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Distributions

1

General Rule: PSP income is taxed—and the income increases O.B.--whether distributed or not so distributions are normally tax free recoveries of O.B.

2

Unlike distributions of appreciated property to a corporate shareholder, distributions of such property to a partner do not trigger gain (or loss) to either the partner or the partnership.

Current Distributions w/o Sec. 751

- Gain only if money distributed exceeds outside basis.
- No loss recognition
- The distributee partner's basis in property received is generally the PSP inside basis in that property.

Ex.: Gain on Distribution

- Linda's predistribution O.B. is $100,000
- $120,000 of money is distributed to her.
- Linda's recognizes gain of $20,000 (Sec. 731(a))

Ex.: Distribution of Property

- Linda's predistribution O.B. is $100,000
- Investment land, basis $80,000 (FMV $100K) is distributed to her.
- PSP and Linda recognize zero gain.
- Linda's basis in the land is $80,000 (Secs. 731and 732)

Ex.: Distribution of Property

- Linda's predistribution O.B. is $100K
- Investment land, PSP basis $80K (FMV $100K) is distributed to her.
- Linda has a $10K Sec. 743(b) adjustment for the land
- Linda's basis in the land is $90K (Secs. 731and 732)

Ex: Distribution of Property

- Linda's predistribution O.B. is $100K
- Investment land, PSP basis $80K (FMV $100K) is distributed to her.
- Another PTR has a $10K Sec. 743(b) adjustment for the land
- Linda's basis in the land is $80K (Secs. 731and 732)

- The other PTR's $10K sec. 743(b) adjustment shifts to other partnership assets.

See Reg. 1.743-1(g)(2)

Exception

If distributed property I.B. > O.B. the distributee's partner's basis is limited to O.B.*

*O.B. is first reduced by money if money is also distributed

Example with IB > OB

- Linda's predistribution O.B. is $100,000
- Land with I.B. of $120,000 is distributed to her.
- Linda's basis in the land is $100,000.

Disguised Sales

Contribution and Distribution within 2 Years – Rebuttable Presumption of Sale

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Mixing Bowl Transactions:

(1) Distribute other property to contributing P within 7 years. (IRC sec. 737)

(2) Distribute contributed property to other P within 7 years. (IRC sec. 704(c)(1)(B))

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Special Rule for Marketable Securities

See Ex. 1

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Liquidating Distributions w/o Sec. 751

"The term 'liquidation of a partner's interest' means the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership." (Sec. 761(d))

Tax consequences of liquidating distributions differ from current distributions in three ways

1) Losses may be recognized when the partner receives only:

- Money,
- Unrealized Receivables, or
- Inventory Items.

Any remaining O.B. is a capital loss. (Sec. 731)

Ex. 1 -- Loss Rec.

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- Linda’s predistribution O.B. is $100,000
- $90,000 liquidating distribution of money to Linda.
- Linda recognizes a capital loss of <$10,000>

Ex. 2 -- Loss Rec.

- Linda’s predistribution O.B. is $100K
- Liquidating distrib.: $20K cash; inventory basis of $70K. (FMV 110K)
- Linda recognizes a capital loss of <$10,000>.

Sec. 731(a)(2) loss for remaining O.B. includes O.B. attributable to syndication costs and unamortizable organization costs (though nonductible at partner level per sec. 709(a))

(Rev. Rul. 87-111 & 81-153)

Compare nondeductible 50% of meals and entertainment expenses which reduce O.B.

2) The distributee partner's basis in cold assets can be increased to match predistribution O.B.

Ex. 3:

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- Linda’s predistribution O.B. is $100K
- Liquidating distrib.: $20K cash; inventory I.B. of $70K (FMV 110K); land (capital asset) with I.B. of $400 (FMV $1K)
- Linda recognizes no loss
- Inventory basis $70K; Land $10,000.

Ex. 4:

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- Linda’s predistribution O.B. is $100K
- Liquidating distrib.: $20K cash; inventory I.B. of $70K (FMV 110K); auto (sec. 1231 asset) with I.B. of $400 (FMV $1K)
- Linda recognizes no loss
- Inventory basis $70K; Auto basis $10,000.

3) Liquidation (retirement) of a partner may also trigger section 736(a)

(detail below after sec. 751)

Section 751(b) Current Regs.

Receipt of Excess "Cold" Assets

1) **If Excess Cold Assets Are Distributed:**

then the partnership is treated as if it made a hypothetical distribution of the partner's proportionate share of the gross value of Hot assets followed by a fictional sale of these Hot assets by the partner back to the partnership at fair market value in exchange for the excess Cold assets actually received in the distribution.

Receipt of Excess Hot Assets

2) **If Excess Hot Assets Are Distributed:**

then the partnership is treated as if it made a hypothetical distribution of the partner's proportionate share of the gross value of Cold assets followed by a fictional sale of these Cold assets by the partner back to the partnership at fair market value in exchange for the excess Hot assets actually received in the distribution.

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Example 1
Sec. 751

Current Distribution With Current Regulations

Jack receives a $1,000,000 distribution that reduces his partnership interest from 50% to 33.3%.

All partnership assets were purchased by the partnership.

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Before

JJJ Partnership

(In Thousands)	Tax Basis	Book Basis	FMV	O.B.
Cash	1,000		1,000	
Accounts Rec.	0		1,000	
Inventory	400		1,000	
Land (Cap. Asset)	600		1,000	
Total Assets	2,000		4,000	
Jack (50%)	1,000		2,000	1,000
Jill (25%)	500		1,000	500
Jane (25%)	500		1,000	500
Debt + Capital	2,000		4,000	

Before

JJJ Partnership

(In Thousands)	Tax Basis	Book Basis	FMV	O.B.
Cash	1,000	1,000	1,000	
Accounts Rec.	0	0	1,000	
Inventory	400	400	1,000	
Land (Cap. Asset)	600	600	1,000	
Total Assets	2,000	2,000	4,000	
Jack (50%)	1,000	1,000	2,000	1,000
Jill (25%)	500	500	1,000	500
Jane (25%)	500	500	1,000	500
Debt + Capital	2,000	2,000	4,000	

Book capital accounts are (optionally) revalued.

Events Warranting Optional Revaluation Include:

- Contribution of money, property, or services as consideration for partnership interest.
- Distribution of money or property as consideration for partnership interest.

