Partnership Tax and Disguised Sales
Navigating Section 707 to Determine Classification of Partners' Contributions and Distributions

WEDNESDAY, FEBRUARY 13, 2013, 1:00-2:50 pm Eastern

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Partnership Tax and Disguised Sales

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The advice expressed in the presentation is not an opinion as to the tax consequences of any transaction.
Contributions of property to a p'ship are **GENERALLY** nontaxable events ...
Disguised Sale
IRC § 707(a)(2)(B)

If

- there is a **transfer** of property **by a partner** to a p'ship, *and*

- there is a related **transfer** of money or other property **by the p'ship** to the partner, *then*

  the facts and circumstances should be examined to determine whether the events should be regarded as a **sale** of property by the partner to the p'ship.
Test
Reg. § 1.707-3(b)(1)

Transfer of property by a partner to a p'ship, plus
Transfer of money or other property to the partner

= SALE, if

Partner's receipt of money or other property would not have occurred but for the contribution of property, and

If the transfers are not simultaneous, the transfer is not dependent on the entrepreneurial risks of p'ship operations.
Facts & Circumstances
Reg. § 1.707-3(b)(2)

- **Timing and amount** of subsequent transfer are determinable with **reasonable accuracy** at the time of earlier transfer

- Transferor has a **legally enforceable right** to subsequent transfer

- Partner's right to receive money or other consideration is **secured**

- Any person has **made** or is legally **obligated** to make contributions to the p'ship, to **permit** the p'ship to make the transfer of money or other consideration

- Any person has **loaned** or **agreed** to lend the p'ship the money or other consideration, to **enable** the p'ship to make the transfer

- P'ship has **incurred** or is **obligated** to incur debt to acquire the money or other consideration, to **permit** the p'ship to make the transfer (considering such facts as whether any person has agreed to guarantee or assume personal liability for the debt)
Facts & Circumstances (cont.)
Reg. § 1.707-3(b)(2)

- P'ship holds money or other liquid assets beyond its reasonable needs that are expected to be available to make the transfer

- P'ship distributions, allocations, or control of p'ship operations are designed to effect an exchange of the burdens and benefits of ownership of property

- The transfer by the p'ship is disproportionately large in relation to the partner's interest in p'ship profits

- Partner either has no obligation to return or repay the money or other consideration, or the obligation is likely to become due at such a distant point in the future that the present value of the obligation is small in relation to the money or other consideration transferred by the p'ship
Two-Year Presumptions
Reg. § 1.707-3(c)(1) & (d)

> 2 Years – If the transfers occur more than two years apart, then they are presumed NOT to be a sale.

≤ 2 Years – If the transfers occur within a two-year period, then they are presumed to be a sale, unless one of four exceptions applies.
Exception to Presumption of Sale – #1 Guaranteed Payments

**Reasonable Guaranteed Payments** are presumed **not** to be part of a sale. Reg. § 1.707-4(a)(1)

- **Checkmark** Payments determined without regard to partner income and for the use of the partner's capital

- **X** Payments designed to liquidate all or part of the partner's interest in the property contributed, rather than provide the partner with a return on investment
Exception to Presumption of Sale – #2 Preferred Returns

Reasonable preferred returns are presumed NOT to be part of a sale.
Reg. § 1.707-4(a)(2)

Preferred distributions of p'ship cash flow with respect to capital contributed, to be matched by an allocation of income or gain
Additional Requirements – Reg. § 1.707-4(a)(3)

- Payments must be pursuant to **written provision** of p'ship agreement

- Payments **must not exceed** the amount determined by multiplying either the partner's **unreturned capital** at the beginning of the year or the partner's **weighted average capital balance** for the year by the **safe harbor interest rate** for the year (which is 150% of the highest AFR in effect from time when right to payment is first established, through the end of the tax year).
Exception to Presumption of Sale – #3 Net Operating Cash Flow

**NET OPERATING CASH FLOW** distributions are presumed **NOT** to be part of a sale.

Reg. § 1.707-4(b)

- One or more transfers of money to a partner to the extent the transfers
  - are **not** guaranteed payments
  - are **not** reasonable preferred returns
  - are **not** distributions to the partner acting in a capacity other than as a partner, and
  - **do not exceed** the net operating cash flow of the p'ship for the year *times the lesser of*
    (a) the partner's interest in p'ship profits for that year *or*
    (b) the partner's interest in p'ship profits for the life of the p'ship
Reimbursements of PREFORMATION EXPENDITURES are presumed NOT to be part of a sale. Reg. § 1.707-4(d)

Capital expenditures that are
- incurred during the two-year period preceding the transfer by the partner to the p'ship and
- incurred by the partner with respect to p'ship organization and syndication costs or with respect to property contributed to the p'ship, but only to the extent the reimbursed capital expenditures do not exceed 20% of the property's FMV at the time of contribution.*

* 20% limit doesn't apply if contributed property's FMV ≤ 120% of the partner's adjusted basis in the property at the time of contribution.
Disclosure Required –
Reg. § 1.707-3(c)(2)

A partner must attach Form 8275, Disclosure Statement, to his or her return if

- the **partner contributes** property to a p'ship,

- the **p'ship transfers** money or other consideration to the partner **within 2 years** before or after the contribution,

- the partner treats the transfers as something **other than a sale, and**

- the transfer of money or other consideration is **not** presumed to be a guaranteed payment for capital, is not a reasonable preferred return, and is not an operating cash flow distribution.
The disclosure should include

- a caption identifying the statement as a disclosure under IRC § 707;

- a description of the transferred property or money, including its value; and

- a description of any relevant facts in determining if the transfers are properly viewed as a disguised sale.
Transfers Within 2 Years
Reg. § 1.707-3(f), Ex #1

- A transfers property to a p'ship in exchange for a p'ship interest.
- Property has a FMV of $4,000,000 and an adjusted tax basis of $1,200,000.
- Immediately after the transfer, p'ship transfers $3,000,000 in cash to A.

RESULT

- A sold a ¾ interest in the property ... $3m received for $4m value

\[
\text{amount realized} = \frac{\$3,000,000}{\$1,200,000} \times \frac{3}{4} = \frac{\$900,000}{\$2,100,000} \text{adjusted basis} \nonumber \\
\text{gain realized} = \frac{\$2,100,000}{\$2,100,000} \nonumber 
\]

- A contributed property with a FMV of $1,000,000 and an adjusted tax basis of $300,000.
Transfers > 2 Years Apart
Reg. § 1.707-3(f), Ex #5

- A transfers land to p'ship in exchange for a p'ship interest. Property has a FMV of $1,000,000 and an adjusted tax basis of $500,000.

- B transfers $1,000,000 in cash to the p'ship in exchange for a p'ship interest.

- Under the p'ship agreement, the p'ship is obligated to construct a building on the land, which the p'ship will fund with its $1,000,000 in cash and a $4,000,000 construction loan secured by the land and improvements.
Shortly before A's transfer, the p'ship secures construction and permanent financing commitments from lending institutions.

