Chapter 22

Nonliquidating Distributions

A. DISTRIBUTIONS NOT SUBJECT TO §751(b)

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B. DISTRIBUTIONS SUBJECT TO §751(b)

Under §751(b), distributions that rearrange the partners' interests in ordinary income assets may be taxed as a sale or exchange between the distributee partner and the partnership. As a result, either the partner or the partnership may recognize gain on the recharacterized transaction. Technically, §751(b) is triggered by a distribution that shifts interests in those ordinary income assets of the partnership falling within the definitions of "unrealized receivables" and "substantially appreciated inventory." Thus, before looking at the operation of §751(b), we need to consider the terms "unrealized receivables" and "substantially appreciated inventory." Note that cash is not §751 property. Treas. Regs. §1.751-1(e).

1. The Definition of Unrealized Receivables

The term "unrealized receivables" includes a variety of ordinary income assets including (but not limited to) uncollected receivables of a cash-method partnership for services performed or to be performed and dispositions of inventory and other noncapital assets. In addition, the second and third sentences of §751(c) have grown as Congress has carved more exceptions to the general definition of a capital asset in §1221. In particular, disposition of some assets—notably depreciable property subject to depreciation recapture under §1245 or §1250 and market discount bonds as defined in §1278—produce both capital gain and ordinary income, and the definition of unrealized receivables includes the ordinary income component of such assets. A partnership's unrealized receivables often are called its "hot assets," but as to these part capital, part noncapital assets, only the noncapital part constitutes a hot asset.[1]

For example, suppose a partnership owns some depreciable equipment. Assume that the partnership has an adjusted basis in equipment of $10,000, that the fair market value of the equipment is $60,000, and that the equipment is subject to depreciation recapture under §1245 of $15,000. Because the equipment is §1231 property, it is not (in general) §751 property. However, the depreciation recapture is included within the definition of unrealized receivables in §751(c). Accordingly, the equipment is treated as if it were two assets: non-§751 property with adjusted basis of $10,000 and fair market value of $45,000 as well as an unrealized receivable with adjusted basis of $0 and fair market value of $15,000.

Because of this expansive definition of the term "unrealized receivables," even accrual method partnerships can have §751(c) hot assets. Such partnerships will not have unrealized

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1. While these part capital, part noncapital assets are bifurcated under §751(b), they are treated as a single asset for all other provisions of the Internal Revenue Code. As a result, if the basis of the capital component is increased, that increase ultimately can reduce the amount of ordinary income that is recognized when the asset is sold by the partnership. Basis increases can arise under §§734(b), 743(b), and 751(b).

receivables in the common sense—because the partnership accrues its items of income as well as of expense, its business receivables should all be realized despite any lack of collection—but they can easily have *unaccrued* contract rights for services to be performed and goods to be delivered as well as the various ordinary income assets (and parts of assets) listed in the final sentences of §751(c).

2. The Definition of Substantially Appreciated Inventory

The ordinary income partnership assets to which §751(b) speaks include not only unrealized receivables but also "substantially appreciated inventory." As provided in §751(b)(3), the determination whether a partnership's inventory is "substantially appreciated" is made by looking at the inventory as a whole. If the inventory as a whole meets the definition of substantial appreciation, every item of the inventory is treated as substantially appreciated. On the other hand, if the inventory as a whole does not qualify as substantially appreciated, then no item of inventory is substantially appreciated. In particular, you *cannot* determine whether one item of the partnership's inventory is substantially appreciated without looking at the inventory as a group.

a. Partnership Inventory Items

The definition of inventory items in §751(d) includes not only what you would expect to be there (inventory as defined in §1221(a)(1)) but also "any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in §1231." This definition seems all-encompassing even to the point of swallowing up the unrealized receivables defined in §751(c). Could Congress really have intended that "inventory" be defined so broadly?

