

# Partnership Update

Howard E. Abrams  
Warren Distinguished Professor and  
Director of Tax Programs  
University of San Diego School of Law  
[www.taxnerds.com](http://www.taxnerds.com)  
[www.taxllc.com](http://www.taxllc.com)

## I. Introduction

In response to the government victory in *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010) (Kroupa, J.), in 2014 the government proposed major changes to the allocation of debt rules under section 752 as well as minor changes to the disguised sale rules under section 707(a)(2). REG-119305-11 (January 29, 2014). This surprised many people because the government won the *Canal Corp.* case, so there seemed no pressing need for the government to tighten up the rules. Further, because the issue in that case was the application of the disguised sale rules, most people assumed that if changes would be proposed, they would be limited to disguised sales.

But that is not what happened. Treasury proposed significant changes to the allocation of partnership recourse indebtedness as well as less significant changes to the allocation of nonrecourse debt. These proposed changes were highly criticized by the tax community, and on October 5, 2016, in final, temporary, and proposed regulations, the government reversed course. Only minor changes were made to the allocation of debt under section 752 but major changes were made to the treatment of liabilities for purposes of section 707(a)(2)(B). TD 9787, 26 CFR Part 1 (October 5, 2016), TD 9788, 26 CFR Part 1 (October 5, 2016).

What follows is a summary of the regulations promulgated on October 5, 2016. Not all features of the new regulations are discussed, and with respect to those provisions that are discussed, not all details are covered.

## II. Section 752: Temporary and Proposed Regulations Regarding Recourse Indebtedness

### A. Bottom Dollar Payment Obligations

The temporary regulations leave the allocation of partnership indebtedness largely unchanged with one major exception: a bottom dollar guarantee (also a bottom dollar indemnity and any similar contractual arrangement, called in the temporary regulations a “bottom dollar payment obligation”) is no longer recognized as shifting risk of loss from a partnership recourse debt to the guarantor, subject to a limited exception for bottom dollar payment obligations covering at least 90% of the benefitted party's obligations, Reg. §1.752-2T(b)(3)(ii), where the “benefitted party” is the party to whom the guarantee runs, Reg. §1.752-2T(b)(3)(ii)(C)(3). A bottom dollar payment obligation that does not fall within the 90% exception is ignored for

determining risk of loss. Reg. §1.752-2T(b)(3)(i).

### 1. Definition of Bottom Dollar Guarantees

A bottom dollar payment obligation is any guaranty, indemnity or similar arrangement which is not triggered by the first dollar of loss. Reg. §1.752-2T(b)(3)(ii)(C). For example, a guarantee of a \$100,000 partnership debt that is triggered only if the lender is paid less than \$60,000 is a guarantee of the bottom \$60,000. A bottom dollar indemnity is similarly defined. Note that a guarantee of a \$100,000 partnership debt that is limited to a maximum payment of \$60,000 is not a bottom dollar payment obligation so long as it is triggered if the lender is not fully paid. Reg. §1.752-2T(3)(ii)(C)(2). Similarly, a guarantee of 60% of any amount unpaid by a partnership (i.e., a vertical slice) is not a bottom dollar payment obligation. *Id.* A guarantee, indemnification or similar arrangement of a bottom dollar payment obligation is itself a bottom dollar payment obligation. Reg. §1.752-2(b)(3)(ii)(C)(1)(ii).

### 2.. The Exception for 90% Indemnities

If partner X has a recognized payment obligation and partner Y gives to X a bottom dollar indemnification that covers 90% or more of X's payment obligation, then Y's indemnification is recognized despite being a "bottom dollar payment obligation." Reg. §1.752-2(b)(3)(ii)(B). For example, suppose a partnership borrows \$100,000 on a nonrecourse basis and the debt is guaranteed in full by partner X. If partner Y agrees to indemnify X to the extent X is required to satisfy the guarantee in any amount in excess of \$5,000, Y's bottom dollar guarantee is recognized as shifting risk of loss from X to Y (to the extent of 95% of the debt) despite being a "bottom dollar payment obligation." X's share of the debt on this facts should be only 5%.