Reg. 1.704-1(b)2)(iv)(f)(5)(i) – (iii)

After Revaluation

(In Thousands)	Tax Basis	Book Basis	FMV	O.B.
Cash	1,000		1,000	
Accounts Rec.	0		1,000	
Inventory	400		1,000	
Land (Cap. Asset)	600		1,000	
Total Assets	2,000		4,000	
Jack (50%)	1,000		2,000	1,000
Jill (25%)	500		1,000	500
Jane (25%)	500		1,000	500
Debt + Capital	2,000		4,000	

After Revaluation

(In Thousands)	Tax Basis	Book Basis	FMV	O.B.
Cash	1,000	1,000	1,000	
Accounts Rec.	0	1,000	1,000	
Inventory	400	1,000	1,000	
Land (Cap. Asset)	600	1,000	1,000	
Total Assets	2,000	4,000	4,000	
Jack (50%)	1,000	2,000	2,000	1,000
Jill (25%)	500	1,000	1,000	500
Jane (25%)	500	1,000	1,000	500
Debt + Capital	2,000	4,000	4,000	

Excess cold assets of $333,333:

	$1,000,000	Gross Value of Hot Before
-	666,667	Gross Value of Hot After
-	333,333	Excess Cold Assets

The partners agree that the excess cold assets (cash) was received for $333,333 of inventory with a basis of $133,333.

Ordinary Income to Jack of $200,000

(sec. 751(b) fictional sale of inventory to PSP)

After Distribution

(In Thousands)	JJJ Partnership			
	Tax Basis	Book Basis	FMV	O.B.
Accounts Rec.	0		1,000	
Inventory	600*		1,000	
Land (Cap Asset)	600		1,000	
Total Assets	1,200		3,000	
Jack (1/3)	200		1,000	200
Jill (1/3)	500		1,000	500
Jane (1/3)	500		1,000	500
Debt + Capital	1,200		3,000	

* Increased by $200,000 as a result of 751(b) exchange

After Distribution

(In Thousands) JJJ Partnership				
	Tax Basis	Book Basis	FMV	O.B.
Accounts Rec.	0	1,000	1,000	
Inventory	600	1,000	1,000	
Land (Cap Asset)	600	1,000	1,000	
Total Assets	1,200	3,000	3,000	
Jack (1/3)	200	1,000	1,000	200
Jill (1/3)	500	1,000	1,000	500
Jane (1/3)	500	1,000	1,000	500
Debt + Capital	1,200	3,000	3,000	

The optional capital account revaluation mandates a reverse section 704(c) tax allocation for the existing assets of the partnership.

If all assets were sold, the tax gain of $1,800,000 (zero book gain) is allocated:

$800,000 to Jack
$500,000 to Jill
$500,000 to Jane

After Sale

(In Thousands)	JJJ Partnership			
	Tax Basis	Book Basis	FMV	O.B.
Cash	3,000	3,000	3,000	
Jack (1/3)	1,000	1,000	1,000	1,000
Jill (1/3)	1,000	1,000	1,000	1,000
Jane (1/3)	1,000	1,000	1,000	1,000
Debt + Capital	3,000	3,000	3,000	

Without Revaluation And Without Special 704(b) Allocations

Same Ordinary Income to Jack of $200,000

(sec. 751(b) fictional sale of inventory to PSP)

After Distribution to Jack

(In Thousands)	JJJ Partnership			
	Tax Basis	Book Basis	FMV	O.B.
Accounts Rec.	0	0	1,000	
Inventory	600	600	1,000	
Land (Cap Asset)	600	600	1,000	
Total Assets	1,200	1,200	3,000	
Jack (1/3)	200	200	?	200
Jill (1/3)	500	500	?	500
Jane (1/3)	500	500	?	500
Debt + Capital	1,200	1,200	3,000	

If all assets were sold, the tax and book gain of $1,800,000 is allocated 1/3-1/3-1/3:

$600,000 to Jack
$600,000 to Jill
$600,000 to Jane

After Sale of All Assets

(In Thousands) JJJ Partnership				
	Tax Basis	Book Basis	FMV	O.B.
Cash	3,000	3,000	3,000	
Jack (1/3)	800	800	800	800
Jill (1/3)	1,100	1,100	1,100	1,100
Jane (1/3)	1,100	1,100	1,100	1,100
Debt + Capital	3,000	3,000	3,000	

$200,000 of Jack's unrealized book gain was shifted to Jill and Jane as a result of the failure to revalue the book capital accounts when Jack's interest was reduced from 1/2 to 1/3

With appreciated PSP assets, and current distributions, failure to revalue capital accounts (no reverse 704(c)) often harms the distributee (Jack in the above example)

With appreciated PSP assets, and contributions, failure to revalue capital accounts (no reverse 704(c)) often harms the continuing partners

Section 751(b) Prop. 2014 Regs.

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REG-151416-06 (Oct. 31, 2014)

Proposed Regulations on Partner's Treatment of U/R and Inventory with Distributions

Existing (1956) sec. 751(b) regulations consider the gross value of assets and ignore built-in gains or losses

Two Hypothetical Sales of PSP Assets at FMV:

1. Share of hot asset gain or loss before the distribution compared to

2. Share of hot asset gain or loss after the distribution

If share of hot assets are reduced, then a "section 751(b) amount."

Each partner must generally recognize ordinary income equal to its "section 751(b) amount."

The 751(b) prop. regs. also require that book capital accounts are restated when a distribution occurs in exchange for php. interest and hot assets remain in the partnership

Mandatory Reverse 704(c)

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Example 2
Same as Ex. 1 but with Prop. Regs. Optionally Applicable after Nov. 3, 2014

Jack receives a $1,000,000 distribution that reduces his partnership interest from 50% to 33.3%.

The key point is that as a result of requiring capital account revaluation and the analysis of hot asset gain (rather than gross value), the reverse section 704(c) rules protect Jack from having a section 751 distribution.

Before

JJJ Partnership

(In Thousands)	Tax Basis	Book Basis	FMV	O.B.
Cash	1,000	1,000	1,000	
Accounts Rec.	0	0	1,000	
Inventory	400	400	1,000	
Land (Capital Asset)	600	600	1,000	
Total Assets	2,000	2,000	4,000	
Jack (50%)	1,000	1,000	2,000	1,000
Jill (25%)	500	500	1,000	500
Jane (25%)	500	500	1,000	500
Debt + Capital	2,000	2,000	4,000	

After Mandatory Revaluation

(In Thousands)	Tax Basis	Book Basis	FMV	O.B.
Cash	1,000	1,000	1,000	
Accounts Rec.	0	1,000	1,000	
Inventory	400	1,000	1,000	
Land (Cap Asset)	600	1,000	1,000	
Total Assets	2,000	2,000	4,000	
Jack (50%)	1,000	2,000	2,000	1,000
Jill (25%)	500	1,000	1,000	500
Jane (25%)	500	1,000	1,000	500
Debt + Capital	2,000	4,000	4,000	

Share of Built-in Gain Before Distribution:

$800K O.I.-$200K C.G. -- Jack

$400K O.I.-$100K C.G. – Jill

$400K O.I.-$100K C.G. -- Jane

After Distribution but Before 751(b)

JJJ Partnership				
(In Thousands)	Tax Basis	Book Basis	FMV	O.B.
Accounts Rec.	0	1,000	1,000	
Inventory	400	1,000	1,000	
Land (Cap. Asset)	600	1,000	1,000	
Total Assets	1,000	3,000	3,000	
Jack (1/3)	0	1,000	1,000	0
Jill (1/3)	500	1,000	1,000	500
Jane (1/3)	500	1,000	1,000	500
Total Debt + Cap	1,000	3,000	3,000	

Share of Built-in Gain After:

$800K O.I.-$200K C.G. -- Jack

$400K O.I.-$100K C.G. – Jill

$400K O.I.-$100K C.G. -- Jane

Thus no “section 751 distribution”.

