decrease in a partner’s share of liabilities are essentially the same as cash distributions, and may or may not result in taxable income.
What is a “Distribution”? 

• Some things that a distribution is not: 
  – Not an “allocation.” 
    • Allocations in the relevant sense determine the amount of partnership income, gain, loss, deduction or credit that passes through to the partner. 
    • A fundamental principle of partnership tax is that a partner is taxable on its share of partnership income whether or not the partnership makes a distribution to the partner. 
    • Allocations are essentially accounting entries. 
    • In contrast, distributions are money or other property transferred to a partner (including in some cases “deemed” transfers). 
    • The general goal of allocations is to determine which partner would benefit from the income if the income were reduced to cash and distributed to the partners. 
    • The validity of allocations is governed primarily by Code § 704 and the regulations thereunder. 
    • Allocations and distributions are inextricably linked, but an allocation is not a distribution.
What is a “Distribution”?  

• Some things that a distribution is not:
  
    
    • An advance or draw against the partner’s distributive share of income is not treated as a distribution at the time it is made.
    
    • However, it is treated as a distribution on the last day of the tax year.
    
    • In principle, if the advance or draw exceeds the partner’s distributive share of partnership income for the year, the partner should be obligated to return the money.
    
    • Waiting until the end of the year to treat an amount as a distribution is often favorable for the partner because the partner may have a higher basis in its partnership interest at the end of the year and therefore may be entitled to receive larger tax-free distributions.

  – Not repayment of debt or interest on debt.
    
    • Distributions are made with respect to equity interests, not debt.
    
    • Some partnership agreements mistakenly or misleadingly treat debt service payments on amounts owed to a partner as if those payments were distributions.
What is a “Distribution”?

• Some things that a distribution is not:
  – Generally not a “guaranteed payment.” Code § 707(c).
    • A guaranteed payment is defined in the Code as a payment to the partner (for services or capital) acting in a partner capacity, but determined without regard to the income of the partnership.
      – “Guaranteed payment” is a technical term, and does not imply that the payment is guaranteed in any real sense.
    • For purposes of Code § 61 (gross income) and Code § 162(a) (trade or business expenses) – which tend to be the most important purposes – a guaranteed payment is not a distribution.
  • However, for some purposes, a guaranteed payment may be a distribution.
What is a “Distribution”?  

• Some things that a distribution is *not*:  
  – Not a payment for the partnership’s purchase of property from a partner.  
  • With some exceptions, when a partnership buys property from a partner, the transaction is generally taxed the same as a transaction between the partnership and a third party. Code § 707(a)(1).  
  • Unlike a sale, a distribution is typically tax-free, although there are important exceptions as discussed below.  
    – Taxpayers may have an incentive to “disguise” a sale as a distribution in order to turn taxable sale proceeds into nontaxable distributions.  
What is a “Distribution”?  

• Some things that a distribution is not:
  – Not a payment for services to a partner acting in a nonpartner capacity. Code § 707(a).
    • As noted above, a payment for services performed in a partner capacity is generally not a distribution either.
  – Not a distribution to the extent it is recharacterized as a sale under Code § 751(b), discussed below.
What is a “Distribution”? 

• Some things that a distribution is not:
  – Not a payment for the sale or exchange of an interest in a partnership.
    • The line between a distribution and a sale or exchange of a partnership interest is sometimes blurry.
  • Compare two situations:
    1. Partnership distributes $100 to A in liquidation of its interest in partnership, leaving B and C as 50/50 partners.
    2. B and C pay $50 each to A to purchase A’s interest.
  • The two situations may be essentially the same economically but only one of them is in the form of a distribution.
  • It has proved nearly impossible for the IRS to specify the circumstances in which a distribution should be recharacterized as a disguised sale of a partnership interest. See IRS Ann. 2009-8, 2009-8 I.R.B. 597, withdrawing Prop. Reg. § 1.707-7.
  • Under most circumstances, the form of the transaction should be respected; if the transaction is in the form of a distribution the IRS should treat it as a distribution.
  • Many advisors believe that a purported distribution will be recharacterized as a sale of a partnership interest only in extreme cases involving contributions followed immediately or almost immediately by distributions.
CURRENT DISTRIBUTIONS (OVERVIEW OF 731, 732, 733 AND 734)
CURRENT DISTRIBUTIONS VS. LIQUIDATING DISTRIBUTIONS

- Liquidating distribution – any distribution to a partner that completely terminates his or her interest

- Current distribution – any distribution to a partner other than a liquidating distribution

  - Partial “redemption” of partnership interest

  - Installment distributions – partnership interest not liquidated until final installment payment
TAXATION OF CURRENT DISTRIBUTIONS

• Issues to address:
  
  • Gain or loss recognized by distributee partner
  
  • Basis of property received in distribution
  
  • Holding Period of property received in distribution
  
  • Character of property received in distribution
  
  • Adjustments to basis of partnership interest
  
  • Effect of distribution on basis of partnership property
GAIN OR LOSS ON CURRENT DISTRIBUTIONS

- Partner does not recognize gain unless money distributed exceeds partner’s adjusted basis immediately before distribution - I.R.C. §731(a)(1).