To obtain the construction loan, B guarantees completion of the building for a cost of $5,000,000. The p'ship is not obligated to reimburse or indemnify B if B must make payment on the guarantee.

The permanent loan (equal the lesser of $5,000,000 or 80% of the improved property) will be funded upon completion of the building - expected to occur two years after A's transfer.

Under the p'ship agreement, the p'ship is obligated to apply the proceeds of the permanent loan to retire the construction loan, and to hold any excess proceeds for transfer to A 25 months after A's transfer to the partnership.
The value of the property at the time the permanent loan is closed is expected to exceed $5,000,000 only if the p'ship is able to lease a substantial portion of the improvements by then, and there is a significant risk that this will not happen.

- The p'ship completes construction for $5,000,000 approximately two years after A's transfer.

- Shortly thereafter, the permanent loan is funded for $5,000,000.

- At funding the property is valued at $7,000,000.

- The p'ship transfers the $1,000,000 excess proceeds to A 25 months after A's transfer.
RESULT – NO DISGUISED SALE

- A's transfer of land to the p'ship and the p'ship's transfer of $1,000,000 to A occurred more than two years apart and are, therefore, presumed not to be a sale unless the facts and circumstances clearly establish otherwise.

- Here, the transfer of $1,000,000 to A would not have been made but for A's transfer.

- In addition, at the time of A's transfer, A had a legally enforceable right to receive a transfer from the p'ship at a specified time, in an amount equal to the excess of the permanent loan proceeds over $4,000,000. In this case, however, there was a significant risk that the property's value would be insufficient to support a permanent loan in excess of $4,000,000. Instead, the transfer of $1,000,000 to A depended on the entrepreneurial risks of p'ship operations.

- Accordingly, A's transfer of the land to the p'ship is not treated as part of a sale.
What about liabilities?
Qualified & Non-Qualified Liabilities

If a p'ship assumes (or takes property subject to) a **NON-QUALIFIED LIABILITY**, the p'ship **WILL** be treated as having transferred consideration to the partner pursuant to a sale to the extent responsibility for the liability is shifted to another partner. Reg. § 1.707-5(a)(1).

If a p'ship assumes (or takes property subject to) a **QUALIFIED LIABILITY**, the p'ship **WILL NOT** be treated as having transferred consideration to the partner pursuant to a sale, **PROVIDED** the transaction is not otherwise treated as part of a sale. Reg. §§ 1.707-5(a)(1), -5(a)(5)(i).
Qualified Liabilities – Reg. § 1.707-6(a)(i)(A)-(D) & (ii)

A liability is a **QUALIFIED LIABILITY** to the extent the liability

- was incurred **> 2 years prior** to the earlier of the date the partner agreed to property or the date the partner transferred the property to the p'ship, and has encumbered the property throughout the 2-year period, *or*

- was **not** incurred **in anticipation** of the transfer to the p'ship, *or*

- is **allocable to capital expenditures** with respect to the property, *or*

- was incurred in the **ordinary course of business**, but only if all of the assets related to the business are transferred other those that are immaterial to the continuation of the business, *or*

- in the case of **recourse** liabilities, does not exceed the FMV of the property (net of any senior debt) at the time of transfer
Qualified & Non-Qualified Liabilities – Reg. § 1.707-5(f), Ex 5

**FACTS**

- A transfers property to a p'ship

- FMV $165,000 · Basis $75,000 · Liability $75,000 incurred > 2 years before transfer, secured by the property since incurred

- Assume liability becomes a p'ship recourse liability & that A's share is $25,000

**RESULT** – This is a qualified liability. Reg. § 1.707-6(a)(i)(A). Since no other transfer was made to A as consideration for the transfer of property, the p'ship's assumption of the liability is not treated as part of a sale.
**Qualified & Non-Qualified Liabilities – Reg. § 1.707-5(f), Ex 6**

**Facts**

- Assume same facts as previous example, but in addition p'ship transfers $30,000 to A in consideration of A's transfer ...
Qualified & Non-Qualified Liabilities

**RECALL THAT** if a p'ship assumes a QUALIFIED LIABILITY, the p'ship WILL NOT be treated as having transferred consideration to the partner pursuant to a sale, PROVIDED the transaction is not otherwise treated as part of a sale ...

**BUT WHAT IF** the transaction is otherwise treated as part of a sale?
Qualified & Non-Qualified Liabilities – Reg. § 1.707-5(a)(5)(i)

If a transfer of property by a partner to the p'ship is treated as part of a sale without regard to the p'ship's assumption of (or taking subject to) a QUALIFIED LIABILITY, then the assumption WILL be treated as a transfer of consideration made pursuant to a sale of the property to the extent of the lesser of

- the extent to which responsibility for the liability is shifted to another partner, or

- the qualified liability times the partner's net equity percentage with respect to the property*

* Total amount of money or other consideration transferred to the partner that are treated as proceeds realized from the sale of the property ÷ (the property's FMV minus any qualified liability encumbering the property)
Qualified & Non-Qualified Liabilities – Reg. § 1.707-5(f), Ex 6 (cont.)

FACTS

- A transfers property to a p'ship

- FMV $165,000 · Basis $75,000 · Liability $75,000 incurred > 2 years before transfer, secured by the property since incurred

- Assume liability becomes a p'ship recourse liability & that A's share is $25,000

- In addition, p'ship transfers $30,000 to A in consideration of A's transfer
**RESULT** – Since the p'ship transferred $30,000 to A in addition to assuming the qualified liability, the assumption of this liability will be treated as a transfer of additional consideration to A (pursuant to a sale of the property) to the extent of the lesser of

- the extent to which responsibility for the liability is shifted to another partner, so $50,000 (the excess of the $75,000 liability over A's $25,000 share), or

- the qualified liability times A's net equity percentage with respect to the property, so $25,000 (total amount of money or other consideration transferred to A that are treated as proceeds realized from the sale of the property, so $30,000 ÷ the property's FMV minus the qualified liability, so $90,000)
**Tax Consequences**

- A sold a \( \frac{1}{3} \) interest in the property (so $55,000 received for a $165,000 value) & will recognize a $30,000 gain.

\[
\begin{align*}
\text{Amount Realized} &= 55,000 \\
\text{Adjusted Basis} &= 75,000 \times \frac{1}{3} = 25,000 \\
\text{Gain Realized} &= 30,000
\end{align*}
\]

- A contributed property with a FMV of $110,000 and an adjusted tax basis of $50,000 in exchange for a p'ship interest.
Partnership Tax and Disguised Sales

§704(c)(1)B

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Section 704(c)(1)(B)

• **Prior Law**
  
  As originally enacted, IRC Section 704(c)(1)(A), a partner contributing property with a built-in-gain or loss to a partnership is generally allocated that gain or loss when the partnership subsequently disposes of the property.