Observation: For Jack to benefit from the section 704(c) revaluation, he needed to remain a partner. Compare the example below in which Jack is liquidated.

Section 754 Impact on Distributions

754 Election Activates

Sec. 743

Sales, Exchanges, Deaths

Sec. 734

Distributions

Two Upward Adjustment Triggers in Sec. 734

1) Distributee recognizes sec. 731(a) gain.

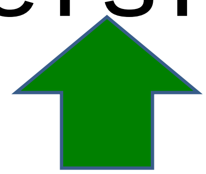
Sec. 734

Gain on Distrib. w/754 Elect.

- Linda's predistribution O.B. is $100,000

- $120,000 of money is distributed to her.

- Linda's recognizes gain of $20,000 (Sec. 731(a))

Partnership adjusts  the common B.S. basis in capital gain property by $20,000

2) Partnership inside basis of distributed property exceeds the distributee's basis in the property

Sec. 734

IB > OB with 754 Election

- Linda's predistribution O.B. is $100,000
- Land with I.B. of $120,000 is distributed to her.
- Linda's basis in the land is $100,000.

Partnership adjusts the common B.S. basis in capital gain property by $20,000

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Downward Adjustment Triggers (Sec. 734)

The two downward triggers only occur with liquidating distributions

1) Distributee recognizes sec. 731(a)(2) loss.

Sec. 734

Loss Rec. with 754 Elect.

- Linda's predistribution O.B. is $100,000
- $90,000 liquidating distribution of money to Linda.
- Linda recognizes a capital loss of <$10,000>

Partnership adjusts the common B.S. basis in cold assets by <$10,000>

If the downward adjustment exceeds $250,000, then a deemed section 754 Election

Ex. of Deemed 754 Election

- Linda’s predistribution O.B. is $500,000
- $240,000 liquidating distribution of money to Linda.
- Linda recognizes a capital loss of <$260,000>

Mandatory partnership adjustment to common B.S. basis in capital gain property by <$260,000>

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2) Distributee partner's basis in cold assets exceeds the partnership's inside basis.

Sec. 734

Cold Asset with 754 Elect.

- Linda’s predistribution O.B. is $100,000
- Invest. Land with I.B. of $90,000 is distributed in liquidation.
- Linda’s basis in the land is $100,000.

Partnership adjusts the common B.S. basis in “capital gain property” by <$10,000>

If the downward adjustment exceeds $250,000, then a deemed (mandatory) section 754 Election

What about Section 734 adjustments impact on book capital account?

Distributions may be mandatory or optional book value revaluation events.

"Book Value" *means, with respect to any Partnership asset, the adjusted basis of such asset for federal income tax purposes,* ***except as follows:***

a) the initial Book Value of any Partnership asset contributed by a Partner to the Partnership shall be the gross Fair Market Value of such Partnership asset as of the date of such contribution;

Observation: Required by IRC; a forward section 704(c).

b) *immediately prior to the* ***distribution by the Partnership*** *of any Partnership asset to a Partner,* ***the Book Value of such asset*** *shall be adjusted to its gross Fair Market Value as of the date of such distribution;*

Observation: Required by IRC. Book gain or loss is thus triggered, but normally not taxable gain or loss.

c) [optional per 704(c) regs.] *the Book Value of* ***all Partnership assets*** *shall be adjusted* ***to equal their respective gross Fair Market Values,*** *as reasonably determined by the Partners, as of the following times:*

   i. *the acquisition of an additional Partnership Interest in the Partnership by a new or existing Partner in consideration for more than a de minimis Capital Contribution;*

ii. *the* ***distribution by the Partnership*** *to a Partner of more than a de minimis amount of property (other than cash)* ***as consideration for all or a part of such Partner's Partnership Interest in the Partnership;*** *and*

iii. *the liquidation of the Partnership within the meaning of Treasury Regulations Section 1.704-1(b)(2)(ii)(g);*

provided, that adjustments pursuant to clauses (i) and (ii) above need not be made if the Partners unanimously…. determine that such adjustment is not necessary or appropriate to reflect the relative economic interests of the Partners and that the absence of such adjustment does not adversely and disproportionately affect any Partner;

Capital Account Adjustments relating to section 734(b) adjustments.

d) the Book Value of each Partnership asset shall be increased or decreased, as the case may be, to reflect any adjustments to the adjusted tax basis of such Partnership asset pursuant to Code Section 734(b) or Code Section 743(b), but only to the extent that such adjustments are taken into account in determining Capital Account balances pursuant to Treasury Regulations Section 1.704-1(b)(2)(iv)(m);

provided, that Book Values shall not be adjusted pursuant to this paragraph (d) to the extent that an [optional revaluation] above is made in conjunction with a transaction that would otherwise result in an adjustment pursuant to this paragraph (d); and

Observation: Optional revaluation adjustments eliminate the Reg. 1.704-1(b)(2)(iv)(m) section 734 or 743 adjustments.

Example 1

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Redemption of Partner Without Section 754 Election But With Revaluation

On Formation of ABC PSP, the founders contribute $12 mil:

- A contributes $3 mil.
- B contributes $3 mil.
- C contributes $6 mil.

ABC purchases Blackacre for $2 mil.

Blackacre is land held for investment (a capital asset)

- Allocation of income/loss:
  - 25% to A,
  - 25% to B,
  - 50% to C.
- Income and expenses are equal except for gain or loss on the sale of Blackacre.
- By the beginning of Year 2, the FMV of Blackacre is $10 million.

The Treasury Method PSP agreement enables the partners to meet the alternative test for economic effect.

Beg. of Yr. 2 Balance Sheet

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Blackacre (cold asset)	2,000	2,000	10,000	
Total Assets	12,000	12,000	20,000	
Capital:				
A 25%	3,000	3,000	5,000	3,000
B 25%	3,000	3,000	5,000	3,000
C 50%	6,000	6,000	10,000	6,000
Total Capital	12,000	12,000	20,000	

If Blackacre were sold for $10 mil., the tax and book gain gain would be $8 mil.

(10 (A.R.) – 2 (A.B.))

The $8 mil. gain would be allocated:

$2 mil. to A (25%)

$2 mil. to B (25%)

$4 mil. to C (50%)

- But Blackacre is not sold.

At the beginning Year 2, the partnership redeems C's entire 50% partnership interest for $10 million cash.