- Consider effect of reduction of liabilities – I.R.C. §752(b)

- Partner never recognizes gain if only property other than money is distributed

- Same rule applies for liquidating distributions
GAIN OR LOSS ON CURRENT DISTRIBUTIONS (CONT.)

• Treatment of marketable securities

• Distribution of marketable securities generally treated as a distribution of cash equal to fair market value of marketable securities - I.R.C. §731(c)(1)

• Distributee partner might recognize gain, but not loss on current distribution of marketable securities
GAIN OR LOSS ON CURRENT DISTRIBUTIONS (CONT.)

- Exceptions: I.R.C. §731(c)(3)
  - Contributing Partner Exception. Securities distributed to the partner that contributed the securities. I.R.C. §731(c)(3)(A)(i).
  - Hedge Fund Exception. Partnership is an “investment partnership,” defined as -
    - Partnership never engaged in a trade or business; and
    - Substantially all of the assets have always consisted of cash, securities, derivatives, etc.

I.R.C. §§731(c)(3)(A)(iii); 731(c)(3)(C)(i).
• Exceptions (cont’d)
  • “IPO” Exception. Securities that were not marketable securities when acquired by partnership if –
    • Entity issuing security had no marketable securities outstanding at the time the partnership acquired the securities.
    • Partnership held securities for at least six months prior to securities’ becoming marketable.
    • Partnership distributes securities within 5 years after securities’ becoming marketable.

GAIN OR LOSS ON CURRENT DISTRIBUTIONS (CONT.)

• Exceptions (Cont.)

• “Reorganization” Exception. Security acquired by partnership in a nonrecognition transaction if –

  • Value of marketable securities exchanged by partnership in nonrecognition transaction is less that 20% of the value of all consideration given by partnership; and

  • Partnership distributed security within 5 years after the date the security received or, if later, the date the security became marketable.

GAIN OR LOSS ON CURRENT DISTRIBUTIONS (CONT.)

- Partner does not recognize loss. I.R.C. §731(a)(2).
  - Partial “redemption” of partnership interest
  - Installment distributions – partnership interest not liquidated until final installment payment
TAX BASIS OF DISTRIBUTED PROPERTY

• Distributee partner’s basis in property received equals lesser of –

  • Partnership’s basis in property immediately prior to distribution; or

  • Distributee partner’s basis in partnership interest immediately prior to distribution

I.R.C. §732(a).
TAX BASIS OF DISTRIBUTED PROPERTY (CONT.)

• Allocation of basis decreases among multiple properties –
  • Basis of distributed property allocated first to “unrealized receivables” distributed; and
  • Any basis decrease allocated among remaining distributed property as follows:
    • First, by assigning to each such property the partnership basis in such property; and
    • Then allocate the basis decrease among properties with basis greater than FMV in proportion to such excess; and
    • Then allocate any remaining basis decrease in proportion to assigned basis.

I.R.C. §732(c).
HOLDING PERIOD OF DISTRIBUTED PROPERTY

• Distributee partner’s holding period in property received generally includes partnership’s holding period, because distributee partner generally takes same basis as partnership. I.R.C. §§ 735(b); 1223(2).
CHARACTER OF DISTRIBUTED PROPERTY

• Generally, character of distributed property determined in hands of distributee partner.

  • Unrealized receivables – gain is always ordinary – I.R.C. §735(a)(1)

  • Inventory items – gain is ordinary if partner sells within 5 years from date of distribution – I.R.C. §735(a)(2)
EFFECT ON BASIS OF PARTNERSHIP INTEREST

• Partner’s basis in partnership interest reduced, but not below zero by
  –
  
• Amount of money distributed (or deemed distributed); and

• Partner’s basis of property distributed.