• Prior to the enactment of IRC Section 704(c)(1)(B), a contributing partner could avoid an allocation of precontribution gain or loss if the partnership distributed the contributed property to another partner rather than selling it.
Section 704(c)(1)(B)

• Prior Law

• Example 1 – Facts:
  • A contributes Blackacre with an adjusted basis of $12,000 and a fair market value of $20,000.
  • B contributes $20,000 cash.
  • Three years later the partnership distributes Blackacre, then worth $23,000, to B.
Section 704(c)(1)(B)

- Prior Law

- Example 1 – Tax:
  - Before Section 704(c)(1)(B), Blackacre could be distributed to B without any gain recognized to A.
  - A’s outside basis would remain at $12,000.
  - Blackacre’s basis in B’s hands would stay at $12,000.
Section 704(c)(1)(B)

• Current Law

• If property contributed by one partner has built-in gain and if that property is distributed to another partner within 7 years of its contribution to the partnership, the contributing partner (or his successor) is treated as recognizing Section 704(c) built-in gain or loss as if the partnership had sold the property for its fair market value at the time of the distribution.

• The contributing partner’s outside basis is increased or decreased by the amount of gain or loss recognized as a result of the distribution.

• To avoid double recognition of that gain or loss, the partnership’s inside basis in the property is increased or decreased PRIOR to the distribution to reflect the gain or loss recognized by the contributing partner.

• The recognition rules apply to contributing partners and their successors. Thus, if a contributing partner transfers a partnership interest, following which the partnership distributes the contributed property to a partner other than the transferee, the transferee recognizes gain in the same manner and amount that would have been allocable to the original contributor (Code §704(c)(3)).
Section 704(c)(1)(B)

- Recognition of Gain and Basis Adjustment Under §704(c)(1)(B)

- Example 2 – Facts:
  - A contributes Blackacre with an adjusted basis of $12,000 and a fair market value of $20,000
  - B contributes $20,000 cash.
  - Three years later the partnership distributes Blackacre, then worth $23,000, to B.
Section 704(c)(1)(B)

• Recognition of Gain and Basis Adjustment Under §704(c)(1)(B)

• Example 2 – Tax:
• Under Section 704(c)(1)(B), A is allocated the $8,000 precontribution gain just as if the partnership had sold the property instead of distributing it.
• A would increase his outside basis by $8,000 to $20,000.
• Blackacre’s basis would be $20,000.
Section 704(c)(1)(B)

• Character of Gain or Loss: Capital or Ordinary

• Rule:
  • The character of this gain or loss is determined as if the partnership sold the property to the distributee.
  • This means that ordinarily the character of the gain or loss will be determined by the character of the property in the hands of the partnership.
  • Recharacterization rules may apply, however, such as IRC §707(b)(2) to convert capital gain to ordinary income.
Section 704(c)(1)(B)

• Character of Gain or Loss: Capital or Ordinary: Recharacterization Rules

• Example 3 - Facts:
  • A and B form partnership AB. A contributes $10,000 cash and Blackacre (nondepreciable real property) with a FMV of $10,000 and an adjusted tax basis of $4,000, in exchange for a 25% interest in AB.
  • B contributes $60,000 cash for a 75% interest.
  • Three years later, Blackacre is distributed to B in a current distribution. Blackacre is used in a trade or business of B.
Section 704(c)(1)(B)

• **Character of Gain or Loss**

• **Example 3 – Tax:**
  • A would have recognized $6,000 of gain on a sale of Blackacre at the time of the distribution (i.e., FMV of $10,000 less adjusted basis of $4,000).
  • Because Blackacre is not a capital asset in the hands of Partner B and B holds more than 50% interest, the character of the gain on a sale of Blackacre to B would have been ordinary income under section 707(b)(2).
  • Thus, the character of the gain to A on the distribution of Blackacre to B is ordinary income.
Section 704(c)(1)(B)

• Effect of Post- Contribution Depreciation on Built-In Gain

• Rule:
• Post-contribution depreciation deductions will reduce the amount of built-in-gain.
Section 704(c)(1)(B)

- **Effect of Post-Contribuition Depreciation on Built-In Gain**
- **Example 4 – Facts:**
  - A, B and C form partnership ABC as equal partners. A contributes Property A, depreciable property with a fair market value of $30,000 and an adjusted tax basis of $20,000.
  - B and C each contribute $30,000 cash.
  - ABC uses the traditional method of making section 704(c) allocations described in §1.704-3(b) with respect to Property A.
  - Property A is depreciated using the straight-line method over its remaining 10-year recovery period.
  - The partnership has book Depreciation of $3,000 per year (10 percent of the $30,000 book basis), and each partner is allocated $1,000 of book depreciation per year (one-third of the total annual book depreciation of $3,000).
  - The partnership has a tax depreciation deduction of $2,000 per year (10 percent of the $20,000 tax basis in Property A).
  - This $2,000 tax depreciation deduction with respect to Property A is allocated equally between B and C, the noncontributing partners, and none to A.
Section 704(c)(1)(B)

- Effect of Post- Contribution Depreciation on Built-In Gain

- Example 4 – Facts:
  - At the end of the third year, the book value of property A is $21,000 ($30,000 initial book value less $9,000 aggregate book depreciation) and the adjusted tax basis is $14,000 ($20,000 initial tax basis less $6,000 aggregate tax depreciation).
  - A’s remaining section 704(c)(1)(A) built-in gain with respect to Property A is $7,000 ($21,000 book value less $14,000 adjusted tax basis).
  - Three years after formation, Property A is distributed to B in complete liquidation of B’s interest in the partnership.
  - If Property A had been sold for its fair market value at the time of the distribution, A would have recognized $7,000 of gain under §704(c)(1)(A) and §1.704-3(b). Therefore, A recognizes $7,000 of gain on the distribution of Property A to B.
Section 704(c)(1)(B)

- **Effect of Post- Contribution Depreciation on Built-In Gain**

- **Example 4 – Tax:**
  - If Property A had been sold for its fair market value at the time of the distribution, A would have recognized $7,000 of gain under §704(c)(1)(A) and §1.704-3(b).