ABC partnership agrees to revalue (book-up) the partnership book capital accounts immediately before the redemption of C's interest so the book gain of $8 million increases the book capital accounts of A, B, and C by $2 mil., 2 mil., and $4 mil. respectively.

Booked-up Balance Sheet Before Redemption of C

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Blackacre (cold asset)	2,000	10,000	10,000	
Total Assets	12,000	20,000	20,000	
Capital:				
A 25%	3,000	5,000	5,000	3,000
B 25%	3,000	5,000	5,000	3,000
C 50%	6,000	10,000	10,000	6,000
Total Capital	12,000	20,000	20,000	

C recognizes $4 mil. on the redemption. Sec. 731

($10 mil. cash – $6,000 (O.B.))

The PSP does not make a section 754 election.

Balance Sheet After Redemption of C

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	0	0	0	
Blackacre (cold asset)	2,000	10,000	10,000	
Total Assets	2,000	10,000	10,000	
Capital:				
A 50%	1,000	5,000	5,000	3,000
B 50%	1,000	5,000	5,000	3,000
Total Capital	2,000	10,000	10,000	

If Blackacre is then sold for $10 mil., the gain of $8 mil. is allocated:

$4 mil. to A

$4 mil. to B

(essentially, they recognize C's $4 mil. of gain)

After Sale of Blackacre

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Total Assets	10,000	10,000	10,000	
Capital:				
A 50%	5,000	5,000	5,000	7,000
B 50%	5,000	5,000	5,000	7,000
Total Capital	10,000	10,000	10,000	

On liquidation of the partnership, A and B would each recognize a loss of <$2 mil.>.

($5 mil. cash - $7 mil. O.B. Section 731)

Example 2

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Redemption of Partner With Section 754 Election and Revaluation

Same as Example 1 above except the PSP makes a section 754 election.

At the beginning Year 2, the partnership redeems C's entire 50% partnership interest for $10 million cash.

Booked-up Balance Sheet Before Redemption of C

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Blackacre	2,000	10,000	10,000	
Total Assets	12,000	20,000	20,000	
Capital:				
A 25%	3,000	5,000	5,000	3,000
B 25%	3,000	5,000	5,000	3,000
C 50%	6,000	10,000	10,000	6,000
Total Capital	12,000	20,000	20,000	

Again, C recognizes $4 mil. on the redemption.
Sec. 731
($10 mil. cash - $6,000 (O.B.))

Due to the section 754 election:

The PSP increases the basis in Blackacre by $4 mil. (sec. 734(b))

Balance Sheet After Redemption of C

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	0	0	0	
Blackacre	6,000	10,000	10,000	
Total Assets	6,000	10,000	10,000	
Capital:				
A 50%	3,000	5,000	5,000	3,000
B 50%	3,000	5,000	5,000	3,000
Total Capital	6,000	10,000	10,000	

If Blackacre is then sold for $10 mil., the gain of $4 mil. is allocated:

$2 mil. to A

$2 mil. to B

After Sale of Blackacre

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Total Assets	10,000	10,000	10,000	
Capital:				
A 50%	5,000	5,000	5,000	5,000
B 50%	5,000	5,000	5,000	5,000
Total Capital	10,000	10,000	10,000	

On liquidation of the partnership, A and B would recognize zero.

($5 mil. cash - $5 mil. O.B. Section 731)

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Example 3

Shows the benefit of revaluation (reverse 704(c)) with a partial redemption

Same as Example 1 above except the PSP makes a section 754 election and ½ of C's 50% interest is redeemed (25% interest in PSP)

Booked-up Balance Sheet Before Partial Redemption of C

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Blackacre	2,000	10,000	10,000	
Total Assets	12,000	20,000	20,000	
Capital:				
A 25%	3,000	5,000	5,000	3,000
B 25%	3,000	5,000	5,000	3,000
C 50%	6,000	10,000	10,000	6,000
Total Capital	12,000	20,000	20,000	

½ of C's PSP interest is redeemed for $5 mil.

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No gain or loss to C-- merely a tax free recovery of O.B.

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Balance Sheet After Partial Redemption of C

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	5,000	5,000	5,000	
Blackacre	2,000	10,000	10,000	
Total Assets	7,000	15,000	15,000	
Capital:				
A (1/3)	3,000	5,000	5,000	3,000
B (1/3)	3,000	5,000	5,000	3,000
C (1/3)	1,000	5,000	5,000	1,000
Total Capital	7,000	15,000	15,000	

C's reverse section 704(c) gain of $4 million is preserved in the excess of C's book basis capital account balance over tax basis capital account (as a result of the revaluation).

If Blackacre were a hot asset, C would prefer to use the sec. 751 proposed regulations which would prevent any immediate income recognition (unlike the current regs.)

Example 4

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Same facts as Ex. 3 above except the ABC partnership does not opt to revalue C’s capital account (book up) when 50% of C’s PSP interest is redeemed.

Balance Sheet Before Partial Redemption of C

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	10,000	10,000	10,000	
Blackacre	2,000	2,000	10,000	
Total Assets	12,000	12,000	20,000	
Capital:				
A 25%	3,000	3,000	5,000	3,000
B 25%	3,000	3,000	5,000	3,000
C 50%	6,000	6,000	10,000	6,000
Total Capital	12,000	12,000	20,000	

½ of C's PSP interest is redeemed for $5 mil.

No gain or loss to C-- merely a tax free recovery of O.B.

Balance Sheet After Partial Redemption of C

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	5,000	5,000	5,000	
Blackacre	2,000	2,000	10,000	
Total Assets	7,000	7,000	15,000	
Capital:				
A (1/3)	3,000	3,000	5,000	3,000
B (1/3)	3,000	3,000	5,000	3,000
C (1/3)	1,000	1,000	5,000	1,000
Total Capital	7,000	7,000	15,000	

The partnership agreement is modified to show that all income and losses are allocated 1/3, 1/3, and 1/3 following the redemption.

The agreement does not make a special section 704(b) allocation of the first $4 million of tax and book gain on Blackacre to A.

As result, if Blackacre were sold for $10 mil in Year 3, the tax and book gain of $8 mil. would be allocated equally to the three partners (1/3 each)--$2.67 mil. to each partner. $1.33 mil. of real economic gain ($4 mil. - $2.67 mil.), and tax gain, has been shifted from C to A and B as a result of the failure to revalue the book capital accounts or make a special sec. 704(b) allocation.

Balance Sheet After Sale of Blackacre

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	15,000	15,000	15,000	
Total Assets	15,000	15,000	15,000	
Capital:				
A (1/3)	5,667	5,667	5,667	5,667
B (1/3)	5,667	5,667	5,667	5,667
C (1/3)	3,667	3,667	3,667	3,667
Total Capital	15,000	15,000	15,000	

C is receiving $1.333 mil. less than the $5 mil. that C should, economically, be entitled to (compare Example 3 above).