I.R.C. §733.
EFFECT ON BASIS OF REMAINING PARTNERSHIP PROPERTY

• Partnership’s basis in partnership property not affected by distribution unless –
  
  • Partnership has Section 754 election in place; or
  
  • Distribution cause a substantial basis reduction in partnership property.

I.R.C. §734(a)
### EXAMPLE

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<td>Total</td>
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Outside A/B

- **A**: 60
- **B**: 20
- **C**: 10

P distributes $20 cash + 1/3 interest in land to each of A, B and C
EXAMPLE (CONT.)

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<td>Interest?</td>
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IRC §731(a)
IRC §732(a)
IRC §733
SPECIAL RULES FOR LIQUIDATING DISTRIBUTIONS (731(A)(2) AND 732(B), 736)
Liquidating Distributions

• “Liquidation” of a partner’s interest is the termination of the interest by means of a distribution or series of distributions to the partner. Code § 761(d).

• If the partner’s interest is not being terminated, a distribution reducing the partner’s share of profits or share of capital is a current (nonliquidating) distribution, even if the parties think of the transaction as a partial redemption.

• Distributions in liquidation of a partner’s interest are treated the same as non-liquidating (“current”) distributions, with a few exceptions.
  – Loss recognition (Code § 731(a)(2)):
    • Loss is recognized on a liquidating distribution where the only property distributed is money, unrealized receivables, or inventory. Marketable securities are not treated as money for this purpose.
  – Exchanged basis (Code § 732(b)):
    • Basis of property distributed in liquidation of a partner’s interest is the adjusted basis of the partner’s interest in the partnership, reduced by any money distributed in the same transaction.
Liquidating Distributions: Examples

• Example: Loss recognition on liquidating distribution.
  – Partner A has a basis of $100 in Partnership
  – Partnership distributes $90 in cash to A in complete liquidation of A’s interest.
  – A recognizes a $10 loss.

• Contrasting Example: No loss recognition on current distribution.
  – A has a basis of $100 in Partnership
  – Partnership distributes $90 in cash to A but A retains some interest in Partnership.
  – A’s basis in Partnership decreases by $90 but A does not recognize a loss.
  – Even if A’s interest in Partnership after the distribution is worth much less than $10, A’s retention of an interest in Partnership precludes loss recognition.
  – However, because A’s basis in Partnership is $10, A may have a built-in loss in its interest in Partnership, so A’s loss is presumably merely deferred.
Liquidating Distributions: Examples

• Example: Exchanged Basis
  – Partner A has a basis of $100 in Partnership
  – Partnership distributes $10 cash, and Property X, worth $80, to A in complete
    liquidation of A’s interest.
  – A does not recognize any loss, but takes a $90 basis in Property X ($100 pre-
    distribution basis in Partnership, less $10 cash).
    • Basis of Property X in the hands of Partnership is not relevant for this purpose.
    • If the transaction had been a current distribution (with A retaining some interest in
      Partnership), the basis of Property X in the hands of Partnership would be relevant.
  – Because Property X has a basis $10 higher than its value (a built-in $10 loss),
    Partner A may be entitled to eventually recognize a $10 loss on selling Property X
    for its $90 value.
  – Exchanged basis example is economically equivalent to the loss recognition
    example; in both cases A receives $90 of value in liquidation of its interest in
    Partnership.
    • However, in the loss recognition example A received all cash.
    • Where A receives a combination of cash and other property, A’s loss is
      deferred.
Payments to a “Retiring” Partner: Code § 736

• Code § 736 places payments to a “retiring” partner or a deceased partner’s successor in interest into two basic categories.
  – Code § 736(b): Payment for interest in partnership.
  – Code § 736(a): Distributive share or guaranteed payment.

• “Retiring” partner simply means a partner whose interest is being liquidated.
  – This need not have anything to do with “retirement” in the sense of an individual withdrawing from the workforce at the end of a career.
  – For example, if a corporation invests in a private equity fund, and the corporation’s investment is completely liquidated by a distribution from the fund, the corporation has “retired” for purposes of Code § 736.
Code § 736(b) Payments

• Code § 736(b) payments are liquidating payments for the partner’s interest in partnership property.