The regulations explicitly provide that inventory items include most unrealized receivables, Treas. Regs. §1.751-1(d)(2)(ii), as well as realized receivables, see Treas. Regs. §1.751-1(g) (example 2(b)). However, proposed regulations carve back this definition, excluding unrealized receivables from the definition of inventory items. Prop. Treas. Regs. §1.751-1(d). Even under the broader interpretation of inventory items in the current regulations, not all of a partnership's hot assets under §751(c) constitute inventory. For example, a capital asset subject to depreciation recapture under §1245 should not constitute inventory because the asset will produce capital gain (albeit not only capital gain) on disposition. Presumably, all unrealized receivables within the definition of §751(c) having both capital gain and ordinary income parts fall without even the most expansive definition of partnership inventory. Accordingly, it must be the case that "unrealized receivables" as used in the definition of "inventory" means "receivables" in the common, nontechnical sense.

b. Substantial Appreciation

A partnership's inventory items are "substantially appreciated" if the inventory's aggregate fair market value exceeds 120 percent of its aggregate adjusted basis. Because this test applies only to the inventory as a whole, either all inventory items will be treated as "substantially appreciated" or none of them will be. If the inventory is "substantially appreciated," then it will constitute §751 property along with the unrealized receivables (if any); if the inventory is not "substantially appreciated," then the inventory items are not §751 property except for those inventory items which also happen to be unrealized receivables.

For example, consider the *P* partnership owning the following assets:

	Adjusted basis	*Fair market value*
Cash	$60,000	$60,000
Receivables	0	30,000
Inventory	15,000	21,000
Land	30,000	45,000

The fair market value of the inventory items (which, for purposes of §751(b), includes the unrealized receivables) is $51,000 while the adjusted basis of the inventory items is $15,000. Because 120 percent of this adjusted basis figure is $18,000, the inventory items pass the appreciation test and so the partnership's inventory items are "substantially appreciated" within the meaning of §751(d). Thus, both the "inventory" and the "receivables" are §751 property.

Now reconsider this example but assume that the partnership uses an accrual method of accounting so that its receivables are realized:

	Adjusted basis	*Fair market value*
Cash	$60,000	$60,000
Receivables	30,000	30,000
Inventory	15,000	21,000
Land	30,000	45,000

Now that the receivables are realized, the aggregate basis of the partnership's inventory items (again including the receivables) is $45,000, and 120 percent of this amount is $54,000. The aggregate fair market value of the inventory items is only $51,000, so that the inventory items fail the appreciation test of §751(b)(3)(A) and are not considered to be substantially appreciated. Of course, the receivables also are *not* §751 property because they are fully realized.

Note that the inventory alone (that is, without the receivables) *would* satisfy the substantial appreciation test. The effect of including the partnership's receivables in this case is thus to allow the partnership to avoid characterizing its inventory as substantially appreciated. We can make the following generalization about including a partnership's receivables in the definition of inventory items: If unrealized, the receivables will make satisfaction of the appreciation test more likely, while if realized, the receivables will make satisfaction of the appreciation test less likely.

It is worthwhile making the following point explicit: Even if a partnership's inventory items are not substantially appreciated, the partnership's *unrealized* receivables are subject to §751(b) including those receivables classified as inventory items under the broad definition of that term in §751(d). That is, a partnership asset is classified as §751 property if it falls within the definition of an unrealized receivable or an inventory item (or both).

3. Operation of §751(b)

Detailed rules under §751(b) were promulgated in 1956 and have not been updated. See Treas. Regs. §1.751-1(b). The government recognizes that these rules no longer accommodate the changes to subchapter K that have been enacted in the last 50 years. In particular, the existing §751(b) rules do not incorporate the "substantial economic effect" requirement in §704(b) nor the principles promulgated under §704(c). Proposed regulations have been promulgated that coordinate section 751(b) with the modernization of Subchapter K as reflected in the current rules of §§704(b) and 704(c). These proposed regulations identify two ways of applying §751(b) to a partnership distribution, called the "Hot Asset Sale" approach and the "Deemed Gain" approach. When a distribution has the effect of reducing a partner's share of gain from the partnership's §751(b) assets, that partner must be taxed on the reduction. Both the Hot Asset Sale approach and the Deemed Gain approach implement ways of computing the appropriate taxation as well as the effect on the partnership and on other partners. In general, these two approaches yield the same outcome. On occasion they do not, and when they differ, the Deemed Gain approach generally yields what most agree is an answer more consistent with §751(b). Only the Deemed Gain approach is discussed below.