In what can only be described as a surprising omission, this 90% exception does not apply to guarantees running directly to the lender. For example, suppose a partnership borrows \$100,000 on a nonrecourse basis and partner X agrees to pay the lender if the lender is unable to recover more than \$5,000 from the partnership. This bottom dollar guarantee is ignored for determining risk of loss from the obligation.

### 3. Combining Multiple Liabilities

A bottom dollar payment obligation also includes:

An arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and with a principal purpose of avoiding having at least one of such liabilities being treated as a bottom dollar payment obligation."

Reg. §1.752-2(b)(3)(ii)(C)(1)(iii).

For example, suppose a partnership borrows \$400,000 on a fully nonrecourse basis and, as

part of the same transaction, also borrows on a subordinated basis and from the same lender an additional \$600,000. A guarantee of the senior \$400,000 loan is a bottom dollar payment obligation unless the same partner (or person related to a partner) also guarantees the subordinated \$600,000 loan. If the two loans have different lenders, the analysis is far from clear. Indeed, if the senior loan was not dependent on the subordinated loan, the two loans presumably will not be treated as a single payment obligation. On the other hand and in all events, a guarantee of the subordinated \$600,000 is not a bottom dollar payment obligation without regard to whether the senior \$400,000 debt is guaranteed even if the two loans are treated as a single payment obligation.

#### 4. Disclosure Requirements

A partnership must disclose any bottom dollar payment obligation – including bottom dollar guarantees that are recognized as payment obligations because they cover at least 90% of the debt – on Form 8275 that is attached to the return of the partnership for the taxable year in which the bottom dollar payment obligation is undertaken or modified. The disclosure must include the following information:

- (1) A caption identifying the statement as a disclosure of a bottom dollar payment obligation under section 752;
- (2) An identification of the payment obligation with respect to which disclosure is made;
- (3) The amount of the payment obligation;
- (4) The parties to the payment obligation;
- (5) A statement of whether the payment obligation is recognized because of the 90% exception; and
- (6) If the payment obligation is recognized because of the 90% exception, the facts and circumstances that clearly establish that a partner or related person is liable for up to 90% of the benefitted party's obligation and that the benefitted party's obligation is recognized for debt allocation purposes (i.e., is not itself an unrecognized bottom dollar payment obligation).

Reg. §.1752-2T(b)(3)(ii)(B).

#### B. Arrangements Tantamount to a Guarantee

The government may treat a partner as bearing economic risk of loss with respect to a partnership liability under a new anti-abuse rule. Reg. §1.752-2(j)(2). It covers any contractual obligation or obligations which are used by the partnership to obtain or retain a loan, significantly reduces the lender's risk of loss from the loan, and one of the principal purposes of using the contractual obligations is (a) to shift liability share from other partners, or (b) is to cause a payment obligation to be disregarded as a bottom dollar payment obligation.

#### C.. Effective Date

These changes are effective for partnership liabilities incurred or assumed on or after October 5, 2016. Reg. §1.752-2(j)(3). A partnership may elect to apply the new rules to all of their liabilities as of the beginning of the first partnership taxable year ending on or after October 5, 2016. *Id.*

Liabilities in place prior to October 5, 2016, are fully grandfathered under the old rules so long as they are not modified or refinanced. If they are modified or refinanced after October 5, 2016, but prior to October 5, 2018, the liability is grandfathered for seven years but only to the extent the partner's share of the bottom dollar guaranty or indemnity exceeds the partner's adjusted basis in his partnership interest as of October 5, 2016. See below.

#### D.. Transition Rule

The temporary regulations permit a partner having a bottom dollar payment obligation as of October 5, 2016, to continue to use the old rules indefinitely. However, if such a debt is modified or refinanced after October 5, 2016 and prior to October 5, 2019, a portion of the liability is grandfathered under the old rules for up seven years. Reg. §1.752-2(l)(3). Such a partner is called a "Transition Partner" and the partnership is called the "Transition Partnership." The amount of the debt that is subject to this rule is called the "Grandfathered Amount." The Grandfathered Amount is the excess of the Transition Partner's adjusted basis in the partnership interest determined under the old rules less the Transition Partner's adjusted basis in the partnership interest determined using the new rules (as of October 5, 2016).

