22-1. X does not recognize gain on the distribution because the amount of cash distributed is less than X's outside basis immediately before the distribution, §731(a)(1), and X cannot recognize loss because the distribution is not in liquidation of X's interest in the partnership, §731(a)(2). Under §732(a)(2), X's will have an aggregate basis of $20,000 in the distributed property (outside basis of $31,000 less distributed cash of $11,000) because that is less than the aggregate inside basis of the distributed property ($6,000 plus $24,000). X reduces outside basis to zero pursuant to §733(1)-(2).

X takes a tentative basis of $6,000 in asset #1 and a tentative basis of $24,000 in asset #2. That requires a negative adjustment of $10,000 allocable under §732(c)(3). The negative adjustment is allocated first to assets with built-in loss to the extent of the built-in loss, §732(c)(3)(A); here, that is asset #2 to the extent of $6,000. Under §732(c)(3)(B), the remaining negative adjustment of $4,000 is allocated in proportion to relative inside (i.e., tentative) bases *after the adjustment pursuant to §732(c)(3)(A) is made*, so that the negative adjustment is allocated 6/24 to asset #1 and 18/24 to asset #2. Since 6/24 of $4,000 equals $1,000 and 18/24 of $4,000 equals $3,000, X takes a basis in asset #1 of $6,000 - $1,000, or $5,000, and in asset #2 of $18,000 - $3,000, or $15,000.

22-2. Section 731 states that there is gain only if the amount of money distributed exceeds outside basis, so here there is no gain. There will be no loss because loss is recognized only on liquidating distributions, when appropriate.

Section 732(a)(1) states that the partner's basis in the distributed assets will be carried over from the partnership's basis, unless that amount exceeds the distributee-partner's outside basis reduced by any cash distributed, §732(a)(2). Here, A's pre-distribution outside basis was $22,000 and the amount of cash distributed was $2,000, so the maximum basis that can be allocated to the distributed assets is $20,000. Since carryover for all the assets would be $24,000, the limitation of §732(a)(2) is in fact implicated; thus, the basis to be allocated among the distributed assets is only $20,000.

Under §732(c)(1)(A), basis is allocated first to the unrealized receivables and inventory, thereby giving A a basis in the distributed receivables of $0 and in the inventory of $2,000. After this step, there is $18,000 of basis remaining to be allocated.

Under §732(c)(1)(B), we then tentatively allocate carryover basis to the capital assets, giving a basis of $8,000 to capital asset 1 and $14,000 to capital asset 2. However, because these bases total more than the $18,000 available to be allocated, we must decrease the bases in the capital assets as provided in §§732(c)(1)(B)(ii) and 732(c)(3). The $4,000 of decrease is first allocated to the capital assets in proportion to unrealized loss, §732(c)(3)(A), and then in proportion to relative adjusted bases, §732(c)(3)(B). Thus, $1,000 of the decrease is allocated to capital asset 1 and then the remaining $3,000 of decrease is allocated $1,000 to capital asset 1 and $2,000 to capital asset 2. Accordingly, A will take the distributed assets with the following bases:

Asset	Basis
Receivables	$ 0
Inventory	2,000
Capital Asset 1	6,000
Capital Asset 2	12,000

22-3. The distribution will have two effects on A's capital account. First, the distributed assets must be revalued, and the capital accounts of all the partners must be restated to account for this revaluation. Second, we must book out of A's capital account the fair market values of the distributed assets. Since the total inside basis of the distributed assets equaled $26,000 will the total fair market values equaled $41,000, each partner's capital account should be increased by one-third of $15,000, or $5,000 (assuming the book value of each asset equaled its inside basis). Then, A's capital account should be reduced by the $41,000, that being the fair market value of the distributed property. Thus, the net reduction to A's capital account was $41,000 minus $5,000, or $36,000. The net reduction to A's outside basis was $22,000, so the distribution created a book/tax disparity to A of $36,000 less $22,000, or $14,000. (Note that if these allocations would drive any partner's capital account negative, then that partner must have a sufficient deficit restoration obligation to support the allocation.)

Of that $14,000 book/tax disparity, $10,000 is a book/tax disparity that could be reduced by a curative or remedial allocation and $4,000 is a permanent book/tax disparity that cannot be eliminated until A's partnership is liquidated. To see this, note that the book-up of the assets resulted in an increase in the capital accounts of $10,000. Thus, the other partner should now have combined capital accounts in excess of outside basis by $10,000, so $10,000 of A's book/tax disparity can be eliminated with offsetting allocations to A and to the other partners. But the additional $4,000 of A's book/tax disparity was caused by application of §732(a) and such disparities are permanent.

Can a partnership elect to use curative or remedial allocations in this circumstance as to $10,000 of A's book/tax disparity? Unclear: Reg. §1.704-1(b)(2)(iv)(g) requires partnerships to resort to §704(c)(1)(A) principles when making allocation with respect to book/tax disparities resulting from asset revaluations, but what caused the disparity was not simply the revaluation but also the distribution. There is no authority for applying the §704(c) principles to distributions.