• The tax effect of a Code § 736(b) payment is determined under the rules governing distributions in general, including Code § 731.
  – The retiring partner often favors Code § 736(b) payments because these payments tend to be capital transactions.
  – The continuing partners often disfavor Code § 736(b) payments because these payments are not deductible and generally don’t have the same effect as a deduction.
Code § 736(a) Payments

• Code § 736(a) payments are any liquidating payments that are not Code § 736(b) payments.
  – Treated as distributive shares of partnership income if computed with regard to partnership income.
  – Treated as guaranteed payments if computed without regard to partnership income.
### Special Rule for Some Service Partnerships

- Special characterization rule for liquidating payments to general partners in “service” partnerships (technically, partnerships for which capital is not a material income-producing factor). Code § 736(b)(2) and (3).
  - Liquidating payments made to general partners of service partnerships for unrealized receivables are classified as Code § 736(a) payments.
  - Liquidating payments made to general partners of service partnerships for goodwill are classified as Code § 736(a) payments, except to the extent the partnership agreement provides otherwise.

- This special rule means that, for example, a law firm or accounting firm may get a deduction (or the equivalent) for payments to retiring partners for the retiring partners’ shares of goodwill.
  - The downside of the special rule is that the retiring partner has ordinary income and not capital gain.
  - If the partnership agreement entitles the retiree to payment for the retiree’s share of goodwill, the retiree might be entitled to capital gain treatment, but then the remaining partners would not get a deduction (or the equivalent).
Example: Code § 736(a) and Code § 736(b) Compared

• A is a general partner in Partnership, which is a service partnership such as a law firm or accounting firm.

• A withdraws from Partnership, and Partnership agrees to pay A $100,000.
  – Assume that this payment is, either explicitly or implicitly, in recognition of A’s share of Partnership goodwill.

• If the partnership agreement does not provide for a payment with respect to goodwill, Code § 736(a) applies.
  – The payment is ordinary income to A.
  – The payment typically will be deductible by the other partners or will reduce the income allocated to the other partners by $100,000.

• If the partnership agreement provides for a payment with respect to goodwill, Code § 736(b) applies.
  – The payment is generally capital gain to A.
  – The other partners generally pay tax on $100,000.
  – However, if Partnership has in effect an election under Code § 754 the payment may create a $100,000 capital asset that will generate amortization deductions of $100,000 for the other partners over 15 years.

• This election between Code § 736(a) and Code § 736(b) is available only with respect to payments for goodwill of general partners in service partnerships.
Continuation as a Partner

• A “retiring” partner is considered a partner until the partner’s entire interest is liquidated. Treas. Reg. § 1.736-1(a)(1)(ii) and -1(a)(6).

• Example:
  – A is a partner with Partnership.
  – At age 65, A retires from Partnership.
    • He ceases to work for the firm.
    • He is no longer a partner under the firm’s partnership agreement.
    • His only right is to receive fixed payments over five years.
  – However, he is technically considered a partner for tax purposes until he has received all the fixed payments.
  – The fixed payments should be reported to him on Schedule K-1.
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INSIDE BASIS ADJUSTMENTS
(734(B) AND 755; MAYBE 732(D))
EFFECT ON BASIS OF REMAINING PARTNERSHIP PROPERTY

• Partnership’s basis in partnership property not affected by distribution unless –
  
  • Partnership has Section 754 election in place; or
  
  • Distribution cause a substantial basis reduction in partnership property.

I.R.C. §734(a).
### REDEMPTION OF A’s INTEREST

#### ASSETS

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#### LIABILITIES/CAPITAL

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<tr>
<td>Total</td>
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</table>

**Partnership distributes $1300 to A in redemption of interest**

**Partnership has made no Section 754 election**

**Each partner’s tax basis in partnership interest equal to tax capital account**
REDEMPTION OF A’s INTEREST (CONT.)

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>TAX/BOOK</th>
<th>FMV</th>
<th>LIABILITIES/ CAPITAL</th>
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What happens if P sells Blackacre for $2400?

P recognizes $1200 gain

B and C each taxable on $600 gain allocated to them

Good result for B and C?
EFFECT ON BASIS OF REMAINING PARTNERSHIP PROPERTY

• Section 754 Election – Election to adjust basis of partnership property in the event of
  • Sale or exchange of partnership interest by a partner (IRC §743(b)) or
  • Distribution of partnership assets to partner (IRC §734(b))
• Substantial basis reduction occurs if the sum of –
  • Loss recognized by distributee partner plus
  • Any basis increase of distributed property in hands of distributee partner exceeds $250,000
I.R.C. §734(d).
BASIS INCREASES

• Partnership increases basis in partnership property by –

  • Gain recognized by distributee partner; plus

  • Excess of A/B of partnership property in hands of partnership over A/B of partnership property in hands of distributee partner (basis step down)

I.R.C. §734(b)(1).
**BASIS DECREASES**

• Partnership decreases basis in partnership property by –
  
  • Loss recognized by distributee partner; plus

  • Excess of A/B of partnership property in hands of distributee partner over A/B of partnership property in hands of partnership (basis step up)

I.R.C. §734(b)(2).
REDEMPTION OF A’s INTEREST

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</tr>
<tr>
<td>Total</td>
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<td><strong>4500</strong></td>
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Partnership distributes $1300 to A in redemption of interest
Partnership has made Section 754 election
Basis in Blackacre increased by $400 = gain recognized by A on distribution
REDEMPTION OF A’s INTEREST (CONT.)

