Buying and Selling a Partnership Interest:
A Checklist for the Tax Advisor[1]

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I. Tax Issues for the Selling Partner

A. Computation of Gain or Loss

Under section 741, a selling partner computes her gain or loss from disposition of the partnership interest by comparing the amount realized on the disposition with her adjusted basis in her partnership interest (that is, with her "outside basis"). In this context, amount realized includes the exiting partner's share of the partnership's liabilities, where that share is determined under section 752. See §752(d) and Reg. §§1.752-1(h), 1.1001-2(a). Note that in determining the exiting partner's outside basis, distributive share for the year of sale must be taken into account. §706(d)(1); see Reg. §1.741-1(a) and the discussion below.

These rules apply whether the interest is sold to one or more members of the partnership or to one or more persons who are not currently members of the partnership. Reg. §1.741-1(b). However, a different set of rules applies if the interest is sold back to the partnership; that is, if the partnership interest is redeemed in exchange for a liquidating distribution (or a series of distributions). If a partnership interest is transferred in an exchange in which gain or loss is not recognized in whole or in part (such as a transfer to a controlled corporation as described in section 351 or to a partnership under section 721), then the tax consequences of the transaction are determined under the applicable nonrecognition provision.[2]

It may be the case that an exiting partner retains exposure on some of the partner's liabilities. Nevertheless, the partner's share of the liability is treated as being reduced to zero on the sale because, under section 752, a partnership's liabilities must be allocated exclusively among its partners. The definition of a "partnership liability" is broad enough to encompass any liability that encumbers a partnership's assets without regard to who else might bear the economic risk associated with nonpayment of the obligation. See §752(c).

B. Character of Gain or Loss and Capital Gain Taxation

1. Character of Gain or Loss

The gain or loss as determined under section 741 is the net gain or loss, but that net figure must be decomposed into its ordinary income and capital gain components. Under section 751(a), the

[2] Note that the transfer of a partnership interest cannot qualify for nonrecognition under the like-kind exchange provisions in section 1031. §1031(a)(2)(D).

ordinary component from the disposition is determined by reference to the distributive share of ordinary income that would includible by the exiting partner if, immediately prior to the disposition, the partnership sold each of its assets at fair market value in a fully taxable exchange. Reg. §1.751-1(a)(2). Note that in determining the ordinary component of the transaction, all provisions that affect distributive share are taken into account including remedial and curative allocations under section 704(c)(1)(A) as well as curative and remedial allocations made under section 704(c) principles in connection with reverse section 704(c) adjustments. Ordinary income assets of the partnership include unrealized receivables as well as inventory items (whether substantially appreciated or not), and the definition of "inventory" in this context is broad enough to capture any asset "which, on sale or exchange by the partnership, would be considered property other than property described in section 1231." §751(d)(2). The definition of "unrealized receivables" has been broadened to include almost every type of property that includes an ordinary income component (such as depreciable tangible property subject to ordinary income recapture under section 1245). See §751(c) (final flush language).

The capital gain component is then determined by subtracting the ordinary income component as determined under section 751(a) from the net income amount as determined under section 741. Note that the net income amount does *not* set a ceiling for the ordinary income or capital gain components. In particular, when the net amount of gain or loss is $0, the ordinary component can be positive and the capital component can be negative, or *vice versa*.

2. Capital Gain Component

a. Rate

To the extent that the selling partner recognizes capital gain on the sale of a partnership interest, the capital gain rate applicable to the gain is determined by reference to the assets of the partnership. §§1(h)(5)(B), 1(h)(9), 1(h)(10)(D); see also Reg. §1.1(h)-1(b)(3)(ii). This look-thru rule applies only to collectibles and unrealized nonrecaptured section 1250 gain of the partnership and not more broadly to such things as income described in section 1231.

b. Holding Period

Despite the number of distinct interests in a single partnership that one partner may own, a partner has one capital account, Reg. §1.704-1(b)(2)(iv)(b), and the Service has long maintained that a partner also has a single, unified outside basis, Rev. Rul. 84-53, 1984-1 C.B. 159. Nevertheless, a partner can multiple holdings periods with respect to the partner's unified interest in the partnership. See generally Reg. §1.1223-3. A bifurcated holding period can arise either by contributing multiple properties to the partnership at one time or by making multiple contributions to the partnership over time. Reg. §1.1223-3(a). A partner having a bifurcated holding period can recognize both long- and short-term capital gain on the sale of her partnership interest or from a distribution of cash (including marketable securities treated as cash under § 731(c)) in excess of outside basis. See Reg. §§1.1223-3(c), -3(d)(2).