- Therefore, A recognizes $7,000 of gain on the distribution of Property A to B.
Section 704(c)(1)(B)

• **Exceptions**

• Exception #1:
  • **Property Distributed to Contributing Partner**
  • Section 704(c)(1)(B) does not apply if the contributed property is distributed back to the contributing partner.
Section 704(c)(1)(B)

- **Property Distributed to Contribution Partner**

- **Example 5:**
  - A contributes Blackacre with an adjusted basis of $12,000 and a FMV of $20,000.
  - B contributes $20,000 cash to the equal AB partnership.
  - Three years later, the partnership distributes Blackacre, then worth $23,000, back to A.
  - Since A is the contributing partner, Section 704(c)(1)(B) does not apply.
Section 704(c)(1)(B)

• Exception #2:

• Distributions that Would Otherwise Qualify for Like-Kind Treatment
  • Section 704(c)(2) provides relief to a contributing partner who receives a distribution of like-kind property (within the meaning of Section 1031) within 180 days after the contributed property is distributed to another partner.
  • The policy is that the contributing partner should not have to recognize gain under Section 704(c)(1)(B) if he would have qualified for nonrecognition if the transaction had taken place outside the partnership.
Section 704(c)(1)(B)

• Distribution of Like-Kind Property

• Example 6 – Facts:
  • A, B, and C form partnership ABC as equal partners.
  • A contributes Property X (nondepreciable real property) with a FMV of $20,000 and an adjusted tax basis of $10,000.
  • B and C each contribute $20,000 cash.
  • ABC subsequently buys Property Y, nondepreciable real property of a like-kind property to X with a FMV and adjusted tax basis of $8,000.
  • The FMV of Property Y subsequently increases to $10,000.
Section 704(c)(1)(B)

- Distribution of Like-Kind Property

- Example 6 – Facts:
  - Three years later, Property X is distributed to B in a current distribution.
  - At the same time, Property Y is distributed to A in a current distribution.
  - A's basis in Y is $8,000 under §732(a)(1)
Section 704(c)(1)(B)

• Distribution of Like-Kind Property

• Example 6 – Tax:
  • A has $2,000 of built-in gain in Y ($10,000 fair market value less $8,000 adjusted tax basis).
  • A would generally recognize $10,000 of gain on the distribution of Property X to B (i.e., FMV of $20,000 less the $10,000 basis).
  • This gain is reduced, however, by the amount of the built-in gain of Property Y in the hands of A.
  • As a result, A recognizes only $8,000 of gain on the distribution of Property X to B.
Section 704(c)(1)(B)

- **Other Exceptions**

- **Distributions of Contributed Property will Not Trigger Gain or Loss in the Case of:**
  - **Contributions before effective date.** Property contributed on or before October 3, 1989 (Reg. §1.704-4(c))
  - **Certain liquidations.** A distribution of an interest in contributed property to a partner in liquidation of the partnership if (1) the contributing partner receives an interest in the contributed property (and no other property) and (2) the built-in gain or loss in the interest distributed to the contributing partner is equal to or greater than the built-in gain or loss that would have been allocated to that partner on a sale of the property immediately before the distribution (Reg. §1.704-4(c)(2)).
  - **Termination.** A deemed distribution caused by a termination of the partnership under Code §708(b)(1)(B) (Reg. §1.704-4(c)(3)).
Section 704(c)(1)(B)

• Other Exceptions (cont’d.)

• Distributions of Contributed Property will Not Trigger Gain or Loss in the Case of:

  Tiered partnership transaction. A partnership that transfers all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described by Code §721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement (Reg. §1.704-4(c)(4)).

  Incorporation. Incorporation of a partnership, provided that the partnership is liquidated as part of the incorporation transaction (Reg. §1.704-4(c)(5)). However, if the partnership distributes its property to the partners, following which that property is contributed to a corporation, this exception does not apply.

  Undivided Interests. Distribution of an undivided interest in property, to the extent that the undivided interest does not exceed the undivided interests, if any, contributed by the distributing partner in the same property (Regs. §1.704-4(c)(6)).
Section 704(c)(1)(B)

• **Anti-Abuse**

• The regulations under Section 704(c)(1)(B) also contain an anti-abuse provision under which the statute and regulations must be applied in a manner consistent with the purpose of the section, or the Service can recast a transaction for federal tax purposes to achieve appropriate tax results.

• For example, the regulations apply Section 704(c)(1)(B) to a distribution that actually takes place after the statute’s time limitation (i.e., more than seven years after the contribution of property), but where the partners took steps that were the functional equivalent of a distribution before the end of that period.
Section 704(c)(1)(B)

• Anti-Abuse

• Example 7 – Facts:
  • A, B, and C form partnership ABC as equal partners.
  • A contributes Property X (nondepreciable real property) with a FMV $10,000 and an adjusted tax basis of $1,000.
  • B and C each contributes $10,000 cash.
  • Three years later, the partners desire to distribute Property X to B in complete liquidation of B's interest in the partnership.
  • If Property X were distributed at that time, however, A would recognize $9,000 of gain under section 704(c)(1)(B).
Section 704(c)(1)(B)

• **Anti-Abuse**

• **Example 7 – Facts (con’t):**
  • On becoming aware of this potential gain recognition, the partners amend the partnership agreement to avoid the gain.
  • As a result, substantially all of the economic risks and benefits of Property X are borne by B
  • Substantially all of the economic risks and benefits of all other partnership property are borne by A and C.
  • The partnership holds Property X until 7 years has lapsed, and then distributes it to B in liquidation of B's interest.
**Section 704(c)(1)(B)**

- **Anti-Abuse**
- **Example 7 – Tax:**
  - The tax-avoidance steps taken by the partnership are the functional equivalent of an actual distribution of Property X to B in complete liquidation of B’s interest in the partnership as of that date.
  - Section 704(c)(1)(B) requires the recognition of gain when contributed section 704(c) property is in substance distributed to another partner within 7 years of its contribution to the partnership.
  - Allowing a contributing partner to avoid section 704(c)(1)(B) through arrangements such as this would effectively undermine the purpose of section 704(c)(1)(B).
  - As a result, the steps taken by the partnership are treated as causing a distribution of X to B on the date the partnership agreement was amended.
  - A recognizes gain of $9,000 at that time.
Section 704(c)(1)(B)

• Anti-Abuse

• Example 7 Alternative:
  • Alternatively, if the partners had instead agreed that B would continue as a partner with no changes to the partnership agreement or to B's economic interest in partnership operations, the distribution of Property X to B would not have been inconsistent with the purpose of section 704(c)(1)(B).
  • In that situation, Property X would not have been distributed until after the expiration of the 7-year period.
  • Deferring the distribution of Property X until the end of the 7-year period for a principal purpose of avoiding the recognition of gain under section 704(c)(1)(B) is not inconsistent with the purpose of that section.
  • Therefore, A would not have recognized gain on the distribution of Property X in that case.
Section 704(c)(1)(B)

Thank you

Belan Wagner – bwagner@wkblaw.com
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Section 737

• **Purpose**

It is possible that the partner who contributed built-in gain property ("B-I-G Property") could be redeemed out of a partnership by way of a distribution of their property in kind to the contributing partner.

Since §704(c)(1)(B) or a subsequent sale of the B-I-G Property would not apply to allocate the built-in-gain to the retired partner, §737 was enacted.
Section 737

• Exception to Nonrecognition

• Under Section 737, the general nonrecognition rule of Section 731 does not apply if a partner who contributes B-I-G Property to a partnership receives a current or liquidating distribution in kind of other property within 7 years of the date of the contribution of the B-I-G Property.