Example 5A

Shows that the Target Method can cure a defect from failure to revalue in a partial redemption.

Example 5B

Shows that revaluation is a better deal even with the Target Method

Example 6

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Illustrates a mandatory downward section 734(b) adjustment (w/o 754 election)

- A contributes $2.5 mil.
  B contributes $2.5 mil.
  C contributed $5 mil.

- The PSP purchases:
  Blackacre for $4 mil.
  Whiteacre for $4 mil.

- By Yr. 10 both parcels had declined to $1 mil. each

Beg. of Yr. 10 In Thousands

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	2,000	2,000	2,000	
Blackacre	4,000	4,000	1,000	
Whiteacre	4,000	4,000	1,000	
Total Assets	10,000	10,000	4,000	
Capital:				
A	2,500	2,500	1,000	2,500
B	2,500	2,500	1,000	2,500
C	5,000	5,000	2,000	5,000
Total Capital	10,000	10,000	4,000	

- $2 mil. cash is distributed to C in liquidation of C's 50% interest.
- The PSP optionally books-down the capital accounts as a result of the liquidating dist.
- C recognizes a capital loss of <$3 mil.> ($2 mil. (dist.) – 5 mil. (O.B.))

- PSP does not make a section 754 election, but the adjustment is mandatory.
- A section 734 "substantial basis reduction" because a downward adjustment of $3 million to Blackacre and Whiteacre (equal to C's recognized loss) if 754 election were in effect.

After Book-Down of Book Basis

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	2,000	2,000	2,000	
Blackacre	4,000	1,000	1,000	
Whiteacre	4,000	1,000	1,000	
Total Assets	10,000	4,000	4,000	
Capital:				
A	2,500	1,000	1,000	2,500
B	2,500	1,000	1,000	2,500
C	5,000	2,000	2,000	5,000
Total Capital	10,000	4,000	4,000	

Book Basis Accounting Entries:

Debit: $2 mil. C's capital account

Credit: $2 mil. Cash

Tax Basis Accounting Entries:

Debit: $5,000,000 C's capital account

Credit:
$2,000,000 Cash
$1,500,000 Blackacre
$1,500,000 Whiteacre

Following Liquidation of C (In Thousands)

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Blackacre	2,500	1,000	1,000	
Whiteacre	2,500	1,000	1,000	
Total Assets	5,000	2,000	2,000	
Capital:				
A	2,500	1,000	1,000	2,500
B	2,500	1,000	1,000	2,500
Total Capital	5,000	2,000	2,000	

If Blackacre and Whiteacre were sold for $1 mil. each, the book loss is zero but the tax loss of <$3 mil.> would be divided between A and B equally (<$1.5 mil.> to each partner).

- When the dust settles, the embedded loss of <$6> mil. (prior to the redemption of C) is allocated:

- <$3 mil.> to C in the redemp.
- <1.5 mil.> to A on the sale.
- <1.5 mil.> to B on the sale.

Assume that the numbers are in thousands (not millions) so the potential section 754 adjustment does not exceed $250,000.

After Book-Down of Book Basis

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	2,000	2,000	2,000	
Blackacre	4,000	1,000	1,000	
Whiteacre	4,000	1,000	1,000	
Total Assets	10,000	4,000	4,000	
Capital:				
A	2,500	1,000	1,000	2,500
B	2,500	1,000	1,000	2,500
C	5,000	2,000	2,000	5,000
Total Capital	10,000	4,000	4,000	

C's loss on liquidation is only <$3,000> -- not a substantial basis reduction.

Tax Basis Accounting Entries:

Debit: $5,000 C's capital account

Credit:
$2,000 Cash
$1,500 A's Cap.
$1,500 B's Cap.

Following Liquidation of C

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Blackacre	**4,000**	**1,000**	**1,000**	
Whiteacre	**4,000**	**1,000**	**1,000**	
Total Assets	**8,000**	**2,000**	**2,000**	
Capital:				
A	**4,000**	**1,000**	**1,000**	**2,500**
B	**4,000**	**1,000**	**1,000**	**2,500**
Total Capital	**8,000**	**2,000**	**2,000**	

- If Blackacre and Whiteacre are each sold for $1,000, then A and B each have a <$3,000> loss.
- The loss would drive each of A and B’s capital accounts to zero and each would have suspended loss of <$500> (sec. 704(d)).

Following Sale of Assets

Assets	Tax Basis	Book Basis	FMV	Outside Basis
Cash	2,000	2,000	2,000	
Total Assets	2,000	2,000	2,000	
Capital:				
A	1,000	1,000	1,000	0
B	1,000	1,000	1,000	0
Total Capital	2,000	2,000	2,000	

- A and B would each recognize $1,000 of section 731(a) gain on liquidation.
- The <$500> suspended loss would not be freed-up (731(a) gain does not increase O.B.)

- When the dust settles, the embedded loss of <$6> mil. (prior the redemption of C) is allocated:

- <$3 mil.> to C in the redemp.
- <1.5 mil.> net to A*
- <1.5 mil.> net to B*

*<2,500> loss on sale and 1,000 gain on liquidation.

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Example 7

Tax Disaster for Beneficiary and the Other Partners

Each year the partnership earns zero net rental income, and generates cash flow equal to the depreciation deduction.

- Founding partner Cindy (1/3 partner) dies in Year 10.
- The building was purchased by the PSP.
- All built-in gain on the building is section 1250 capital gain.

Balance Sheet on DOD (Yr. 10)

Assets (in thousands)	Tax Basis	FMV	Outside Basis
Cash	$1,500	$1,500	
Building	$3,000	$4,500	
Total Assets	$4,500	$6,000	
Capital:			
Abe	$1,500	$2,000	$1,500
Bonnie	$1,500	$2,000	$1,500
Cindy	$1,500	$2,000	$1,500
Total Capital	$4,500	$6,000	

- DOD FMV of Cindy's PSP interest is $2 mil.
- Kathy inherits so her O.B. is $2 mil.
- The building holds its value at $4.5 mil. until sold.

The partnership refuses to make a section 754 election.

Kathy is denied the section 743(b) inside basis adjustment on the building.

Balance Sheet After Inheritance

Assets (in thousands)	Tax Basis	FMV	Outside Basis
Cash	$1,500	$1,500	
Building	$3,000	$4,500	
Total Assets	$4,500	$6,000	
Capital:			
Abe	$1,500	$2,000	$1,500
Bonnie	$1,500	$2,000	$1,500
Katherine	$1,500	$2,000	$2,000
Total Capital	$4,500	$6,000	

- 9 years transpire
- Depreciation reduces the building basis to $1.5 mil (but FMV holds at $4.5 mil.).

- The building is sold at the end of Year 18 for $4.5 mil for a gain of $3 mil.

Balance Sheet on Date of Sale of Bldg.