Suppose that X is a member of the P Partnership, and assume that X has a holding period in its partnership interest in excess of one year. If the fair market value of X's interest equals $500 and X contributes additional cash of $250 to the partnership (increasing the value of X's interest to $750), then X will be treated as having a short-term holding period in one-third of the partnership interest because of the cash contribution. So, for example, if X sells her partnership interest six months later, one-third of any gain or loss will be short-term. Note that this is true even though all of the appreciation in X's partnership interest may have accrued many years earlier. Note also that this result would not change if X had contributed property rather than cash unless the property had been a capital asset in X's hands immediately prior to the contribution and X had had a holding period in the contributed property in excess of six months. See §1223(1) (tacking for substitute basis capital assets).

As a general rule, distributions from a partnership do not affect the distributee partner's holding period in the partnership interest. Reg. §1.1223-3(d)(1). However, distributions of cash can reduce the shirt-term portion of a bifurcated holding period because only the *net* cash contributions made during any 12-month period create a bifurcated holding period for an otherwise long-term partnership interest. Reg. §1.1223-3(b)(2). For this purpose, deemed distributions arising from a decrease in a partner's share of partnership liabilities are ignored. Reg. §1.1223-3(b)(3). Deemed contributions arising from an increase in liability share equally are ignored. *Id.*

3. Installment Sales

A partnership interest can be sold with one or more payments received in the year after the year of sale. In such circumstances, the sale will be taxed to the selling partner under the installment method unless the selling partner makes an election to the contrary. See §453(a). In computing gain under the installment method, the selling partner's share of the partnership's indebtedness is not treated as a payment received in the year of sale, at least if the debt share does not exceed the selling partner's outside basis. Rev. Rul. 76-483, 1976-2 C.B. 131. And while sections 453(b) and 453(i) deny installment sale treatment for sales of inventory and depreciation recapture, these provisions do not include an express look-through rule applicable to sales of partnership interests. Nevertheless, the Service has ruled that installment sale treatment is inapplicable to the gain recognized on the sale of a partnership interest to the extent attributable to partnership inventory and depreciation recapture. Rev. Rul. 89-108, 1989-2 C.B. 100. Note that because the reach of section 751(b) is broader than that of sections 453(b) and 453(i), it is unclear if the Service will deny installment sale treatment to the sale of a partnership interest to the extent of the selling partner's share of all ordinary income items. In *Mingo v. Commissioner*, T.C. Memo 2013-149, 773 F.3d 629 (5th Cir. 2014), the court denied installment sale treatment for an exiting partner's share of all unrealized receivables.

C. Distributive Share in the Year of Sale

Under section 706(c)(2)(A), a disposition of a partner's entire interest in the venture closes the taxable year of the partnership with respect to the selling partner. In general, this requires an interim closing of the books of the venture (also called a "hard close"), though current regulations allow for an end-of-the-year *pro rata* allocation in lieu of a hard close. Note that if the partnership elects to use the *pro rata* method, the exiting partner's distributive share for the final year will be affected by partnership tax items occurring after she has exited the venture and as to which the exiting partner has no real economic interest. Because distributive share affects outside basis, see §705(a)(1)-(2), distributive share of the exiting partner for the final (short) taxable year will affect the computation of gain or loss recognized on the sale by the exiting partner of her partnership interest. See Reg. §1.706-1(c)(2)(ii) (example).

II. Tax Issues for the Buying Partner

A. Outside Basis

The purchasing partner's outside basis is equal to the price paid for the partnership interest plus the purchasing partner's share of the partnership's liabilities (as determined under section 752). See §742. The purchasing partner's share of these liabilities may not equal the selling partner's share of those liabilities. For example, if the creditor has rights against the individual partners by reason of the loan agreement, the purchasing partner will bear no individual responsibility for repayment of the loan unless she specifically agrees to assume such responsibility, usually represented by an amendment to the loan agreement. Thus, while some of the loan was allocable to the selling partner, no amount of the loan will be allocable to the buying partner absent an agreement to the contrary. Rather, the selling partner's share of the loan will be reallocated among the remaining partners who are liable on the debt.

B. Capital Account

The purchasing partner's capital account equals the selling partner's capital account as of the moment of sale. Reg. §1.704-1(b)(2)(iv)(*l*). As a result, the purchasing partner's capital account should be adjusted for the selling partner's distributive share arising from the close of the partnership's taxable year (with respect to the selling partner only) as of the date of sale. See section I(C) above. Note that the purchasing partner's capital account is not adjusted for any unrealized appreciation or loss in the partnership's assets, Reg. §1.704-1(b)(2)(iv)(f), and this is true even if the partnership has an election under section 754 in effect for the year of sale, Reg. §1.704-1(b)(2)(iv)(m)(2). This final result places an inappropriate disability on a purchasing partner unless that partner has an unlimited capital account deficit restoration obligation (imposed by the partnership agreement or otherwise).