The transition rule terminates if the Transition Partner is a partnership, S Corporation or a disregarded entity and ownership of the Transition Partner changes (directly or indirectly) by more than 50%. A technical termination of a Transition Partnership does not terminate the transition rule so long as the Transition Partner remains a member of the new partnership and the new partnership is treated as a continuation of the Transition Partnership.

The amount of any Grandfathered Amount can be reduced (but not increased) by the sale by the Transition Partnership of any property. The amount of the reduction is determined using a complex formula that is dependent on the amount of taxable income from such sale allocated to the Transition partner, the amount realized by the Transition Partnership from such sale, the Transition Partner's percentage interest in the partnership, and any decrease in liability share of the Transition Partner arising from the sale. Reg. §1.752-2(l)(3).

## II. Section 707(a)(2)(B): Temporary and Final Regulations Regarding Disguised Sales

### A. Allocation of Partnership Recourse Debt for Disguised Sales

The temporary regulations change how otherwise recourse debt is allocated for purposes of the disguised sale provision, having the effect of increasing the likelihood that a contribution of encumbered property will be treated as a disguised sale and increasing the amount of gain recognized on a disguised sale. The new rule is described in a roundabout way in the proposed regulations but ultimately result in a rule that is easy to understand.

If property is contributed to a partnership encumbered by a nonqualified liability that is a recourse liability under section 752, the encumbrance is allocated among the partners for disguised sale purposes using the rules under section 752 *but ignoring any payment obligation of the contributing partner*. By ignoring the contributing partner's share of the economic risk of loss, some or all of the liability may be treated as a nonrecourse liability. For disguised sale purposes, contributed nonrecourse liabilities are allocated to each partner in accordance with each partner's share of partnership profits, determined by taking account of all facts and circumstances. Reg. §1.752-3(a)(3). The effect of this rule is to reduce the liability share of the contributing partner and thereby increase the disguised sale implications of the transaction.

The way they get to this result is as follows. First, the regulations generally provide that all debt, both recourse and nonrecourse, must be allocated in accordance with third-tier debt allocations, subject to some limitations (without any recognition that many partnerships don't incur nonrecourse debts and so have no third tier allocations). Reg. §1.707-5T(a)(2)(I). But then they add: "without including in [the transferor partner's] share any amount of the liability for which another partner bears the economic risk of loss." *Id.*

#### 1. Example 1

Individual T contributes property to a partnership in exchange for a 50% partnership interest. The property has adjusted basis of \$40,000, fair market value of \$100,000, and is encumbered by a debt of \$60,000 that is fully recourse as to T. The liability is not a "qualified liability." The partnership takes the property subject to the debt but does not assume it, and T remains fully liable for repayment of the debt. On these facts, T must recognize \$18,000 of gain, computed as follows: No partner other than T has any economic risk of loss from the property. Accordingly, the entire debt is allocated using partnership profit shares, here 50%/50%. Accordingly, one-half of the \$60,000, or \$30,000, is treated as shifting to other partners and so constitutes an amount realized. Because this represents 30% of the value of the property, T allocated 30% of his \$40,000 basis, or \$12,000, to the sale portion of the property, and so his gain equals \$30,000 minus \$12,000, or \$18,000.

#### 2. Example 2

Use the facts of Example 1 with the following change: the partnership assumes the \$60,000 liability, and each partner is jointly and severally liable for repayment with a right of contribution against the other partner. Now, T must recognize gain of \$35,000, computed as follows: Because the other partners have an economic risk of loss of \$30,000, that amount of the liability is allocated to those other partners. The remaining \$30,000 of the debt must be

allocated among the partners in accordance with their profits interest, and that means T's debt share equals 50% of \$30,000, or \$15,000. Accordingly, the remaining \$45,000 (75) portion of the debt is treated as an amount realized to T. T is permitted to use 25% of the \$40,000 adjusted basis in the property, or \$10,000. As a result, T's gain equals \$45,000 minus \$10,000, or \$35,000.