Assets	Tax Basis	FMV	Outside Basis
Cash	$3,000	$3,000	
Building	$1,500	$4,500	
Total Assets	$4,500	$7,500	
Capital:			
Abe	$1,500	$2,500	$1,500
Bonnie	$1,500	$2,500	$1,500
Katherine	$1,500	$2,500	$2,000
Total Capital	$4,500	$7,500	

Economically, Kathy's share of post-death PSP equity has increased by $500,000

(cash flow)

The $3 mil. gain on sale is allocated:

$1 mil. to Abe

$1 mil. to Bonnie

$1 mil. to Kathy

Balance Sheet After Sale of Bldg.

Assets	Tax Basis	FMV	Outside Basis
Cash	$7,500	$7,500	
Capital:			
Abe	$2,500	$2,500	$2,500
Bonnie	$2,500	$2,500	$2,500
Katherine	$2,500	$2,500	$3,000
Total Capital	$7,500	$7,500	

In Year 19, Kathy's partnership interest is redeemed for $2.5 mil. cash

Kathy recognizes a <$500,000> capital loss on liquidation.

($2.5 mil. cash – $3 mil. (O.B.))

(Sec. 731)

Summary for Kathy:

Yr. 18 - $1 mil. 1250 Cap.

Yr. 19 - <$500,000> Cap. Loss

The two net to $500,000 (Kathy's economic gain).

Kathy wishes the sale and liquidation were in same year. (same issue with S corps but without the sec. 754 option)

Tax Problem for Abe and Bonnie

The <$500,000> capital loss would force the PSP to reduce the inside basis in subsequently purchased capital gain property by $500,000

(a section 734(b) “substantial basis adjustment”)

A section 754 election when Cindy died would have given Kathy a $500,000 section 743(b) basis adjustment for the building that would have eliminated her capital loss on liquidation.

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Example 8

Offers a partial solution for the problem illustrated in Example 7.

Balance Sheet Before Sale of Bldg.

Assets	Tax Basis	FMV	Outside Basis
Cash	$3,000	$3,000	
Building	$1,500	$4,500	
Total Assets	$4,500	$7,500	
Capital:			
Abe	$1,500	$2,500	$1,500
Bonnie	$1,500	$2,500	$1,500
Katherine	$1,500	$2,500	$2,000
Total Capital	$4,500	$7,500	

Katherine inherited her 1/3 PSP interest 9 years ago which explains the $500K excess of O.B. over I.B.

The PSP refused to make a section 754 election in the year Katherine inherited her 1/3 PSP Interest

In 2018, before the sale of the building, the PSP agrees to make a 754 election (too late for year of death).

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Katherine could contribute her PSP interest to another partnership -- UTP

(sec. 721 tax free)

and UTP will be eligible for a sec 743(b) adjustment of

$500,000

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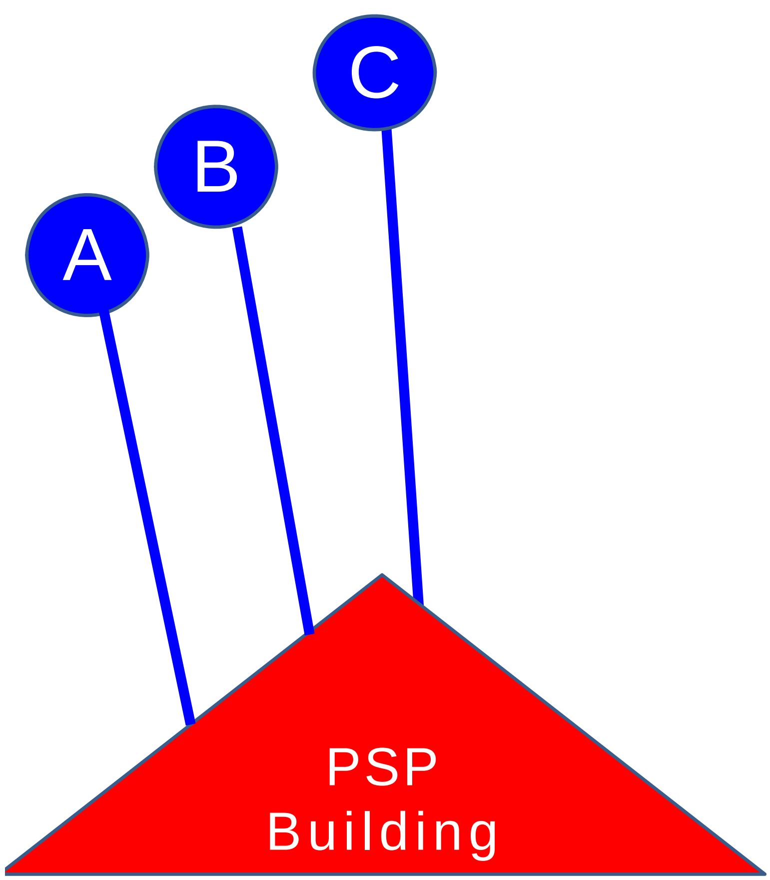
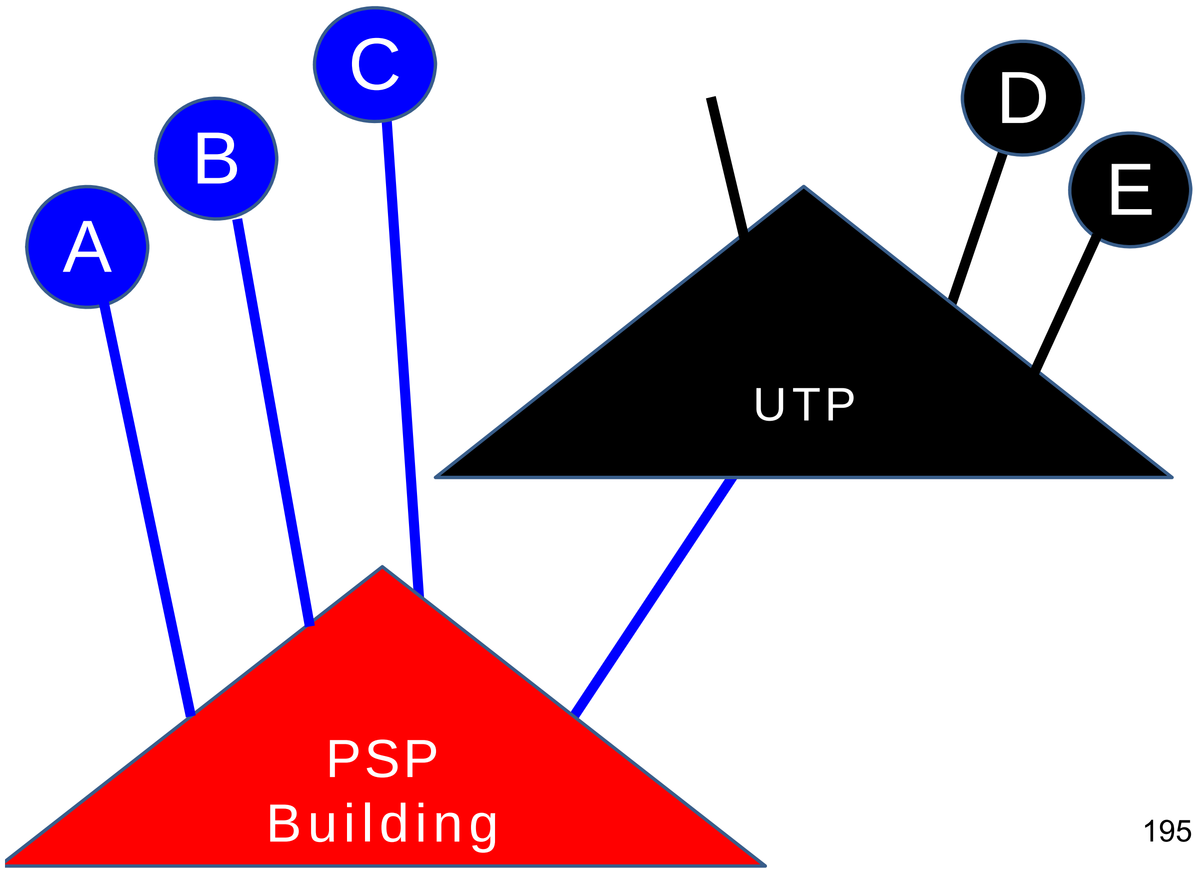
Or contribute it to a 100% owned S corporation