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<td>Total</td>
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What happens if P sells Blackacre for $2400?

P recognizes $800 gain

B and C each taxable on $600 gain allocated to them

Good result for B and C?
ALLOCATED OF §734(b) ADJUSTMENTS

• Rules for allocating basis adjustments among multiple assets (Treas. Reg. §§1.755-1(a); 1.755-1(c))
  • Determine the value of each of the partnership’s assets.
  • Determine the character of any assets distributed.
  • Basis adjustments arising from distributions of capital gain property are generally allocated to capital assets and §1231(b) property.
  • Basis adjustments arising from distributions of ordinary income property are generally allocated to ordinary income property.
  • The basis adjustment allocated to each class is allocated among the items within each class.
Allocation of basis adjustments within a class (Treas. Reg. §1.755-1(c)):

- Basis adjustment resulting from the recognition of gain or loss from the distribution must be allocated to the partnership’s capital gain property.
- Basis increases due to “lost basis” are allocated first to properties with unrealized appreciation up to and in proportion with their respective unrealized appreciation. Any excess is allocated among all properties in the class in proportion to FMV.
- Basis decreases due to “acquired basis” are allocated first to properties with unrealized depreciation up to and in proportion with their respective amounts of unrealized depreciation. Any excess is allocated among all the properties within the class in proportion to their adjusted bases (after taking into account the first allocation).
ALLOCATION OF 734(b) ADJUSTMENTS (CONT.)

• Special Rules:

  • If a decrease in basis is required and the basis adjustment exceeds the remaining basis in the assets in a class, the assets are reduced to zero, but not below zero.

  • When an increase or decrease in the basis of undistributed property cannot be made because the partnership owns no property of the character required to be adjusted, the adjustment is made when the partnership acquires property of a like character to which an adjustment can be made.
# ALLOCATION OF BASIS STEP-UP

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P distributes $1300 to A

734(b) adjustment = $400

Hypothetical gain to D on sale of Blackacre = $300

Hypothetical gain to D on sale of Whiteacre = $100
### Allocation of Basis Step-Up

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<tr>
<td>Cash</td>
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<td>Blackacre</td>
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<td>Whiteacre</td>
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<td></td>
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734(b) adjustment = $400

Hypothetical gain to D on sale of Blackacre = $300

Hypothetical gain to D on sale of Whiteacre = $100
“DISPROPORTIONATE” DISTRIBUTIONS
“Disproportionate” Distributions: Code § 751(b)

• Partnership tax is notoriously complicated.
• Many advisors consider Code § 751(b) the most complicated of all the partnership tax provisions.
  – A brief presentation such as this one barely scratches the surface.
• Code § 751(b) was enacted to prevent converting ordinary income to capital gain and shifting ordinary income among the partners.
• However, Code § 751(b) can also have the effect of accelerating gain.
• It recharacterizes certain distributions as, in whole or in part, sales between the partner and the partnership.
• Very roughly speaking, it targets distributions that alter a partner’s indirect interest in ordinary income assets of the partnership.
• Code § 751(b) divides partnership property into two classes:
  – 751(b) property (also known as hot assets), which generally are assets that would result in ordinary income if sold. Code § 751(b)(1)(A).
  – Other property (also known as cold assets). Code § 751(b)(1)(B).
“Disproportionate” Distributions: Code § 751(b)

- 751(b) property comprises:
  - Unrealized receivables, including:
    - Rights to payment for goods and services (to the extent not previously included in income under the partnership’s accounting method).
    - Depreciation recapture. Depreciation recapture is not usually thought of as an unrealized receivable, but 751(b) treats it an unrealized receivable, and it is often the biggest – or even the only – type of 751(b) property that a partnership owns.
    - Substantially appreciated inventory, defined as inventory with an aggregate fair market value higher than 120% of basis.
  - Other property is anything other than 751(b) property.
    - Capital gain property is other property.
    - Cash is other property.
“Disproportionate” Distributions: Code § 751(b)

- Code § 751(b) applies to distributions in which a partner is deemed to “exchange” its interest in one class of property for an interest in the other class.
  - If the distribution increases the partner’s interest in 751(b) property, and decreases the partner’s interest in other property, the partner is treated as receiving other property (such as cash) in a distribution and exchanging the other property for 751(b) property.
  - If the distribution reduces the partner’s interest in 751(b) property, and increases the partner’s interest in other property, the partner is treated as receiving 751(b) property in a distribution and then exchanging that 751(b) property for other property (such as cash). See example below.