• Section 737 requires recognition of gain but does not allow for loss recognition.
Section 737

• **Amount of Gain Recognized**

  • Gain is recognized to the extent of the **LESSER** of:
  • “Excess Distribution” = the excess of FMV – Adjusted Basis in Partnership;
  • the “Net Precontribution Gain” of the partner.
Section 737

• Amount of Gain Recognized

• “Net Precontribution Gain” –
• The amount of net gain (i.e., gain reduced by any loss) that the distributee partner would be required to recognize under Section 704(c)(1)(B) if all property owned by the partnership immediately before the distribution that had been contributed by the distributee within 7 years of the distribution was distributed to a different partner.
Section 737

- **Amount of Gain Recognized**

- **Example 1 – Facts:**
  - A and B form partnership AB.
  - A contributes Property Y, unimproved real estate having a basis of $10,000 and a FMV of $100,000.
  - B contributes Property Z, unimproved real estate having a basis and FMV of $100,000.
  - A’s basis in his partnership interest is initially $10,000 and B’s basis is $100,000.
  - Subsequently, Property Y is worth $150,000 and Property Z is worth $110,000.
  - The partnership then distributes Property Z to A in a nonliquidating distribution.
Section 737

• **Amount of Gain Recognized**

• **Example 1 – Tax:**
  • A’s Net Precontribution Gain is $90,000 (the amount of gain A would be required to recognize under §704(c)(1)(B) if Property Y were distributed to B).
  • The Excess Distribution is the excess of the FMV of Property Z ($110,000) over A’s adjusted basis in his partnership interest ($10,000) = $100,000.
  • Since the Net Precontribution Gain is less than the Excess Distribution, A is required to recognize the lesser of the two – $90,000.
Section 737

• Computation of Excess Distribution When Cash and Debt Involved

• Example 2 – Facts:
• ABC partnership: partner A contributes nondepreciable real property with a FMV of $10,000 and a basis of $4,000.
• ABC acquires Property X, which is nondepreciable real estate worth $9,000 and is subject to a $9,000 nonrecourse liability.
Section 737

• Computation of Excess Distribution When Cash and Debt Involved

• Example 2 – Facts:
• Within 7 years, A receives, in partial liquidation of his interest:
  o (1) Property X, which still has a FMV of $9,000 and is subject to a $9,000 nonrecourse liability, and
  o (2) $2,000 cash.
• No other events have occurred that affect A’s outside basis.
Section 737

• **Computation of Excess Distribution When Cash and Debt Involved**

• **Example 2 – Tax:**
  • To determine the amount of the Excess Distribution to A, the original $4,000 outside basis of his interest is:
  • Increased by $9,000 to reflect his share of the nonrecourse liability on Property X and assumed as a result of the distribution;
  • Reduced by the $2,000 cash contribution to him.
  • Thus, the basis of A’s partnership interest for purposes of computing “Excess Distribution” is $11,000.
  • Since the FMV of the distributed Property X is only $9,000, there is no Excess Distribution.
  • Since the gain recognized is the lesser of the Excess Distribution or the Net Precontribution Gain, there is no gain recognized.
Section 737

• **Effect of Post-Contribution Depreciation**

• **Example 3 – Facts:**
  - ABC partnership: partner A contributes depreciable Property X, which has a FMV of $30,000 and a basis of $20,000, for a 1/3 interest.
  - Property X is depreciable under the straight-line method over 10 years.
  - Over the next three years, book depreciation of $9,000 and tax depreciation of $6,000 is claimed with respect to Property X.
  - Under the traditional method of dealing with book-tax differences on contributed property, A is allocated $1,000 per year of book depreciation but no tax depreciation.
Section 737

• Effect of Post- Contribution Depreciation

• Example 3 – Facts:
  • After 3 years, A receives Property Y, which has a FMV and a tax basis to the partnership of $30,000, in liquidation of his interest.
  • No other events have occurred that affect A’s basis
Section 737

• **Effect of Post- Contribution Depreciation**

• **Example 3 – Tax:**
  • The basis of A’s interest prior to the distribution is still $20,000, so the Excess Distribution to A is $10,000 (i.e., $30,000 value of Y less $20,000 basis).
  • However, A’s Net Precontribution Gain has been reduced to $7,000.
  • The difference between the adjusted book value of X of $21,000 (i.e., $30,000 less $9,000 of book depreciation) and its adjusted tax basis of $14,000 (i.e., $20,000 less $6,000 of tax depreciation) = the Net Precontribution Gain.
Section 737

- **Effect of Post- Contribution Depreciation**

- **Example 3 – Tax:**
  - Accordingly, A’s §737 Net Precontribution Gain is $7,000.
  - Property Y takes a $27,000 basis in A’s hands.
  - Effectively $3,000 of unrealized tax gain (representing the $3,000 of book depreciation that was allocated to A, but not matched with tax depreciation under §704(c)(1)(A)) is shifted from Property X to Property Y.
Section 737

• **Basis Adjustment**

• Under Section 737(c)(1), a distributee partner recognizing gain under Section 737(a) increases the basis of his partnership interest to the extent of the gain recognition.

• Under Section 737(c)(2), the partnership’s basis in the contributed property is also appropriately adjusted to reflect gain recognized under Section 737(a).
Section 737

• **Basis Adjustment**

• **Example 4 – Facts:**
  • At formation, partner A contributes nondepreciable real properties X1 and X2, each with a FMV of $10,000 and an adjusted basis of $6,000.
  • Four years later, A receives property Y (FMV and basis of $20,000) in liquidation of his partnership interest.
  • At the same time Property X1 (which still has a FMV of $10,000) is distributed to another partner.
Section 737

- **Basis Adjustment**

- **Example 4 – Facts:**
  - No other events have occurred that affect A’s basis.
  - Prior to these distributions, A’s basis for his partnership interest is $12,000 and A has $8,000 of Net Precontribution Gain.
Section 737

• **Basis Adjustment**

• **Example 4 – Tax:**
  - The distribution of Property X1, which is subject to §704(c)(1)(B), is treated as occurring first, regardless of the actual order.
  - Under §704(c)(1)(B), A recognizes $4,000 of gain on the distribution of Property X1.
  - This increases the basis of his interest to $16,000 and reduces his Net Precontribution Gain to $4,000.
Section 737

• **Basis Adjustment**

• **Example 4 – Tax:**

• Under §737, A has an Excess Distribution of $4,000 ($20,000 value of Y less $16,000 basis of interest) and $4,000 of remaining Net Precontribution Gain.

• A’s §737 gain is $4,000.
Section 737

• Character of Gain

The character of gain recognized under §737 is determined by the “proportionate character of the Net Precontribution Gain.”

For this purpose, all gains and losses from §704(c) property of a like character are netted, and any character category that has a net loss is ignored.