### 3, Observations

#### a. Book Profits or Tax Profits

The regulations provide no guidance on how a partner's interest in partnership profits should be determined, "taking account of all facts and circumstances." In each example in the regulations, a partner contributes appreciated property to a partnership. And in each example, the partner's share of profits is determined *without regard to the built-in gain in the contributed property*. Perhaps that means the "partnership profits" refers to book rather than tax profits. But what if property contributed by some other partner is sold during the current year. Is any section 704(c) gain in that property also ignored. *There is no hint that the drafters of the new regulations gave any thought to this issue.* There is no guidance on any of this, and these rules already are effective. Recall that the regulations under section 706 (b)(1)(B)(iii) regarding determination of a partnership's taxable year references taxable income (including both forward and reverse 704(c) layers) rather than book income. Reg. §1.706-1(a)(4)(ii)(C).

#### b. Special Allocations

If the partnership allocates profits from different activities in different ways, how should they be blended? Greatest percentage? Average percentage (how then is the average computed)? Pro rata?

#### c. Allocations that Vary Over Time

More generally, what if the allocation of partnership profits changes over time. Should share of partnership profits be determined by looking only at shares during the current year (which might also vary), or allocations of profits in past years and the current year, or perhaps using profit shares including past years, the present year, and anticipated events in future years?

#### d. Preferred Returns

Or what if a partner has a reasonable preferred return. For example, suppose partner X is entitled to receive the first 5% of annual profits as well as one-third of the remaining 75%. Should it be relevant whether the preferred return is cumulative?

#### e. Substantiality

My guess is that aggressive taxpayers will get very creative with allocation provisions, with true-up provisions that carry just enough economic risk to be credible. Presumably the Commissioner will challenge such allocations under the substantiality part of the "substantial economic effect" requirement. Yet, of all the regulations written under Subchapter K, those governing substantiality are the least mechanical, totally devoid of meaningful guidance except

in the most obvious of cases, and are easily abused because of the conclusive presumption that fair market value always equals book value.

#### 4. Applicability

These rules apply both to potential disguised sales of property to a partnership from a partner and to potential disguised sales of property to a partner from the partnership. Reg. §1.752-6(d) (example 2).

#### B. Allocation of Nonrecourse Tier 3 Debt for Disguised Sales

Temporary regulations modify the regulations under section 752 to provide that for purposes of section 707(a)(2)(B), allocations of third tier nonrecourse debt can only be allocated in accordance with partnership profits, taking account of all facts and circumstances. Reg. §1.752-3(a)(3).

#### C. Technical Changes

##### 1. Preformation Capital Expenditures

a. The capital expenditures limitation (20% or less of the property's value) generally must be made on a property by property basis. Reg. §1.707-4(d)(1)(ii)(B). However, aggregation is permitted when large numbers of relatively low value properties are contributed. In addition, the value of the aggregated property is limited to the lesser of \$1,000,000 and 10% of the value of all partnership assets excluding money and marketable securities. *Id.*

b. "Capital expenditures" for purposes of the preformation capital expenditures exception "has the same meaning as the term *capital expenditures* has under the Internal Revenue Code and applicable regulations, except that it includes capital expenditures taxpayers elect to deduct and does not include deductible expenses taxpayers elect to treat as capital expenditures." Reg. §1.707-4(d)(ii)(C)(5). Remarkably, this cross-reference does not identify any Code provision or applicable regulation to which it might refer!

##### 2. De Minimis Provision for Certain Nonqualified Liabilities

If both a qualified liability and a nonqualified liability encumbers contributed property, the qualified liability will be ignored for disguised sale purposes if the nonqualified liabilities are no greater than then the lesser of (a) \$1,000,000 and (b) 10% of the amount of all qualified liabilities. Reg. §1.707-5(a)(iii)

##### 3. Step-In-the-Shoes Rule for Nonrecognition Transactions

For determination whether a liability is qualified and for determining whether the preformation exception applies, a step-in-the-shoes rule applies if the contributing partner acquired the property, assumes a liability, or takes subject to a liability of another person in connection with a nonrecognition transaction under section 351, 381(a), 721, or 731. Reg. §1.707-4(d)(1)(ii)(C)(2). Rev. Rul. 2000-14, 2000-2 C.B. 336, is superceded.