For example, suppose a one-quarter interest in a limited liability company is sold for $10,000 when the LLC holds a single asset having inside basis and book value of $12,000 and current fair market value of $40,000. If the selling partner has a capital account of $3,000, then that is the purchasing partner's initial capital account. As a result, under the alternate text for economic effect, a maximum of $3,000 of loss from the property can be allocated to the purchasing partner if the purchasing partner cannot be forced to contribute additional funds to the venture. See Reg. §1.704-1(b)(2)(ii)(d) (flush language between (3) and (4)). But the purchasing partner's cash outlay equals $10,000, and there is no obvious reason why this entire amount should not be available to absorb an allocation of loss. Note that if the purchasing partner had joined the venture by contributing cash of $10,000 directly to the partnership in exchange for a new partnership interest, her initial capital account would equal the full $10,000.

C. Share of Inside Basis

Unless an election under section 754 is made or is in effect for the year of sale, no adjustment is made to the partnership's adjusted basis of its assets ("inside basis"), §743(a), unless there is a mandatory negative adjustment triggered by a substantial built-in loss in the partnership's assets, see §743(d). If a §754 election is made or is in effect, the purchasing partner pushes her cost basis into the partnership's assets, with ordinary income assets getting a cost basis first and the capital assets (including assets described in §1231) getting the remainder of any basis increase. Note that there can be both positive and negative basis adjustments under §754, not only across the two classes of assets but also within each class. In no event can the inside basis adjustment allocable to an ordinary income asset increase the purchasing partner's share of its inside basis beyond fair market value of the asset (that is, a §743 basis adjustment cannot create a built-in loss in an ordinary income asset).

D. Distributive Share

1. Distributive Share in the Year of Purchase

Under section 706(c)(2)(A), a disposition of a partner's entire interest in the venture closes the taxable year of the partnership with respect to the selling partner. In general, this requires an interim closing of the books of the venture, though current regulations allow for an end-of-the-year *pro rata* allocation in lieu of a hard close. Note that if the partnership elects to use the *pro rata* method, the purchasing partner's distributive share for the final year will be affected by partnership tax items occurring before she has joined the venture and as to which she has no real economic interest.

2. Share of Built-In Gain and Loss

Because the purchasing partner takes over the capital account of the selling partner, the purchasing partner succeeds to any forward or reverse 704(c) gain inherent in the transferred partnership interest. However, as discussed below in paragraph III(A), an adjustment under section 743(b) may eliminate some or all of the transferred built-in gain or loss. To the extent such built-in gain or loss is not eliminated (because an election under section 754 is not in effect for the year of transfer or the purchasing partner does not pay the full liquidation value for the partnership interest), the purchasing partner ultimately will include that built-in gain or loss when the associated partnership asset is sold.

However, if there is some built-in loss attributable to property contributed by the selling partner, and if that built-in loss existed when the property was contributed to the partnership (so it constitutes a forward 704(c) loss), then the purchasing partner cannot enjoy a tax benefit attributable to this loss. §707(a)(2)(C).

E. Admission to the Partnership

Under some circumstances the sale of a partnership interest will be valid for federal income tax purposes even though the buyer of the partnership interest will not be treated as a partner for other purposes. In particular, if the partnership agreement provides that no interest in the venture may be sold, a sale of a partnership interest in contravention of the partnership's interest restriction may nevertheless be valid to transfer the economic benefits and burdens of ownership to the purchasing partner. However, the purchasing partner might not be admitted to the partnership, an action that is independent of the federal tax status of the purchasing partner. In such circumstances the purchasing partner might lack important non-tax rights of a partner such as the right to participate in partnership decision-making as well as the right to inspect the books and records of the entity. See, e.g., Rev. Rul. 77-137, 1977-1 C.B. 178; Rev. Rul. 77-332, 1977-2 C.B. 484.

III. Tax Issues for the Partnership

A. Section 754 Election

An election under §754 must be filed by the partnership (not by each partner separately), and it must be filed along with the partnership's tax return. Under some circumstances, a partnership is not required to file a partnership return. Nonetheless, if such a partnership wishes to file a §754 election, it must file a return and attach the §754 election to it.

A positive basis adjustment under §743(b) will benefit the purchaser of a partnership interest by allowing the purchaser to recognize less gain when the partnership sells its appreciated assets, albeit at the cost of additional gain (or less loss) upon a subsequent disposition of the partnership interest. Thus, the nominal beneficiary of the optional basis adjustment is a prospective purchaser of a partnership interest. Accordingly, the purchaser should be willing to pay more for an appreciated partnership interest if there is an election under §754 in effect, so that some of the value of the §754 election should be captured by the selling partner in the form of a higher sale price.