Character is determined at the partnership level as if all §704(c) property were sold to an unrelated party at the time of the distribution and includes any separately allocated items.
Section 737

• **Character of Gain**

• **Example 5 – Facts:**
  • On the formation of the ABC partnership, partner A contributes nondepreciable Properties X1 (value $30,000, basis $20,000), X2 (value $30,000, basis $38,000) and X3 (value $10,000, basis $9,000).
  • The character of the gain or loss from Property X1 and Property X2 is long-term, U.S.-source capital gain or loss, while the character of the gain from Property X3 is long-term, foreign-source capital gain.
  • Four years later, A receives Property Y (fair market value and basis $70,000) in liquidation of his partnership interest.
  • No other events have occurred that affect A’s basis.
Section 737

• Character of Gain

• Example 5 – Tax:
  • This distribution triggers $3,000 of §737 gain to A (both the Excess Distribution and the Net Precontribution Gain are $3,000).
  • Since U.S.-source and foreign-source gains are required to be separately stated under §702, A must divide his Net Precontribution Gain into these two categories.
  • A’s Net Precontribution Gain of $3,000 consists of $2,000 of net U.S.-source gain and $1,000 of net foreign source gain, so two-thirds ($2,000/$3,000) of gain recognized under §737 is long-term, U.S.-source capital gain and one-third ($1,000/$3,000) is long-term, foreign-source capital gain.
Section 737

• *Exceptions*

• **Exception if Same Property is Distributed**
  
  No gain is recognized by a distributee partner under Section 737 if the same property contributed by the distributee is distributed to him.
Section 737

• Distribution of Same Property

• Example 6 – Facts:
  • At formation of a partnership, A contributes nondepreciable real Properties X1 (FMV $20,000, basis $10,000) and X2 (FMV $10,000, basis $6,000).
  • Four years later, A receives Property X2 and Y (Y has FMV and basis of $20,000) in liquidation of his interest.
  • No other events have occurred that affect A’s basis.
Section 737

- **Distribution of Same Property**

- **Example 6 – Tax:**
  - Under the previously-contributed property exception, Property X2 is not taken into account in computing the amount of the Excess Distribution or the amount of A’s Net Precontribution Gain.
  - The basis of Property X2 to A is determined independently of the rest of the distribution.
  - Hence, Property X2 takes a carryover basis of $6,000 under §732(a)(1) (general carryover basis rule for current distributions).
  - The basis of A’s interest is reduced to $10,000.
Section 737

• Distribution of Same Property

• Example 6 – Tax:
  • The §737 distribution then consists of Property Y and the Excess Distribution is $10,000 ($20,000 FMV in Property Y less $10,000 basis of A’s interest).
  • A’s Net Precontribution Gain (with respect to Property X1) is $10,000, as is A’s §737 gain.
Section 737

- Application Following Section 708(b)(1)(B) Termination

- In the context of §§704(c) and 737, the Regulations clarify that a §708(a)(1)(B) termination will have no effect on partnership and partners.
- Regulations under §704(c) provide that property deemed to be contributed to the new partnership will only be treated as §704(c) property in the hands of the new partnership to the extent it was §704(c) property in the hands of the terminated partnership.
Section 737

• **Transfer to Subsidiary Partnership**

• Section 737 is not triggered by a transfer of all partnership assets and liabilities to a second partnership where the transfer is followed by a distribution of interests in the second partnership in complete liquidation of the transferor partnership as part of the same plan or arrangement.
Section 737

- Incorporation of Partnership

Section 737 does not apply to distributions in connection with the incorporation of a partnership (provided that the partnership liquidates as part of the incorporation transaction) unless the incorporation is accomplished by means of an actual distribution of partnership assets to the partners followed by a contribution of such assets from the partners to the new corporation. Thus, form continues to govern, as it does with respect to other aspects of partnership incorporation.
Section 737

- **Undivided Interests**

- The distribution of undivided interest in property is treated as a distribution of previously contributed property to the extent that the distributed interest does not exceed the undivided interest, if any, contributed by the distributee-partner in the same property.

- The relevant comparison is of fractional interests, not values; thus, a distribution to a partner of a one-half interest in contributed Property X is treated as a distribution of previously contributed property as long as such partner contributed at least one-half interest in Property X.
Thank you

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(925) 478-7308
To the extent a partner receives a

- **DISTRIBUTION** of unrealized receivables or substantially appreciated inventory items in exchange for the partner's interest in other p'ship property, *or*

- **DISTRIBUTION** of other p'ship property, in exchange for the partner's interest in unrealized receivables or substantially appreciated inventory items,

the transaction will be considered a **SALE OR EXCHANGE** of such property between the partner and the p'ship. IRC § 751(b)(1).
Gain or loss recognized on the SALE OR EXCHANGE of a p'ship interest shall be considered a gain or loss on the sale or exchange of a capital asset ... 

... except as provided in § 751
Ordinary Gain or Loss
IRC § 751(a)

The amount of any money, or the FMV of any property, received by a partner in exchange for the partner's partnership interest that is attributable

- UNREALIZED RECEIVABLES or

- INVENTORY items

shall be considered an amount realized from the sale or exchange of property OTHER THAN A CAPITAL ASSET. IRC § 751(a).
So what does this look like in practice?

**If you see that –**

- A partner has received a distribution of unrealized receivables or substantially appreciated inventory and has **NOT** received a **PROPORTIONATE DISTRIBUTION** of other p'ship property, *or*

- A partner has received a distribution of other p'ship property and has **NOT** received a **PROPORTIONATE DISTRIBUTION** of unrealized receivables or substantially appreciated inventory,

**Then**

The partner will be treated as having sold his or her interest in certain assets in exchange for a portion of the distributed assets, to the extent of the disproportionality – And the gain or loss realized will be ordinary in nature.
Unrealized Receivables
IRC § 751(c)

Any rights to payment for

- GOODS DELIVERED or to be delivered, to the extent the income would be ordinary
- SERVICES RENDERED or to be rendered

Such term also includes –

Mining property; stock in a DISC; § 1245 property; stock in certain foreign corporations; § 1250 property; § 1252(a) farm land; franchises, trademarks, or trade names; oil, gas, or geothermal property; any market discount bond; and any short-term obligation ... but only to the extent gain would be recognized if such property had been sold by the p'ship at its FMV. IRC § 751(c), flush.
Substantially Appreciated Inventory
IRC § 751(d), (b)(3)

**INVENTORY**

- **Stock in Trade**, other property properly included in INVENTORY if on hand at the close of the tax year, PROPERTY HELD PRIMARILY FOR SALE to customers in the ordinary course of business;

- **Property used in the trade or business** that is held for > 1 YEAR and is not property described above; and

- Any other property which, if held by the partner, would be considered property listed above

**Substantially Appreciated** – FMV > 120% of adjusted basis*

* Property acquired for the principal purpose of avoiding § 751(b)(1) will be excluded. IRC § 751(b)(3)(B).
§ 751(b) Analysis – A Step-by-Step Approach

1. Has there been a CHANGE in the partner's aggregate share of § 751 assets (unrealized receivables & substantially appreciated inventory) or § 741 assets (all other property)?