#### 4. Special Rules for Tiered Partnerships

a. A contributing partner's share of a liability from a lower-tier partnership is treated as a qualified liability to the extent the liability would be a qualified liability had the liability been assumed or taken subject to by the upper-tier partnership in connection with a transfer of all of the lower-tier's partnership property to the upper-tier partnership. Reg. §1.707-4(d)(1)(ii)(C)(4).

b. If property is transferred to one partnership (the lower tier partnership) and then an interest in that partnership is transferred to another partnership (the upper-tier partnership), the upper-tier partnership steps into the shoes of the person transferring the partnership interest for the purposes of applying the preformation capital expense reimbursement exception and characterization of the liability as a qualified liability. Reg. §1.704-5(d)(1)(ii)(C)(3); Reg. §1.707-5(a)(5)(iii).

#### 5. Anti-Abuse Rule for Anticipated Subsequent Reduction in Debt Share

A new anti-abuse rule has been promulgated for anticipated reductions of liability share if the anticipated reduction is not subject to the entrepreneurial risks of partnership operations and the reduction is part of a plan that has one of its principal purposes minimizing the extent to which the assumption of or taking property subject to a liability constitutes a disguised sale. Reg. §1.707-5(a)(3); Reg. §1.707-5(a)(8)(b)(2)(iii).

#### G, Effective Date

Both the final and temporary regulations generally are effective as of October 5, 2016, as to liabilities incurred, assumed or taken subject to that date, although parts of the regulations are effective for such liabilities as of April 1, 2016. Reg. §1.707-9(a)(1).



### III. Proposed Regulations Under Section 751(b)

Proposed regulations under section 751(b) were promulgated on November 17, 2014, REG-151416-06, 79 Fed. Reg. 65,151-01 (2014), generally applicable to distributions of partnership property that occur on or after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register. These proposed regulations largely follow the approach described in Notice 2006-14, 2006-1 C.B. 498, to modernize section 751(b) and better coordinate its working with changes to Subchapter K since the existing section 751(b) regulations were promulgated in 1956.

#### A. The Section 751(b) Issue

Section 751(b) applies to those distributions from a partnership to a partner that have the effect of rearranging the partners' shares of ordinary income from the partnership's assets. It thus is not an anti-conversion provision such as section 751(a) but rather seeks to protect the Treasury from rate arbitrage by the partners. Note, however, that section 751(b) can apply even if all partners are in the same tax bracket. Further, shifting ordinary income from one taxable corporate taxpayer to another will be captured by section 751(b) even though there is no general preferential tax rate for corporations. Finally, when section 751(b) applies, it generally will have the effect of accelerating the recognition of income by one of more partners in addition to preserving each partner's share of the partnership's ordinary income.

The proposed 751(b) regulations offer two slightly different ways to compute the section 751(b) gain that arises from certain distributions, the "deemed gain" approach and the "hot asset sale" approach. Prop. Reg. §1.751-1(g) (example 3(v)-(viii)). In general, these two approaches will generate the same results. According to the preamble to the proposed regulations, the "deemed gain" approach "produces an appropriate outcome in the greatest number of circumstances." Only the "deemed gain" approach is discussed in this paper.

#### B. Section 751(b) Assets

##### 1. Substantially Appreciated Inventory

Section 751(b) property includes unrealized receivables as well as inventory items of a partnership, §751(b)(1)(A), but inventory items are captured in this context only if the partnership's inventory as a whole is "substantially appreciated." In this context, "substantial appreciation" means fair market value in excess of 120% of adjusted basis. §751(b)(3). "Inventory" includes any property which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231." §751(d)(2). Thus, accrued accounts receivables owned by a partnership and received in exchange for the sale of inventory are treated as "inventory" under this broad definition as are, under current regulations, unaccrued receivables received in exchange for the sale of partnership inventory. Reg. §1.751-1(d)(2)(ii). Without explanation, the proposed regulations remove such unaccrued receives from the definition of "inventory," Prop. Reg. §1.751-1(d), and thereby slightly reduce the likelihood that a partnership's "inventory" will be treated as substantially appreciated.