- We will focus on the treatment of the partner receiving the distribution, but the partnership (and therefore the other partners) may have gain or loss on the deemed sale, just as in an actual sale.
“Disproportionate” Distributions: Code § 751(b)

- Code § 751(b) applies to current and liquidating distributions.
  - However, in practice current (nonliquidating) distributions are less likely to be “disproportionate” in the Code § 751(b) sense, and so Code § 751(b) is less likely to require current distributions to be recharacterized.

- Exceptions to Code § 751(b):
  - Does not apply to a distribution of property to a partner if that partner originally contributed the property.
  - Does not apply to Code § 736(a) payments.
    - As described above, Code § 736(a) payments are liquidating payments that are treated as distributive shares or as guaranteed payments.
Illustrative Example

- The following discussion employs a widely-used seven-step method for applying Code § 751(b), derived from an influential treatise.
  - McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners, ¶ 21.03.
- The application of the seven-step method is illustrated with a simple example.
  - A, B, and C each has a 1/3 interest in Partnership.
  - Each partner has a basis of $150 in its partnership interest.
  - Partnership’s assets consist of:
    - Cash of $300.
    - Inventory with a fair market value of $300.
      - Basis of the inventory is only $150, so the inventory is substantially appreciated.
  - Partnership distributes $200 cash to A in liquidation of A’s interest in Partnership.
  - The difference between A’s $150 basis and the $200 it receives in liquidation is attributable to the appreciation in value of the inventory.
### Example: Pre-Distribution Balance Sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>FMV</th>
<th>Liabilities/Capital</th>
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<td>Cash:</td>
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<tr>
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<td></td>
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<td></td>
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<td></td>
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<td>B’s Capital</td>
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<td>$600</td>
<td>Total:</td>
<td>$450</td>
<td>$600</td>
</tr>
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</table>
Seven-Step Method

• Step 1:
  – Divide the partnership’s assets into two classes:
    • 751(b) property.
    • Other property.
  – If the partnership has assets in only one of the two classes then Code § 751(b) does not require any recharacterization; the analysis is over.
  – In our example, however, Partnership has both 751(b) property (substantially appreciated inventory) and other property (cash).
Seven-Step Method

• Step 2:
  – Determine the distributee partner’s interest in the *gross* fair market value of each item in each class:
    • Before the distribution.
    • After the distribution.
  – In the simplest partnerships, a partner’s share of each item is the partner’s percentage interest multiplied by the gross value of the item.
  – In our simple example, A has a 1/3 pre-distribution interest in the cash (i.e., $100) and the inventory (i.e., $100).
  – A receives a distribution of $200 cash in complete liquidation of A’s interest, so A’s post-distribution interest in Partnership’s retained assets is zero.
  – In real-life examples, determining a partner’s share of an item can be very challenging.
Seven-Step Method

• Step 3:
  – Prepare an “exchange table.”
  – The table compares:
    • The post-distribution value of the partner’s interest in undistributed assets in each class, with
    • The value of the assets in each class that are distributed to the partner.
  – The table shows whether the partner has exchanged an interest in one class for an interest in the other.
  – In the complete liquidation of a partner, the post-distribution interest in undistributed assets will be zero, since after the distribution the partner has no interest in any partnership assets.
### Step 3 Exchange Table

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<th>Post-Distribution Interest</th>
<th>+</th>
<th>Assets Distributed</th>
<th>-</th>
<th>Pre-Distribution Interest</th>
<th>=</th>
<th>Increase (Decrease) in Interest</th>
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<td>$(100)</td>
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- As this table shows:
  - A’s interest in other property (i.e., cash) increases by $100.
  - A’s interest in 751(b) property (i.e., appreciated inventory) decreases by $100.
Seven-Step Method

• Step 4:
  – Determine which assets are involved in the exchange.
    • Which assets is the partner deemed to sell?
      – A here is deemed to sell $100 worth of inventory for $100 cash.
    • Which assets is the partner deemed to purchase?
      – In this example, A is not deemed to purchase any assets.