2. Compare the partner's FMV OWNERSHIP of each asset BEFORE the distribution to the partner's FMV ownership of each asset AFTER the distribution, and note the extent to which (s)he was overpaid or shortchanged as it relates to each asset.*

* When a partner receives too much of a § 751 asset too little of both § 751 & § 741 assets, the net excess § 751 assets is the number that goes to the McKee exchange table. Likewise, when a partner receives too much of a § 741 asset too little of both § 741 & § 751 assets, the net excess in § 741 assets is the number that goes to the McKee exchange table.
3. The p'ship is deemed to have distributed that which the partner was shortchanged.

**Cash Distribution** – Cash received in excess of partner's outside basis results in a capital gain or loss. IRC §§ 731(a), 741. Partner's outside basis is decreased by cash received. IRC § 733.

**Property Distribution** – Partners recognize no gain or loss on operating distributions of property. IRC § 731(a). Partner takes p'ship's basis in property, not to exceed partner's outside basis. IRC § 732(a). Partner's outside basis is decreased by transferred basis in property received. IRC § 733.
§ 751(b) Analysis – A Step-by-Step Approach (cont.)

4. The partner is deemed to have exchanged the property received in the phantom distribution for the excess § 751 or § 741 property received in the actual distribution.

**PARTNER CONSEQUENCES**

- Amount realized (excess § 751 or § 741 property) minus aggregate adjusted basis in assets shortchanged equals capital gain or loss if partner was shortchanged a capital asset, or ordinary income or loss if partner was shortchanged an ordinary income asset.
  
  - Partner may tack the p'ship's holding period if (s)he was shortchanged a capital asset or § 1231 property. IRC § 1223(1).

  - Partner takes a FMV basis in the property (actually) received. IRC § 1012.
4. The partner is deemed to have exchanged the property received in the phantom distribution for the excess § 751 or § 741 property received in the actual distribution.

**PARTNERSHIP CONSEQUENCES**

- Amount realized (amount it shortchanged the partner) minus its adjusted basis in the excess property given up equals capital gain or loss if p'ship over-distributed a capital asset, or ordinary income or loss if p'ship over-distributed an ordinary income asset.

  - P'ship may tack the partner's holding period. IRC § 1223(2).

  - This gain or loss then passes to the partners who did not participate in the distribution.

  - P'ship takes a FMV basis in the property received (what it shortchanged the partner). IRC § 1012.
§ 751(b) Analysis – A Step-by-Step Approach (cont.)

5. The remaining portion (non-excess portion) of the § 751 & § 741 assets distributed is taxed under the general rules.

**Cash Distribution** – Cash received in excess of partner's outside basis results in a capital gain or loss. IRC §§ 731(a), 741. Partner's outside basis is decreased by cash received. IRC § 733.

**Property Distribution** – Partners recognize no gain or loss on operating distributions of property. IRC § 731(a). Partner takes p'ship's basis in property, not to exceed partner's outside basis. IRC § 732(a). Partner's outside basis is decreased by transferred basis in property received. IRC § 733.
§ 751(b) Analysis – An Example

- X has a \( \frac{1}{3} \) interest in XYZ p'ship, which has the following balance sheet

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables</td>
<td>$ -</td>
<td>$15,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td></td>
<td>$15,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity</th>
<th>Basis</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
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<tr>
<td>Y</td>
<td>$5,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Z</td>
<td>$5,000</td>
<td>$10,000</td>
</tr>
<tr>
<td></td>
<td>$15,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

- X's basis in her partnership interest is $5,000.

- In complete liquidation of her interest, X receives $10,000 in cash.
§ 751(b) Analysis – An Example (cont.)

1. Has there been **A CHANGE** in the partner's aggregate share of § 751 assets (unrealized receivables & substantially appreciated inventory) or § 741 assets (all other property)? **YES**

2. Compare the partner's **FMV OWNERSHIP** of each asset **BEFORE** the distribution to the partner's FMV ownership of each asset **AFTER** the distribution, and note the extent to which (s)he was overpaid or shortchanged as it relates to each asset.

<table>
<thead>
<tr>
<th></th>
<th>Total</th>
<th>X's Share</th>
<th>Before B</th>
<th>After A</th>
<th>Overpaid (Short) A - B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables</td>
<td>$15,000</td>
<td>$5,000</td>
<td>$5,000</td>
<td>$</td>
<td>$ (5,000)</td>
</tr>
<tr>
<td>Cash</td>
<td>$15,000</td>
<td>$5,000</td>
<td>$10,000</td>
<td>$5,000</td>
<td></td>
</tr>
</tbody>
</table>
§ 751(b) Analysis – An Example (cont.)

3. The p'ship is deemed to have distributed that which the partner was shortchanged.

- X recognizes no gain or loss on the distribution. IRC § 731(a).
- X takes XYZ's basis in the receivables, $0. IRC § 732(a).
- X's outside basis of $5,000 is decreased by the $0 transferred basis in the property received. IRC § 733.
§ 751(b) Analysis – An Example (cont.)

4. The partner is deemed to have exchanged the property received in the phantom distribution for the excess § 751 or § 741 property received in the actual distribution.

- Amount realized, $5,000 in receivables minus basis in the excess property given up, $5,000 in cash equals $0 ordinary income to XYZ.

- XYZ takes a $5,000 FMV basis in the receivables. IRC § 1012.
5. The remaining portion (non-excess portion) of the § 751 & § 741 assets distributed is taxed under the general rules.

- $5,000 cash received in excess of X's $5,000 outside basis results in no capital gain or loss to X. IRC §§ 731(a), 741.

- X's outside basis is reduced to $0 by the cash received. IRC § 733.
RECAP

- X recognizes $5,000 of ordinary income and is left with no basis in her partnership interest, which was terminated.

- XYZ takes a FMV basis in the receivables, and its balance sheet looks like this:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables</td>
<td>$5,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Total</td>
<td>$10,000</td>
<td>$20,000</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity</th>
<th>Basis</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td>Y</td>
<td>$5,000</td>
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<td>$10,000</td>
</tr>
<tr>
<td>Total</td>
<td>$10,000</td>
<td>$20,000</td>
</tr>
</tbody>
</table>
§ 751(b) Analysis – Another Example

- Y has a $1/3$ interest in XYZ p'ship, which has the following balance sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
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<td>$15,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$21,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Property (no recap)</td>
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<td>$48,000</td>
</tr>
<tr>
<td>Land</td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
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<td><strong>$111,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
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<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
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</tr>
<tr>
<td>Long term</td>
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<td>$21,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$36,000</strong></td>
<td><strong>$36,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity</th>
<th>Basis</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>$20,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Y</td>
<td>$20,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Z</td>
<td>$20,000</td>
<td>$25,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$60,000</strong></td>
<td><strong>$75,000</strong></td>
</tr>
</tbody>
</table>

- Y's basis in his partnership interest is $32,000.