The analysis under §751(b) proceeds in five steps. In Step 1, each partner's pre-distribution share of the partnership's §751(b) income is determined. In Step 2, each partner's post-distribution share of the partnership's §751(b) income is determined. In Step 3, for all those partners whose share of the §751(b) income is reduced from step 1 to step 2, ordinary income is recognized in an amount equal to the reduction. In Step 4, the amount of gain recognized in step 3 is added to the partner's outside basis as well as to the asset's inside basis. And in Step 5, the usual rules of §§731, 732 and 733 are applied to the actual distribution, albeit with the basis adjustments made pursuant to step 4.

a. Step 1: Determine Each Partner's Pre-Distribution Share of the Partnership's §751(b) Income

Immediately prior to any partnership distribution, each partner's share of the partnership's §751(b) gain must be computed. This is done by assuming the partnership sells all of its assets for fair market value immediately prior to the actual distribution and then computing each partner's distributive share of the gain from the partnership's §751(b) assets recognized as part of that hypothetical sale. *See* Prop. Treas. Regs. §1.751-1(b)(2)(ii).

Recall that distributed property must be revalued to current fair market value immediately prior to the distribution. Treas. Regs. §1.704-1(b)(2)(iv)(e)(1). The proposed §751(b) regulations extend this to all partnership property if the partnership owns any §751(b) property after the distributions. Prop. Treas. Regs. §1.751-1(b)(2)(iv). Under current regulations, such revaluations of undistributed property often are permitted but never are required. Treas. Regs. §1.704-1(b)(2)(iv)(f). Thus, this aspect of the proposed §751(b) regulations works a significant change in how partnerships must keep their books and records.

b. Step 2: Determine Each Partner's Post-Distribution Share of the Partnership's §751(b) Income

Similar to the computation in Step 1, each partner's share of the partnership's §751(b) gain must be determined. As before, we assume that all partnership assets (remaining in the hands of the partnership after the distribution) are sold for fair market value, and we determine each partner's distributive share of the §751(b) income arising from this hypothetical distribution. We add to the distributive share for each partner that partner's share of any gain that would be recognized on the sale of any §751(b) assets received by that partner in the distribution. In this way, we account for the extent, if any, that the distribution worked a change in the partners' shares of the §751(b) income. See Prop. Treas. Regs. §1.751-1(b)(2)(iii).

There is one wrinkle in this step 2 computation. Recall that §751(b) only captures inventory if the inventory in the aggregate is "substantially appreciated." If inventory of the partnership is included in the distribution, it is possible that the aggregate inventory prior to the distribution was substantially appreciated but the undistributed inventory after the distribution is not. Similarly, it is possible that the aggregate inventory prior to the distribution was not substantially appreciated but undistributed inventory after the distribution now is.[2] While the proposed regulations do not speak to this issue, presumable the partnership's inventory should be tested for "substantial appreciation" immediately prior to the distribution but not retested after the distribution.

c. Step 3: Compute the §751(b) Ordinary Income to the Partners

For each partner, the share of §751(b) income as computed in Steps 1 and 2 are compared, and for any partner whose share declines, that partner must report ordinary income under §751(b) equal to the decline. See Prop. Treas. Regs. §1.751-1(b)(3)(i). Note that there are no direct tax consequences to any partner's whose share increases. It may be the case that no partner's share of the §751(b) income declines as the result of a particular distribution. If so, no partner is taxed under §751(b).

d. Step 4: Adjust Inside and Outside Bases for the Income Recognized in Step 3

Two basis adjustments are made if a partner is taxed under §751(b). See generally Prop. Treas. Regs. §1.751-1(b)(3)(iii). First, the outside basis of any partner recognizing income under §751(b) is increased by the amount of the gain so recognized. Second, there is an asset basis adjustment. Assuming the distribution includes §751(b) property, that distribution can trigger income under §751(b) to the nondistributee partners. If so, the inside basis of the distributed asset is increased by the gain recognized under §751(b) to the nondistributee partners. This asset basis increase and the outside basis increase are treated as occurring immediately prior to the application of Step 5.

