In Revenue Ruling 79-205, 1979-2 C.B. 233, the Service considered the consequences of two distributions of encumbered property, one to each partner, as part of a single transaction. The two conclusions reached in this Ruling were: (1) the two debt shifts are netted against one another, so that only the net liability change to each partner is treated under §752; and (2) the §752 effects of the distribution are determined before the application of the distribution provisions (§§731, 732, and 733).

While this Ruling predates the current rules under §752, there is no obvious reason why its conclusions should not continue to be valid. If the conclusions of Rev. Rul. 79-205 remain good law, the second conclusion -- that the debt shift arising from a distribution is taken into account prior to determining if the distribution triggers gain under §§752(b) and 731(a)(1) -- can have profound consequences.

Reconsider first the PQ general partnership, in which P and Q each contribute $30 for a one-half interest in profits and losses. Because capital accounts and outside basis are credited with the amount of cash contributed by the partners to the partnership, each partner's capital account and outside basis equals $30. The partnership then borrows $40 on a fully recourse basis, and under section 752(a) this partnership-level borrowing increases each partner's outside basis from its pre-borrowing value of $30 to $50. That is, each partner is credited with $20 of the $40 debt.

Suppose the partnership then distributes $64 of its $100 cash to P. Section 731(a)(1) provides that a distribution of money to a partner in excess of the partner's outside basis trigger gain to the distributee equal to such excess. Thus, the $64 distribution to P seems to trigger a gain to P of $14.

But Rev. Rul. 79-205 say that the basis consequences of a distribution are determined *prior* to applying §§752 and 731. The effect of the distribution is to reduce P's capital account from $30 to negative $34; Q's capital account remains at $30. A zero-value sale and liquidation of the remaining partnership cash of $36 thus generates a book loss of $36, and that loss is allocated equally between the partners. Putting the hypothetical book loss from the zero value sale into the capital accounts, P's capital account is reduced to negative $52 while Q's capital account is reduced to positive $12. Accordingly, all of the debt is now allocated to P.

P		Q		
CA	OB	CA	OB	
$ 30	$ 50	$ 30	$ 50	Initial values
	20		(20)	Debt reallocation
(64)	(64)	0	0	Distribution
($ 34)	$ 6	$ 30	$ 30	Ending values

That is, the distribution is tax free!