- In complete liquidation of his interest, Y receives $10,000 in cash & $15,000 of property.
§ 751(b) Analysis – Another Example (cont.)

1. Has there been **A CHANGE** in the partner's aggregate share of § 751 assets (unrealized receivables & substantially appreciated inventory) or § 741 assets (all other property)? **YES**

<table>
<thead>
<tr>
<th>§ 751 Assets</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables</td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$21,000</td>
<td>$30,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$30,000</strong></td>
<td><strong>$39,000</strong></td>
</tr>
<tr>
<td><strong>120%</strong></td>
<td></td>
<td><strong>$36,000</strong></td>
</tr>
</tbody>
</table>

Since the aggregate FMV of the receivables and inventory does exceed 120% of the assets' aggregate basis, XYZ does have substantially appreciated inventory.
2. Compare the partner's **FMV OWNERSHIP** of each asset **BEFORE** the distribution to the partner's FMV ownership of each asset **AFTER** the distribution, and note the extent to which (s)he was overpaid or shortchanged as it relates to each asset.

<table>
<thead>
<tr>
<th>Total FMV</th>
<th>Y's Share</th>
<th>Before B</th>
<th>After A</th>
<th>Overpaid (Short) A - B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash 15,000</td>
<td>(\div 3) =</td>
<td>$ 5,000</td>
<td>$ 10,000</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Receivables 9,000</td>
<td></td>
<td>$ 3,000</td>
<td>$ -</td>
<td>$ (3,000)</td>
</tr>
<tr>
<td>Inventory 30,000</td>
<td></td>
<td>$ 10,000</td>
<td>$ -</td>
<td>$ (10,000)</td>
</tr>
<tr>
<td>Property (no recap) 48,000</td>
<td></td>
<td>$ 16,000</td>
<td>$ 15,000</td>
<td>$ (1,000)</td>
</tr>
<tr>
<td>Land 9,000</td>
<td></td>
<td>$ 3,000</td>
<td>$ -</td>
<td>$ (3,000)</td>
</tr>
<tr>
<td></td>
<td>$111,000</td>
<td>$37,000</td>
<td>$25,000</td>
<td>$ (12,000)</td>
</tr>
<tr>
<td>Liabilities (36,000)</td>
<td></td>
<td>(12,000)</td>
<td>$ -</td>
<td>$ 12,000</td>
</tr>
<tr>
<td></td>
<td>$ 75,000</td>
<td>$ 25,000</td>
<td>$ 25,000</td>
<td>$ -</td>
</tr>
</tbody>
</table>
§ 751(b) Analysis – Another Example (cont.)

3. The p'ship is deemed to have distributed that which the partner was shortchanged.

- Y recognizes no gain or loss on the property distribution. IRC § 731(a).

- Y takes XYZ's basis in the property received. IRC § 732(a).

- Y's outside basis of $32,000 is decreased by the $13,875 transferred basis in the property received, leaving outside basis of $18,125. IRC § 733.

<table>
<thead>
<tr>
<th></th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$10,000</td>
<td>$7,000</td>
</tr>
<tr>
<td>Property (no recap)</td>
<td>$1,000</td>
<td>$875</td>
</tr>
<tr>
<td>Land</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$17,000</strong></td>
<td><strong>$13,875</strong></td>
</tr>
</tbody>
</table>
§ 751(b) Analysis – Another Example (cont.)

4. The partner is deemed to have exchanged the property received in the phantom distribution for the excess § 751 or § 741 property received in the actual distribution.

<table>
<thead>
<tr>
<th></th>
<th>FMV, Amount Realized</th>
<th>Basis</th>
<th>Gain, (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$-</td>
</tr>
<tr>
<td>Inventory</td>
<td>$10,000</td>
<td>$7,000</td>
<td>$3,000 ordinary</td>
</tr>
<tr>
<td>Property (no recap)</td>
<td>$1,000</td>
<td>$875</td>
<td>$125 § 1231</td>
</tr>
<tr>
<td>Land</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$-</td>
</tr>
<tr>
<td></td>
<td>$17,000</td>
<td>$13,875</td>
<td>$3,125</td>
</tr>
</tbody>
</table>

- XYZ recognizes no gain or loss on the receipt of $17,000 of assets in exchange for $17,000 of consideration.

- XYZ takes a FMV basis in the property received. IRC § 1012.

- Y recognizes $3,000 of ordinary income & $125 of § 1231 gain.
### § 751(b) Analysis – Another Example (cont.)

5. The remaining portion of the § 751 & § 741 assets distributed is taxed under the general rules.

<table>
<thead>
<tr>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$5,000 $5,000</td>
</tr>
<tr>
<td>Property (no recap)</td>
<td>$15,000 $13,125</td>
</tr>
<tr>
<td>$20,000</td>
<td>$18,125</td>
</tr>
</tbody>
</table>

- The $5,000 of cash received minus Y's outside basis of $18,125 results in no gain or loss to Y. IRC §§ 731(a), 741. Instead, Y will reduce his outside basis by the $5,000 of cash received. IRC § 733.

- Y recognizes no gain or loss on the $15,000 of property received. IRC § 731(a). Instead, Y will reduce his outside basis by the $13,125 transferred basis taken in the property. IRC §§ 732(a), 733.
§ 751(b) Analysis – Another Example (cont.)

RECAP

- Y recognizes $3,000 of ordinary income and $125 of § 1231 gain, and is left with no basis in his p'ship interest, which was terminated.

- Y takes a transferred basis of $13,125 in the property.

- XYZ's balance sheet looks like this ...

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## Recap

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$5,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$24,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Property (no recap)</td>
<td>$125</td>
<td>-</td>
</tr>
<tr>
<td>Land</td>
<td>$9,000</td>
<td>$9,000</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>$76,000</strong></td>
<td><strong>$86,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Long term</td>
<td>$21,000</td>
<td>$21,000</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td><strong>$36,000</strong></td>
<td><strong>$36,000</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity</th>
<th>Basis</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>$20,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>Y</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Z</td>
<td>$20,000</td>
<td>$25,000</td>
</tr>
<tr>
<td><strong>Total Equity</strong></td>
<td><strong>$40,000</strong></td>
<td><strong>$50,000</strong></td>
</tr>
</tbody>
</table>
Statements Required – Reg. § 1.751-1(b)(5)

- **A p'ship that**

  - distributes § 751 property to a partner in exchange for his or her interest in other p'ship property, or

  - distributes other property in exchange for any part of the partner's interest in § 751 property

  shall submit with its return for the year of the distribution a statement showing the computation of any income, gain, or loss to the p'ship under the provisions of § 751(b) and this paragraph.

- **The distributee partner** shall submit with his or her return a statement showing the computation of any income, gain, or loss to him or her.
Each statement should set forth –

- the **date** of the sale or exchange,

- the amount of any **gain or loss attributable to § 751 property**, and

- the amount of any **gain or loss attributable to capital gain or loss** on the sale of the partnership interest