• Step 5:
  – Determine the basis of the assets the partner is deemed to relinquish.
  – This is the basis that the assets would have had under Code § 732 if the assets had been distributed in a nonliquidating distribution before the exchange.
  – If Partnership had made such a distribution of inventory to A, A would have received 1/3 of the inventory of Partnership, and would have had a carryover basis under Code § 732(a)(1) of $50.
    • A’s basis in Partnership would have been reduced by the $50 basis that A would have had in the inventory
    • A’s basis in Partnership would have gone from $150 to $100. Code § 733(2).
Seven-Step Method

• Step 6:
  – Determine the consequences of the exchange.
    • Amount of gain or loss.
      – A has income of $50 (deemed sale of $50 basis inventory for $100 cash).
      – Partnership has no gain or loss (deemed purchase of inventory from A for cash).
    • Character of gain or loss.
      – A’s income is ordinary because A is deemed to sell inventory.
    • Basis of property deemed purchased.
      – Partnership is deemed to have paid $100 for 1/3 of the inventory.
      – Partnership’s basis in the inventory purchased is therefore $100.
      – Partnership’s aggregate basis in the inventory increases from $150 to $200.
    • Reporting requirements are set forth in Treas. Reg. § 1.751-1(b)(5).

• Step 7:
  – Treat the balance of the distribution as simply a distribution.
    • Apart from the deemed sale of inventory for $100, A is treated simply as receiving a $100 distribution.
    • $100 distribution does not exceed basis and is not taxable.
Related Provisions

• Several provisions play a role in preventing partners from using distributions to convert ordinary income into capital gain:
  – Code § 732(c)(1).
  – Code § 735.
  – Code § 751(b).
  – Code § 755.
Summary of Taxable Distributions

• Taxable distributions discussed previously:
  – “Money” in excess of basis (Code § 731(a)(1)), discussed above.
    • Includes deemed distributions on reduction in the partner’s share of liabilities.
  – “Disproportionate” distributions (Code § 751(b)).

• Other taxable distributions:
  – “Mixing bowls” (Code §§ 704(c)(1)(B) and 737).
  – “Disguised sales” (Code § 707(a)(1)(B)).
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AVOIDING TAX ON MIXING BOWLS AND LEVERAGED PARTNERSHIPS (704(C)(1)(B), 707(A)(2)(B), 737 AND 752)
MIXING BOWL EXAMPLE

- A would like to dispose of Asset A, which is appreciated
- A wants to acquire Asset B (or cash)
- B would like to dispose of Asset B, which may or may not be appreciated
- B wants to acquire Asset A
- A and B wish to defer any built-in gain in their businesses as long as possible
- Section 1031 is unavailable because Asset A and Asset B assets are not “like-kind”
- Combining the businesses in corporate form would introduce an additional layer of tax since no party will have an 80%+ interest in the corporate joint venture
MIXING BOWL EXAMPLE (CONT.)

- Asset A profits, losses, and cash flow: A: 10%  B: 90%
- Asset B profits, losses, and cash flow: A: 90%  B: 10%
- Daily operations of Asset A managed by B/Daily operations of Asset B managed by A
- Liquidate in accordance with capital accounts
  - To extent available, A receives Asset B assets/B receives Asset A assets
**MIXING BOWL EXAMPLE (CONT.)**

- A and B effectively exchange Asset A and Asset B
- Neither A nor B recognize gain with respect to relinquished assets
ANTI-MIXING BOWL RULES

• Disguised Sales – I.R.C. §707(a)(2)(B)
  • If a partner contributes property with FMV > adjusted basis of property (built-in gain property)
  • Partnership distributes property to contributing partner
  • Contribution and distribution, when viewed together, are more properly characterized as a sale or exchange

• Transaction recast as a sale of property between contributing partner and partnership
ANTI-MIXING BOWL RULES (CONT.)

- General rules to treat as disguised sale:
  - Simultaneous transfers: second transfer would not have been made “but for” first transfer
  - Nonsimultaneous transfers: same “but for” test + subsequent transfer not dependent on “entrepreneurial risks of partnership operations”

- Presumptions:
  - Transfers w/in 2 years presumed disguised sales unless facts “clearly establish” otherwise
  - Transfers not w/in 2 years presumed not disguised sales unless facts “clearly establish” otherwise
  - “Clearly establish” appears to be high standard – can help & hinder partners

- Whether distribution is simultaneous or not, disguised sale deemed to occur at time of contribution
  - But possibility of using installment sale rules to defer gain on sale
ANTI-MIXING BOWL RULES (CONT.)

