CHAPTER 25 – DISPOSITIONS OF PARTNERSHIP INTERESTS

Problem, page 776

25-1. First we must divide the distribution into its §736(a) and its §736(b) components. Because capital was a material income-producing factor, there is no §736(a) component. See §736(b)(3). Accordingly, we treat the entire amount distributed as made in exchange for A's share of the partnership's assets.

Treating the total proceeds as received in one payment, there is gain of $150,000 because the $200,000 received is more than A's pre-distribution outside basis of $50,000. However, to determine the character of that gain, we look to §751(b) as well as to §741.

The partnership's §751 assets include the receivables and the inventory. Prior to the distribution (we are still treating the $200,000 as received in a single distribution), A's share of each partnership asset was one-third. In particular, that makes A's share of the §751 assets equal to $110,000. After the distribution, A's interest in each partnership asset is zero. Because A will receive only cash in liquidation of her interest, her share of the §751 property drops to zero.

Thus, there is a hypothetical distribution to A of her share of the §751 property; that is, one-third of the receivables and one-third of the inventory. A takes this property tax-free under §731, takes a carryover basis in the receivables of $0 and $10,000 in the inventory under §732(a)(1), and A reduces her outside basis to $40,000 under §733(2).

Next, A is treated as selling this property back to the partnership for its fair market value. On that sale, A recognizes gain of $80,000 on the receivables and $20,000 on the inventory under §1001(a), ordinary under §735. The partnership takes a cost basis in the property deemed repurchased.

Finally, A is treated as receiving the remainder of the $200,000 (that is, $90,000), taxable as a liquidating distribution under §§731-732. On this distribution, A recognizes a gain of $50,000 under §731(a)(1). Thus, there is total income of $150,000, of which $100,000 is ordinary and $50,000 is capital.

Having determined how much of the total $200,000 received by A will be treated as return of basis ($50,000), capital gain ($50,000), and ordinary income ($100,000), those amount must be allocated among the five $40,000 payments. A has two options: either a return of basis first, then all gain, or treat each payment as part return of capital, part income. See Reg. §1.736-1(b)(6).

If A elects to report income on a basis-first method, it is unclear precisely how that applies. A would like to report no income upon receiving the first payment, $30,000 of income from payment two, and $40,000 of income from payments three through five. Of the $30,000 income from payment two, $10,000 will be capital gain and $20,000 will be ordinary income. Of the $40,000 income from payments three through five, $13,333 will be capital gain and $27,667 will be ordinary income. However, it is not clear that the service will interpret Reg.§1.736-1(b)(6) as permitting such deferral. Cf. §453(i) (denying installment sale treatment to depreciation recapture). If the ordinary income cannot be deferred, then presumably A will report $20,000 of ordinary income from each payment, no other income from payment 1 or 2, $10,000 capital gain from payment 3, and $20,000 capital gain from payments 4 and 5.

Under the second, pro rata method, A will treat $10,000 of each payment as nontaxable return of capital, $10,000 as capital gain, and $20,000 as ordinary income.

Problems, page 778

25-2. Section 736(b)(3) does not apply here because this is not a liquidation of a partnership interest. Section 741 says go to §751(a), which deals with the disposition of a partnership interest. Under §751(a) as interpreted by the proposed regulations, A will recognize ordinary income on the sale equal to what would be A's distributive share of ordinary income if the partnership sold all of its assets for fair market value (taking into account all provisions of the code including sections 704(b) and 704(c)). Here, that is $100,000. A must recognize capital gain equal to the total gain realized on the sale less the ordinary income component already determined, where that total gain equals the excess of A's amount realized for her partnership interest over her adjusted basis in her partnership interest. Because that total gain is $150,000 and the ordinary income component is $100,000, there is a capital gain of $50,000.

Note the following: (1) A's total gain on the transaction always equals the amount realized by A on the sale less A's outside basis in her partnership interest; and (2) there can be a capital gain and an ordinary loss or, more commonly, a capital loss and ordinary income. Of course, there can also be two gains (as in this problem) or two losses.

Under the liquidation, there was a basis increase for the partnership. Here, there is none, unless the partnership makes an election under §754 triggering an optional basis adjustment under §743(b). Thus, §741 does not provide the basis increase automatically, as did operation §751(b).

25-3. The §751 assets include the receivables and the inventory. G's share of each asset should be one-half of its basis (because G has a 50% interest in partnership capital), and three-fourths of the unrealized gain (because G has a 75% interest in profits). Thus, G's share of the capital asset equals $15,000 (half the basis) plus $15,000 (three-quarters of the gain), or $30,000; G's share of the receivables equals $0 (half the basis) plus $30,000 (three-quarters of the gain), or $30,000; of the Inventory equals $30,000 (half the basis) plus $3,000 (three-quarters of the gain), or $33,000; and of the Cash, $5,000 (half the basis). Thus, G's interest in the partnership is worth $30,000 + $30,000 + $33,000 + $5,000, or $98,000.

Under §751(a), G will recognize her share of the appreciation in the ordinary income assets as ordinary income. Thus, G must recognize ordinary income of $33,000. Because

A is selling her partnership interest for $98,000 while having an adjusted basis in that interest of only $50,000, there is a total gain of $48,000. Because she recognizes $33,000 of ordinary income, there is $15,000 capital gain.