(If Katherine were a 50% partner (not on our facts), that would cause a deemed termination of the PSP per caselaw).





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Payments to a Retiring Partner or Deceased Partner's Successor -- Section 736(a)

Sec. 736 divides all "[p]ayments to a retiring partner or deceased partner's successor" into two categories:

1) Payments in exchange for the FMV of PSP property—Sec. 736(b).

2) Payments in excess of FMV of PSP property--Sec. 736(a).

- Distributive Share (736(a)(1))
- Guaranteed Payment (736(a)(2)

Special Rule for Service Phps.

Amounts paid for

Unstated Goodwill, and "Unrealized Receivables"

are treated as NOT made in exchange for an interest in partnership property (i.e., forced into sec. 736(a))

Example 3

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Liquidation: No Section 754 Election and Unstated Goodwill

Balance sheet for the JJJ law firm (LLP) before Jack sells his 50% partnership interest to John for $2 mil. (in thousands):

	Tax Basis	FMV	O.B.
Cash	2,000	2,000	
Unstated Goodwill	0	2,000	
Total Assets	2,000	4,000	
Jack (50%)	1,000	2,000	1,000
Jill (25%)	500	1,000	500
Jane (25%)	500	1,000	500
Total Debt + Cap.	2,000	4,000	

- Jack recognizes capital gain of $1 mil. ($2 mil. sales price minus $1 mil. O.B.).
- The sale to John occurred on December 31 of Year 1.
- The partnership is a service partnership.

- The partnership does NOT make a section 754 election.

- The partnership is on a calendar year.

Post-sale Balance Sheet

	Tax Basis	FMV	O.B.
Cash	2,000	2,000	
Unstated Goodwill	0	2,000	
Total Assets	2,000	4,000	
John (50%)	1,000	2,000	2,000
Jill (25%)	500	1,000	500
Jane (25%)	500	1,000	500
Total Debt + Capital	2,000	4,000	

Jan. 1, Yr. 2, due to a dispute with Jill and Jane, the partnership buys-out new partner, John for $2 mil. per a pre-existing buy-out agreement.

Because John lacks a section 743(b) adjustment, so lacks basis in the goodwill, $1,000,000 of the liquidating distribution is pushed into section 736(a).

Observation: Per the section 736 regulations, if John did have a section 743(b) adjustment with respect to the unstated goodwill, then payment for that goodwill would not be pushed into section 736(a).

Alternatively, reg. 1.736-1(b)(3) makes it clear that the partnership agreement could declare (state) the maximum amount, if any, that represents goodwill (i.e., the portion, if any, that falls under section 736(b)):

John’s Tax Consequences:

$1 Mil. guaranteed Payment (Sec. 736(a))

<$1 Mil.> capital Loss on the liquidation ($1 mil. (736(b) pyt) - $2 mil (O.B.))

The PSP (Jill and Jane):

A deemed section 754 election due to sec. 734 “substantial basis reduction” of <$1 mil.> if sec. 754 were in effect.

(no deemed 743 adjustment)

PSP (Jill and Jane) impact:

- Deduct guaranteed pyt. of $1 mil.
- When cap. gain property is acquired, reduce the basis by $1 mil..

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Example 4

Liquidation of Partner: Unstated Goodwill

JJJ LLP Law Firm Balance Sheet

(In Thousands)	Tax Basis	FMV	O.B.
Cash	**2,000**	**2,000**	
Unstated Goodwill	**0**	**2,000**	
Total Assets	**2,000**	**4,000**	
Jack (50%)	**1,000**	**2,000**	**1,000**
Jill (25%)	**500**	**1,000**	**500**
Jane (25%)	**500**	**1,000**	**500**
Total Debt + Capital	**2,000**	**4,000**	

- Jack retires and is redeemed for $2 mil.

- Nothing in the partnership agreement refers to goodwill or characterizes the liquidation proceeds (unstated goodwill).

The partnership makes a Sec. 754 election but it is irrelevant on these facts

(Jack's O.B. = I.B.).

- $1 mil. is a payment for Jack's share of the unstated goodwill and is a section 736(a)(2) guaranteed payment:
  - Ordinary Income to Jack
  - Deductible by other Ptrs.

The remaining $1 mil. payment to Jack

(section 736(b))

is a tax free recovery of Jack's outside basis.

Observation: Jack might try to argue that the entire transaction was a sale to the existing partners and thus duck section 736.

Example 5 93

Partnership Agreement Supersedes Reality with Unstated Goodwill

JJJ LLP Law Firm Balance Sheet

(In Thousands)	Tax Basis	FMV	O.B.
Cash	**2,000**	**2,000**	
Unstated Goodwill	**0**	**2,000**	
Total Assets	**2,000**	**4,000**	
Jack (50%)	**1,000**	**2,000**	**1,000**
Jill (25%)	**500**	**1,000**	**500**
Jane (25%)	**500**	**1,000**	**500**
Total Debt + Capital	**2,000**	**4,000**	

Same as Example 4, but the partnership agreement characterizes $1 million of the liquidation proceeds (the portion in excess of Jack's share of the cash) as unrealized receivables and a section 736(a) guaranteed payment.

The agreement is a simplified version of the one in *Tolmach v. Comm'r*, T.C. Memo. 1991-538.