The effect of a §743(b) adjustment is, in general, to give the purchasing partner a cost basis in her share of each of the partnership's assets. While that result ensures that the purchasing partner will not be allocated any phantom income or deductions from operation of the partnership, it can require that a single §743(b) adjustment give rise to both positive and negative basis adjustments, a result finding little support in the statute.

Technically, the regulations provide that the net amount of a §743(b) basis adjustment is equal to the difference between (1) the transferee's outside basis immediately after the transfer and (2) the transferee's share of the adjusted basis of the partnership's property. The first of these two values is easy to determine: when a partnership interest is sold or exchanged, the transferee's outside basis will be the purchasing partner's cost of the partnership interest, while if the partnership interest is transferred as a result of the death of a partner, the transferee's outside basis generally will be fair market value as of the date of death. In each case, the regulations make clear that the transferee's outside basis includes the transferee's share, if any, of partnership indebtedness as provided for under §752.

The second of the two values—the transferee's share of the adjusted basis of the partnership's property—is somewhat more complex. The regulations provide that the transferee's "share of the partnership's adjusted basis in the partnership's assets" is equal to the sum of (1) the transferee's share of "previously-taxed capital" plus (2) the transferee's share of partnership liabilities. The transferee's share of "previously-taxed capital" is then defined to equal the amount of cash that the transferee would receive if the partnership immediately sold all of its assets and then liquidated, but increased by the transferee's distributive share of loss from that hypothetical sale of assets and decreased by the transferee's distributive share of gain. Note that this computation provides for an increase for distributive share of *loss* and a decrease for distributive share of *gain*, adjustments that might at first glance seem reversed.

When a partnership interest is sold, exchanged, or passes through the estate of a decedent, the transferee will take what amounts to a fair market value basis in the partnership interest. If an election under §754 is in effect at the time of the transaction, an optional basis adjustment will be made to each partnership asset in an amount that reflects the transferee's share of the unrealized appreciation or loss in that asset. In contradistinction to the basis adjustment arising from distributions under §734(b), this basis adjustment triggered by application of §743(b) affects the transferee partner only and so has no effect on the partnership's common basis.

Because optional basis adjustments under §743(b) affect the transferee partner only, the partnership must now keep two sets of partnership books, one unadjusted by §743(b) for the entire partnership and one reflecting the §743(b) adjustment for the transferee partner. Indeed, once an election under §754 is filed, the partnership must open an additional set of books every time a partnership interest is sold or exchanged, or when a partner dies.

B. Technical Termination

The sale or exchange partnership interests constituting of 50% or more of the capital and profits within any 12 month period will cause the partnership to terminate under section 708(b)(1)(B). The principle consequence of such a technical termination is that the partnership must treat all of its depreciable property as newly placed in service. §168(i)(7). If it can be determined in advance that a partner is likely to sell or exchange its partnership interest, properly structuring a tiered partnership arrangement can avoid the technical termination. Note that the sale or exchange of an interest in an upper-tier partnership is not treated as the sale or exchange of a partnership interest owned by the upper-tier partnership unless the sale or exchange triggers a technical termination of the upper-tier partnership. Reg. §1.708-1(b)(2).

While all depreciable property is treated as newly placed in service following a technical termination of the partnership, the same is not true as to amortizable §179 intangibles held by the partnership. See §197(f)(2). This is an extremely peculiar result because, for all other purposes, amortizable §197 intangibles are treated as depreciable property. §197(f)(7).

C. Change to the Partnership’s Taxable Year

While the sale of an interest in the venture does not close the partnership’s taxable year unless the sale triggers a technical termination of the partnership, see § 706(b)(1)(B), if the purchasing partner has a taxable year different from that of the selling partner, the sale may affect the partnership's taxable year on a going-forward basis. Under section 706, a partnership's taxable year is determined by the taxable years of its partners. If partners owning more than 50% of capital and profits share a common taxable year, then the partnership must use that common year. §§706(b)(1)(B)(i), 706(b)(4). If there is no common majority taxable year, then the partnership must use the common year of all its principal partners (if there are one or more principal partners and they share a common taxable year), §§706(b)(1)(B)(ii), 706(b)(3). If neither of those two rules generates the partnership's taxable year, the partnership must adopt as its taxable year a taxable year of one of its partners having the least aggregate deferral, §706(b)(1)(B)(iii), Regs. §1.706-1(b)(3). If a partnership determined its taxable year using a majority interest common year, then it need not recompute its taxable year during the year of adoption of the majority interest common year or for the two subsequent taxable years. Reg. §1.706-1(b)(8)(i)(C). If a partnership determines its taxable year using the taxable year of its principal partners or using a least aggregate deferral taxable year, then it must retest its taxable year annually. See Reg. §1.706-1(b)(8)(i)(A); see also Reg. §1.706-1(b)(8)(i)(B) (short taxable years).