## 2. Unrealized Receivables

Unrealized receivables include not only the colloquial unrealized receivables but also carved-out exceptions to capital gain property such as depreciation recapture under section 1245 and 1250. §751(c) (final flush language). Historically, positive basis adjustments under section 734(b) and 743(b) to such assets could reduce the amount of a partnership's ordinary income (and thus its 751(b) property) despite being triggered by recognition of capital gain in other assets. The proposed regulations close this loophole by treated such 751(b) property as two distinct assets, the 751(b) asset (such as depreciation recapture under section 1245) having a zero basis and the capital gain (or section 1231) asset that can accept the positive basis adjustment. Prop. Reg. §1.751-1(b)(2)(ii). As a result, the sale of such a partnership asset (such as depreciable equipment) can generate both ordinary income and capital gain or loss.

### C. Determining if There Has Been a Reduction in Ordinary Income Share

If a partnership owning any section 751(b) property makes a distribution, it must compute each partner's share of the partnership's 751(b) ordinary income both immediately before and immediately after the distribution. To compute each partner's share immediately before the distribution, the partnership determines each partner's distributive share from a hypothetical sale of all the partnership's 751(b) property. Each partner's share immediately after the distribution is computed in the same way except that each distributee partner must include in post-distribution share any gain that would be recognized if the distributed 751(b) were immediately sold for fair market value. Prop. Reg. §1.752-1(b)(2).

To properly determine each partner's share of section 751(b) property before and after a distribution, the proposed regulations provide that a partnership owning any section 751(b) property immediately after a distribution must revalue its assets and restate capital accounts immediately prior to the distribution. Prop. Reg. §1.751-1(b)(iv). Now, such revaluations are optional. Reg. §1.704-1(b)(2)(iv)(f). Of course, distributed property must be revalued to current fair market value immediately prior to the distribution under both the current regulations and the proposed regulations. Reg. §1.704-1(b)(2)(iv)(e)(1).

### D. Computing the Section 751(b) Gain

1. If a liquidating or nonliquidating distribution of 751(b) property causes a reduction in the ordinary income share of one or more nondistributee partners, then each such partner recognizes ordinary income equal to such reduction. Prop. Reg. §1.751-1(b)(3). There are two basis increases that flow from this income recognition. First, each partner recognizing income under section 751(b) increases outside basis by the amount of reduction in share of ordinary income. Second, these bases increases are duplicated into the distributed property immediately prior to determining the tax consequences to the distributee so that gain recognized to the nondistributee partners will not be recognized again to the distributee partner when the property is sold. Prop. Reg. §1.751-1(g) (example 3(v)).

2. Example 1: P, Q and R are each one-third partners in the PQR partnership owning cash of \$150 along with three unrealized receivables, each having an inside basis and book value of \$0 as well as current fair market value of \$30. Each partner has an outside basis of \$50 in its interest worth \$80. Suppose P is distributed \$20 of cash along

with two of the unrealized receivables in a liquidating distribution. Immediately prior to the distribution, each partner has a \$30 share of the partnership's section 751(b) gain. After the distribution, Q and R have a share equal to only \$15, for a reduction of \$15 each. Accordingly, Q and R each recognize ordinary income of \$15 and each increases outside basis from \$50 to \$65. Immediately prior to the distribution, the inside basis of the two distributed receivables is increased from \$0 each to \$15 each (\$30 total). The distribution to P is then taxed under section 731 to P, and that yields no gain or loss on the cash and a carryover basis of \$15 in each receivable. Accordingly, when P sells the distributed receivables, P will recognize ordinary income of \$15 on each, or P's \$30 share of ordinary income in total. Further, when the partnership sells the remaining receivable, it will recognize ordinary income of \$30, or \$15 per remaining partner. That \$15 per remaining partner, when combined with the \$15 to Q and to R recognized on the distribution to P, represents the proper ordinary income share to Q and to R.