25-4. There are no §751 assets here because there are no unrealized receivables or substantially appreciated inventory. (Note that for determining whether the inventory is substantially appreciated, we include the receivables as inventory.)

Under Plan A, the entire distribution of $52,000 is taxed under §731(a)(1) via §736(b). Under §731(a)(1), X recognizes again of $7,000, that being the excess of the cash distributed over X's outside. That gain is capital under §741.

Under Plan B, there is no gain or loss to X under §731. Under §732(b), X's basis in the assets will be X's original outside basis of $45,000 less the $20,000 cash distributed, or $25,000. Under §732(c)(1)(A)(i), carryover basis of $15,000 of this amount is allocated to the inventory (whether substantially appreciated or not, and including the realized receivables), and the remaining $10,000 is allocated to the capital asset.

Since X then sells the distributed assets to the other partners, there is $5,000 gain on the capital asset, none on the receivables, and $2,000 on the inventory (which will be ordinary under §735). This gain is computed under §1001. Thus, because §735 applies to all inventory while §751(b) applies only to substantially appreciated inventory, plan B is slightly worse than plan A.

Under Plan C, X recognizes total gain of $7,000. Under §751(a), X must recognize ordinary income of $2,000, leaving $5,000 as capital gain. Thus, plan C is equivalent to plan B (because the reach of §751(a) is the same as that of §735(a)).

25-5. Now, the §751 assets include the inventory as well as the receivables. Under Plan A, §751(b) will force X to recognize ordinary income of $12,000, leaving X with capital gain of $5,000. The same result obtains under plan B, with the ordinary income caused by application of §735, and under plan C, with the ordinary income captured by §751(a). Thus, when the inventory is substantially appreciated, plan A, plan B and plan C produce the same tax consequences to X.

25-6. The analysis under plan A does not change because the reduction in X's share of the debt is treated as an additional $4,000 cash received by X as part of the liquidating distribution, for a total of $52,000, just as in problem 3. Under plan B, release of X's share of the debt again is treated as an additional $4,000 received in the distribution, simply substituting for some of the actual cash in problem 3. Thus, presumably X will receive less actual cash in the distribution. Accordingly, X will receive the same amounts of the partnership's property, and the subsequent sale of these assets should be taxed just as in problem 3. Again, no change. The analysis under plan C does not change because the reduction in share of liabilities is treated as an additional amount realized. Reg. §1.752-1(h).

25-7. Plan (a) is tax-free in all respects: the sale is for adjusted basis so there is no gain or loss, and the subsequent liquidating distribution of cash just equals each partner's outside basis. Plan (b) requires each partner to report ordinary income of $200,000 along with an offsetting capital loss of the same amount. These items arise because the sale of a partnership interest is governed by application of §751(a), and under that provision an exiting partner's share of ordinary income equals her distributive share of ordinary income determined if the partnership sold all of its assets for fair market value. That assumption of a sale of $1,400,000 yields depreciation recapture of $200,000 per partner; the offsetting capital loss arises because the total gain on the sale of each interest is $0 (amount realized equals outside basis of $500,000). Note, however, that the partners will argue that option affects the fair market value of the partnership's property; to wit, that the fair market value of property equals the amount of money for which the property can be sold. If that argument is accepted, then there is no income or deduction arising from plan (b).

Problems, page 785

25-8. A technical termination occurred on April 1. Before the sale, the partnership was ABE. Afterwards, it was FBE. The transaction is treated as if the FBE partnership transferred all of its assets to new-FBE in exchange for partnership interests in new-FBE (yes, for this moment new-FBE has only a single partner, namely old-FBE), and then those partnership interests are distributed to F, B and E in complete liquidation of old-FBE. Note that new §704(c) problems are not created, Reg. §1.704-3(a)(3)(i), even though you might expect the reverse. Note also that the sale on May 1 does not trigger a technical termination because this transaction represents less than 50% of the capital and profits in the partnership deemed formed on April 1.

25-9a. Assuming the form is respected, this structure provides the desired benefit. A sale by Q of Q's interest in the upper-tier partnership will not trigger a technical termination of the upper-tier partnership because Q owns less than 50% of that partnership. Because Q's exit does not trigger a technical termination of the upper-tier partnership, Q's exit is not treated as a sale or exchange by the upper tier partner of any portion of its interest in the lower-tier partnership. Reg. §1.708-1(b)(2). Accordingly, there is no technical termination of the lower-tier partnership because only Q's direct interest in that partnership is treated as sold. Note that a sale of P of P's interest both partnership's would trigger a technical termination of both partnerships.

But will the form of the structure be respected? If the upper-tier partnership owns no assets other than its interest in the lower-tier partnership, the structure arguably lacks economic substance and so easily could be ignored. See Reg. §§1.701-2(a)(3), 1.701-2(e)(2).

25-9b. The following structure, if respected, would give Q a 60% interest in the overall venture yet will still allow Q to exit without triggering a technical termination. P and Q form the PQ partnership, with P owning two-thirds and Q owning one-third of the PQ partnership, P, Q and PQ then form a lower-tier partnership, with P owning 10% of the lower-tier partnership and Q as well as PQ each owning 45%.