A referee appointed by the New York Supreme Court determined that goodwill was worth $1,000,000 and accounted for 50% of the value of the firm (77% in the Tolmach case).

Can Jack successfully argue that because the actual goodwill is worth $1,000,000, that his entire liquidation payment falls under section 736(b)?

No says Judge Halpern!

Section 736(b)(2)(B)

"exempts from ordinary income treatment under section 736(a) payments for goodwill only if such payments are called for in the partnership agreement and only to the extent there called for."

(a ceiling but not a floor)

"For the purposes of section 736(b)..., payments made to a retiring partner or to a successor in interest of a deceased partner in exchange for the interest of such partner in partnership property shall not include any amount paid for the partner's share of good will of the partnership in excess of its partnership basis, including any special basis adjustments for it to which such partner is entitled, except to the extent that the partnership agreement provides for a reasonable payment with respect to such good will."

(Reg. 1.736-1(b)(3))

"Generally, the valuation placed upon good will by an arm's length agreement of the partners, whether specific in amount or determined by a formula, shall be regarded as correct."

(Reg. 1.736-1(b)(3))

Example 6

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Partner Dies and Successor is Liquidated

Recall that the partnership makes a section 754 election but it was irrelevant in Examples 4 and 5

Same facts as Example 5, except Jack dies and Jack's estate (Estate) is liquidated by JJJ pursuant to a pre-existing buy-out agreement and JJJ pays the Estate $2,000,000 pursuant to the same buy-out agreement.

JJJ LLP Law Firm Balance Sheet

(In Thousands)	Tax Basis	FMV	O.B.
Cash	**2,000**	**2,000**	
Unstated Goodwill	**0**	**2,000**	
Total Assets	**2,000**	**4,000**	
Estate (50%)	**1,000**	**2,000**	**?**
Jill (25%)	**500**	**1,000**	**500**
Jane (25%)	**500**	**1,000**	**500**
Total Debt + Capital	**2,000**	**4,000**	

One School of Thought

- Same answer as Example 5 because no outside basis (O.B.) increase for IRD and unstated goodwill generates IRD per sections 736(a) and 753.

- And no section 743(b) adjustment for the actual unstated goodwill.

Author's Opinion

Arguments in *Alice* article:

- Sec. 736 is independent of the outside basis determination in sec. 742 and 1014.
- Goodwill (unlike say zero basis accounts receivable) is not an IRD asset so DOD FMV is not reduced under sec. 742

Beneficiary O.B.

- FMV of PSP interest on DOD (§1014(a)(1))

  +

- Share of PSP debt (§§752/742)

  -

- Value of PSP interest attributable to IRD (§1014(c))

(Reg. 1.742-1)

Therefore, the Estate's O.B. is $2 mil.

(no IRD assets)

And the estate is eligible for a $1 mil. section 743(b) adjustment for the unstated goodwill.

Regardless, per *Tolmach*, the partnership agreement controls under section 736 and the agreement declares that $1 mil. is a section 736(a) payment

The Estate

$1 mil. guaranteed payment ordinary income

(section 736(a))

<$1 mil. capital loss>

($1 mil. (sec. 736(b) pyt.) –

$2 mil. (O.B.)) (Sec. 731(a)

The PSP

$1 mil. deduction for guaranteed payment.
(section 736(a))

$1 mil. reduction in capital gain property basis per section 734(b). (same with or w/o 754 election)

Examples 9

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Current sec. 751 Regs.
Jack is liquidated for:
$1 mil. Cash
$1 mil. Inventory

754 Election

Not a Service Partnership

Before (In Thousands)	Tax Basis	Book Basis	FMV	O.B.
JJJ Partnership				
Cash	1,000	1,000	1,000	
Accounts Rec.	0	0	1,000	
Inventory	400	400	1,000	
Land (Capital Asset)	600	600	1,000	
Total Assets	2,000	2,000	4,000	
Jack (50%)	1,000	1,000	2,000	1,000
Jill (25%)	500	500	1,000	500
Jane (25%)	500	500	1,000	500
Debt + Capital	2,000	2,000	4,000	

Book capital accounts are (optionally) revalued.

Proportionate Under Current Regs – No sec. 751(b) distribution

Jack is receiving his 50% share of hot asset gross value ($1 mil.)

Impact on Jack:

$1,000,000 cash is a tax free recovery of $1,000,000 O.B.

$1,000,000 of inventory has zero basis to Jack

Impact on PSP

Upward $400,000 sec. 734 adjustment for the inventory I.B. that disappeared due to secton 754 election.

Tax Basis

Debits:

$1,000,000 Jack's Cap.

$400,000 A/R (734(b)(1)(B)

Credits:

$1 mil. cash

$400,000 inventory

After	JJJ Partnership			
(In Thousands)	Tax Basis	Book Basis	FMV	O.B.
Accounts Rec.	400	1,000	1,000	
Land (Cap. Asset)	600	1,000	1,000	
Total Assets	1,000	2,000	4,000	
Jill (50%)	500	1,000	1,000	500
Jane (50%)	500	1,000	1,000	500
Debt + Capital	1,000	2,000	4,000	

Section 754 Election Benefits Existing Partners

Tax Basis
Debits and Credits are challenging without a Sec. 754 Election

Example 10

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Same Facts
but use 2014 Prop. Regs.
Jack is liquidated for:

$1 mil. Cash
$1 mil. Inventory

754 Election

Before

JJJ Partnership

(In Thousands)	Tax Basis	Book Basis	FMV	O.B.
Cash	1,000	1,000	1,000	
Accounts Rec.	0	0	1,000	
Inventory	400	400	1,000	
Land (Capital Asset)	600	600	1,000	
Total Assets	2,000	2,000	4,000	
Jack (50%)	1,000	1,000	2,000	1,000
Jill (25%)	500	500	1,000	500
Jane (25%)	500	500	1,000	500
Debt + Capital	2,000	2,000	4,000	

Jack's Share of Unrealized 751(b) gain Before:

$800K (50% x $1.6 mil.)

Jack's Share of Unrealized 751(b) gain After:

$1 mil. (zero basis Inv.)

Thus no "section 751 distribution".

After but Before 751(b)

(In Thousands)	Tax Basis	Book Basis	FMV	O.B.
Accounts Rec.	400	1,000	1,000	
Land (Cap. Asset)	600	1,000	1,000	
Total Assets	1,000	2,000	4,000	
Jill (50%)	500	1,000	1,000	500
Jane (50%)	500	1,000	1,000	500
Debt + Capital	1,000	2,000	4,000	

Jill's Share of Unrealized 751(b) gain Before:

$400K (25% x 1.6 Mil.)

Jill's Share of Unrealized 751(b) gain After:

$300K (50% x $600K)

Thus a "section 751 distribution" of $100K

Jane's consequences match Jill

Ord. Inc. of $100,000 each