3. If a liquidating distribution causes a reduction in ordinary income share to the distributee, then the distributee recognizes ordinary income in an amount equal to the reduction in ordinary income share. This income recognition then triggers two basis adjustments. First, the distributee increases outside basis by the amount of income recognized immediately prior to determining the tax consequences of the distribution. Second, there is an equivalent basis increase in undistributed ordinary income assets which should eliminate the distributee's pre-distribution distributive share of ordinary income in the undistributed 751(b) property.

4. Example 2: P, Q and R are each one-third partners in the PQR partnership owning cash of \$150 along with three unrealized receivables, each having an inside basis and book value of \$0 as well as current fair market value of \$30. Each partner has an outside basis of \$50 in its interest worth \$80. Suppose P is distributed \$80 of cash in a liquidating distribution. P's share of the partnership's section 751(b) gain was \$30, and it drops to \$0 after the distribution. Accordingly, P is taxed in \$30 of ordinary income under section 751(b), and P's outside basis increases from \$50 to \$80. This increase ensures that P is not taxed a second time on the distribution of \$80 of cash. The partnership increases its inside from \$0 to \$10 in each of the three (undistributed) unrealized receivables.

#### E. Observations

##### 1. Nonliquidating Distributions of Cash and Other Non-Section 751(b) Assets

A nonliquidating distribution of non-section 751(b) should not implicate section 751(b) because the mandatory asset revaluation locks each partner's share of ordinary income into the partner's capital account and thereby ensures the distribution does not rearrange the ordinary income shares. Because most partnership distributions are made in cash, this means that section 751(b) should play only a modest role in the taxation of nonliquidating distributions.

However, the proposed regulations include a special rule that expands the role that section 751(b) can play in nonliquidating distributions. Under this rule, the distributee partner can be required to include his share of section 751(b) gain even if the distribution works no change

in his share of that income. This rule is triggered when:

- (1) a partner's interest in net section 751 unrealized gain is at least four times greater than the partner's capital account immediately after the distribution,
- (2) a distribution reduces a partner's interest to such an extent that the partner has little or no exposure to partnership losses and does not meaningfully participate in partnership profits aside from a preferred return for the use of capital,
- (3) the net value of the partner (or its successor) becomes less than its potential tax liability from section 751 property as a result of a transaction,
- (4) a partner transfers a portion of its partnership interest within five years after the distribution to a tax-indifferent party in a manner that would not trigger ordinary income recognition in the absence of this anti-abuse rule, or
- (5) a partnership transfers to a corporation in a nonrecognition transaction section 751 property other than pursuant to a transfer of all property used in a trade or business (excluding assets that are not material to a continuation of the trade or business).

For example, a partner might receive a nonliquidating distribution of cash almost equal to the full value of the partner's final capital account balance so that his continuing interest in the partnership is very small. If his share of the partnership section 751(b) gain remains large, then in effect the distribution will, *for purposes of section 751(b)*, be taxed as if it were a liquidating distribution, forcing the distributee to include his entire share of section 751(b) gain at the time of the distribution.

## 2. Liquidating Distributions of Cash

Liquidating distributions of cash always will trigger taxation under section 751(b) to the distributee partner if the partnership owns any section 751(b) assets. This makes sense because such a distribution necessarily shifts ordinary income from the exiting partner to the continuing partner. The same tax results should occur under the current rules although the mechanics currently are more complex.

## 3. Non-Liquidating Distribution of Section 751(b) Property

Consider the following three-person partnership, XYZ. X, Y and Z each are entitled to one-third of the partnership's items of income, gain, loss, deduction, and credit. Each partner has an outside basis of \$0 and a capital account of \$0. The partnership owns six identical assets, with each asset being an unrealized receivable having a current fair market value of \$30, an inside basis of \$0, and a book value of \$0. None of the gain in any of the partnership's assets is described in section 704(c).

If the partnership distributes all of its assets in complete liquidation of the interests of all of its partners, the analysis should go as follows. First, the partnership must revalue each of its assets to current fair market value (that is, to \$30), allocating one third of the revaluation gain (that is \$60) to each of the partners. After this step, each partner has a capital account of \$60 constructed by allocating \$10 of book gain from each asset to each partner.