• IRC §704(c)(1)(B)
  • If a partner contributes property with FMV > adjusted basis of property (built-in gain property)
  • Partnership distributes contributed property within 7 years after contribution, then
  • Contributing partner recognizes built-in gain as if he or she sold property on date of distribution
• Gain recognized on date of distribution
• Contrast with disguised sale rules
• Character of gain determined based on character of partner’s built in gain
ANTI-MIXING BOWL RULES (CONT.)

- IRC §737
  - If a partner contributes property with FMV > adjusted basis of property (built-in gain property)
  - Partnership distributes other property to contributing partner in liquidation of partnership interest within 7 years after contribution, then
    - Contributing partner recognizes built-in gain as if he or she sold property on date of distribution
  - Gain recognized on date of distribution
  - Contrast with disguised sale rules
  - Character of gain determined based on character of partner’s built in gain
LEVERAGED PARTNERSHIP TRANSACTIONS

- A wants to reduce its ownership in Asset A in exchange for cash immediately but defer gain recognition.
- P losses, and cash flow: A:10% B:90%
- Nonliquidating distribution of loan proceeds to A=90% FMV of Asset A assets
- Liquidate in accordance with capital accounts
  - To extent available, B receives Asset A assets
LEVERAGED PARTNERSHIP: HOPED-FOR RESULTS

- A extracted 90% of the value of Asset A in the form of partnership distribution
- A doesn’t recognize any gain inherent in Asset A
LEVERAGED MIXING BOWL TRANSACTIONS: ADDITIONAL ISSUES

• Section 707 – Treas. Reg. 1.707-5(b)

• A must receive distribution of loan proceeds (or other consideration traceable to loan proceeds) w/in 90 days of P’s incurring bank loan to avoid disguised sale
LEVERAGED MIXING BOWL TRANSACTIONS: ADDITIONAL ISSUES (CONT.)

• Section 707 – Treas. Reg. 1.707-5(b) (cont.)
  • A also must have sufficient share of loan under section 752 to avoid disguised sale
  • Sufficient share=(modified section 752 share x percentage of total liability proceeds distributed to A)
  • Tier 1 (p/s min. gain) and Tier 2 (section 704(c) min. gain) rules of nonrecourse liability rules do not apply for this purpose
  • Must rely on recourse liability rules and general Tier 3 rule (profit-sharing ratios) of nonrecourse liability rules
  • Since profit-sharing ratios usually not enough, focus falls on recourse liability rules
  • In this example, A could have only a 10% share of bank loan under Tier 3 rule (and it might be lower)
  • Thus, A having share of bank loan merely equal to amount distributed to A may not be sufficient if P retains some loan proceeds
LEVERAGED MIXING BOWL TRANSACTIONS: ADDITIONAL ISSUES (CONT.)

• Making an otherwise non-recourse liability a recourse liability allocable to A. Treas. Reg. §1.752-2

• A guarantees portion (or all of) bank loan
  • Guarantee must be enforceable under state law
  • Notice of guarantee to creditor
  • All of A’s rights of contribution, reimbursement, and subrogation from B, P, and all related parties must be waived

• Guarantee of portion of bank loan historically could be “bottom-dollar” – Treas. Reg. §1.704-2(m) ex. 1(vii), §1.752-2(b), but see Prop. Reg. §1,752-2(f), Ex. 10. (not recourse to guarantor partner if only a bottom dollar guarantee).
LEVERAGED PARTNERSHIP TRANSACTIONS: ADDITIONAL ISSUES

- Necessary capitalization of A to support guarantee obligation
  - Presumption that A will satisfy guarantee regardless of net worth - Treas. Reg. 1.752-2(b)(6)
  - However, anti-abuse rules could apply to disregard A’s guarantee - Treas. Reg. 1.752-2(j)
  - No bright-line rule for appropriate level of net worth
  - Do not need net worth equal to debt guaranteed
    - 50%?
    - 21%? Canal Corp. v. Comm’r, 135 T.C. 199 (2010) (net worth of 21 percent of maximum exposure on indemnity cited as factor in court disregarding indemnity pursuant to Treas. Reg. 1.752-2(j))
    - 10%? Rev. Proc. 89-12 (former entity classification ruling guideline)
    - 0%?
    - Rules suggest that lack of net worth alone is not sufficient to disregard guarantee – Treas. Reg. 1.752-2(j) ex.; CCA 200246014