In Step 4, Y and Z each increase their outside basis by $200 from $1,500 to $1,700. And the partnership increases its basis in the distributed receivable from $0 to $40 immediately prior to the distribution of the receivable.

e. Step 5: Apply the rules of §§731, 732 and 733 to the Actual Distribution

Once taxation under §751(b) is finished, we apply the distribution rules of §§731, 732 and 733 to the actual distribution, though with bases adjusted for the distribution. Under §731, gain is recognized only to the extent cash is distributed in excess of the distributee's outside basis, asset basis carries over under §732(a)(1) unless the limitation in §732(a)(2) is triggered, and the distributee's outside basis is reduced (though not below zero) by the amount of cash distributed as well as the asset basis allocated to distributed property under §732.

f. Example[3]

Consider the following example. The XYZ partnership owns four assets: cash of $1200, a capital asset with fair market value of $1,200 and adjusted basis of $900, an unrealized receivable with a fair market value of $600 and adjusted basis of $0, and an inventory item with fair market value of $600 and adjusted basis of $450. The book value of each asset equals its adjusted basis to the partnership, and each of the three equal partners (X, Y and Z)

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2. For example, suppose the partnership owns two items of inventory, one with a fair market value and adjusted basis of $100 and a second with fair market value of $100 but adjusted basis of only $50, and assume that the partnership distributes only the appreciated inventory item. As a second example, reconsider these facts but assume that the appreciated inventory item has an adjusted basis of $75 rather than $50, and now assume it is the unappreciated item that is distributed.
3. For additional examples, see Prop. Treas. Regs. §1.751-1(g).

has an outside basis and capital account of $850. Assume the partnership distributes the unrealized receivable to partner X.

In Step 1, we revalue all partnership assets and then determine each partner's pre-distribution share of the partnership's §751(b) property. Here, each partner has a $200 share of the receivable gain as well as $50 of gain from the inventory, for a pre-distribution total of $250.

In Step 2, we determine each partner's share of the post-distribution share of the partnership's §751(b) property, taking account of the distribution. For Y and Z, that is $50 from the inventory. For X, there is also $50 from the undistributed inventory as well as $600 from the distributed receivable, for a total of $650. Accordingly, in Step 3, Y and Z are taxed on $200 of ordinary income each.

In Step 4, Y and Z each increase their outside basis by $200 from $850 to $1,050. And the partnership increases its basis in the distributed receivable from $0 to $400 immediately prior to the distribution of the receivable.

In Step 5, we apply §§731, 732 and 733 to the distribution. Because there is no cash distribution, there is no gain recognized by X under §731(a)(1). X takes the distributed receivable with a carryover basis of $400 under §732(a)(1), and X reduces her outside basis from $850 to $450 under §733(2). X also reduces her capital account from $1,200 to $600.

To see how well things have worked out, look at what happens if the partnership sells its remaining assets and then liquidates. On the sale of the capital asset, each partner will recognize $100 of income and will increase outside basis and capital account by the same amount. On the sale of the inventory, each partner will report ordinary income of $50 and will increase outside basis and capital account by the same amount. At this point, the partnership has cash of $3,000 and the t-accounts stand as follows.

X		Y		Z		
CA	OB	CA	OB	CA	OB	
850	850	850	850	850	850	Starting Values
350	0	350	0	350	0	Asset Revaluation
___	___	___	___	___	___	Taxation under §751(b)
0	0	0	200	0	200	Inside Basis Increase
-600	-400	0	0	0	0	Distribution
0	150	0	150	0	150	Final Asset Sale
600	600	1200	1200	1200	1200	Totals

Partner X received $600 of value on the distribution and will receive an additional $600 on liquidation, for a total of $1,200. Y and Z received no value on the distribution and will $1,200 on liquidation, showing all three have received the same aggregate return ($1,200) from the venture. Each partner is taxed on one-third of the capital gain when the partnership's capital asset is sold as well as one-third of the ordinary income when the partnership's inventory item is sold. As to the unrealized receivable, Y and Z were each taxed on $200 when it was distributed. Because X takes a basis of $400 on that receivable, when it is sold for $600, X will pick up her additional one-third share of the ordinary income from the receivable. Thus, the partners have been taxed equivalently and enjoy the same return.