The partnership then distributes two of its assets to each partner. In this step, each partner receives assets worth \$60, the final value of each partner's capital account. Prior to the distribution, each partner's share of the partnership's ordinary income equaled \$60, composed of \$10 of ordinary income from each of the partnership's six assets. After the distribution, each partner's share of the partnership's ordinary income again equals \$60, although it now is composed for each partner of \$30 of ordinary income from each of the two assets distributed to that partner. There is no taxation under section 751(b) resulting from the distribution under the Proposed Regulations because no partner's share of the partnership's ordinary income is reduced by reason of the distribution. The Proposed Regulations focus on each partner's share of the partnership's ordinary income and not on the assets that generate those shares before or after the distribution.

Reconsider this example but assume that instead of distributing all of its assets in complete liquidation of all partnership interests, the partnership distributes one asset to each of its partners in a nonliquidating distribution. Under the Proposed Regulations, the partnership is required to revalue all of its assets and restate capital accounts, again bringing each partner's capital account to \$60 immediately prior to the distribution. And again, as before, each partner's capital account has been increased by a \$10 share of ordinary income from each of the partnership's six assets.

This distribution does not trigger taxation under section 751(b) because it does not reduce any partner's share of the partnership's ordinary income. Prior to the distribution, each partner had a \$60 share of the partnership's ordinary income composed of \$10 from each asset. After the distribution, each partner has a \$60 share of the partnership's ordinary income composed of \$10 from each of the three undistributed assets as well as \$30 from the single asset distributed to that partner. In effect, each partner has given up a \$10 share of ordinary income in each of the two assets distributed to the other partners in exchange for an additional \$20 share of ordinary income from the asset received in the distribution. Because there is no net reduction in shares of ordinary income, there is no taxation under section 751(b). As before, application of section 751(b) is indifferent to the composition of each partner's share of ordinary income, focusing instead only on each partner's share of the ordinary income.

Finally, consider this partnership a third time, but assume that only a single asset is distributed to one partner (partner X) in a nonliquidating distribution. The Proposed Regulations again require that the partnership revalue its assets immediately prior to the distribution, and if each partner is again allocated one-third of the unrealized book gain in each asset, each partner again will have a \$60 capital account balance immediately prior to the distribution. Immediately after the distribution, X's capital account balance will stand at \$30 while the other two partners will continue to have capital account balances of \$60.

This distribution presumably will trigger immediate taxation to Y and to Z because each will see her share of the partnership's ordinary income decline from \$60 to \$50. X will see an

increase in her share of ordinary income because X continues to have a one-third share of the ordinary income of each of the five undistributed assets (that is, \$10 per asset) as well as a 100% share of the ordinary income of \$30 in the distributed asset, for a total post-distribution share of \$80.

From the analysis presented above, both Y and Z will be taxed under section 751(b) on \$10 of ordinary income. This ordinary income recognition will then increase the adjusted basis of the asset distributed to X, preventing X from taking a carryover basis in the asset unless X recognizes gain (capital gain under the Proposed Regulations) of \$20 solely for the purpose of increasing X's pre-distribution outside basis so that X can take a \$20 basis in the distributed asset. Thus, the distribution triggers immediate taxation to all of the partners even though not only is no partner receiving more than her share of the partnership's ordinary income assets but X in fact is receiving only half of her share. Recall that if X received not one asset but two assets (in a liquidating distribution), there would be no immediate taxation to any partner. Further, X is forced to recognize capital gain of \$20 even though the partnership owns no capital assets, making it difficult to justify immediate recognition imposed on each of the partners and impossible to determine the appropriate capital gain rate that should apply to such capital gain.

#### 4. Mandatory Revaluations

If a partnership makes a distribution to a partner and owns any ordinary income immediately after the distribution, the partnership is required to revalue its assets and restate capital accounts immediately prior to the distribution. This rule will convert many revaluations that currently are option into mandatory revaluations. The proposed regulations do not authorize synthetic revaluations (made via special allocations) in lieu of a bookup.