22-4a. There is no income or loss. §731(a). C takes a carryover basis of $10,000, under §732. C's outside basis is reduced to $5,000 under §733.

We then book up the assets. C's capital account is increased by one-third of the unrealized appreciation of $20,000 and the full $30,000 fair market value of the asset is taken out of C's capital account.

22-4b. There will be no gain or loss under §731. C's basis in the property is $15,000 under §732(a)(2), because C's outside basis was not enough to carry over the partnership's basis. C's outside basis then becomes zero under §733.

Now we book the asset down to fair market value and allocate the $10,000 in unrealized loss to the partners as per the partnership agreement. C's one-third share of that unrealized loss is subtracted from C's capital account and then the asset's fair market value of $15,000 is taken out of C's capital account.

22-4c. We first determine the capital account effects of the distribution. Thus, assuming the asset has a current book value equal to its adjusted basis, we book down the asset, splitting the $10,000 in unrealized loss between the three partners. Then we reduce C's capital account by the value C takes out; here, $9,000. C technically received $15,000 in value (Z's fair market value), but C had to pay $6,000 (the amount of debt C now must pay on Z) to get Z.

Second, we determine the debt reallocation under §752. Here, assuming the debt was allocated equally among A, B and C immediately prior to the distribution, C's outside basis increases by $4,000, which was A's and B's share of the debt on asset Z. A and B each lose $2,000 from their outside basis. Note that under Revenue Ruling 79-205 we make the §752 debt reallocation prior to computing the §731-733 tax consequences of the distribution.

Third, we determine the tax consequences to C under §731-733. There is no gain or loss under §731, C's basis in the asset is $19,000 under §732(a) (i.e., carryover limited by pre-distribution outside basis, as adjusted by the debt), and C's outside basis is reduced to $0 under §733(2).

22-5. **[Revised]** These marketable securities will be treated as money for purposes of gain recognition, §731(c)(1)(A), except to the extent provided in §731(c)(3)(B). Before applying this limitation, the distribution would be treated as a distribution of $9,000. However, we reduce that amount by the excess of (i) 50% of $9,000 (or $4,500) over (ii) 50% of $3,600 (or $1,800). Thus, the reduction equals $2,700, so that we treat the distribution as consisting of only $6,300 in cash. *See* Reg. §1.731-2(j) (ex. 2).

Accordingly, X recognizes no gain on the distribution because the amount of securities treated as cash is less than X’s pre-distribution outside basis. §731(a)(1). X takes the distributed securities with a carryover basis of $3,600 under §§731(c)(4)(A)(1), 732. X's outside basis is reduced under §733(2) to $2,900. *See* Reg. §1.732-1(j) (ex. 5).

For determining the capital account implications of the distributions, the application of §731(c) is irrelevant. Accordingly, we book the distributed assets to fair market value (i.e., we increase each partner's capital account by $2,700) and then we reduce X's capital account by the value of the distributed securities (i.e., by $9,000). Thus, X's capital account is increased from $6,500 to $9,200 and then is reduced by $9,000 to $200 while Y's capital account is increased to $9,200. If we use this distribution as an opportunity to book all undistributed assets to fair market value, then each partner's capital account is increased by an additional $1,800.

If the distribution includes cash of $1,000 in addition to the marketable securities, X is treated as receiving cash of $7,300, thus triggering a recognized gain to X of $800. Under §732, X's basis in the distributed securities is again carryover of $3,600. But under §731(c)(4)(A)(ii), X's basis in the distributed securities is increased by "such" gain: that is, by the gain recognized by treating the securities as cash. In this problem, the gain was only recognized because there was both marketable securities and cash. Should §731(c)(4)(A)(ii) apply to this distribution?

If §731(c)(4)(A)(ii) does not apply, then X takes the securities with an adjusted basis of $3,600 and X reduces outside basis from $6,500 to $2,900, as before. That means X's aggregate basis in her partnership interest and in the distributed securities equals $2,900 plus $3,600, or $6,500. But X recognized income of $800 on the distribution so X's aggregate basis should equal X's pre-distribution outside basis of $6,500 plus that recognized gain. If we treat the recognized gain as being described in §731(c)(4)(A)(ii), then X takes a basis in the distributed securities of $3,600 plus $800, or $4,400, and now X's post-distribution aggregate basis reflects the recognition of income on the distribution. Thus, the gain *should be* treated as described in §731(c)(4)(A)(ii).

22-6a. But for §735, the gain would be capital. Section 735, however, states that the gain will be ordinary if sold by the distributee within five years. All gain will be ordinary, not just the built-in gain.

22-6b. This will be ordinary in full because it's ordinary to the partner. Section 735 will turn capital gain into ordinary income, but it will never turn ordinary income into capital gain.

22-6c. The loss is ordinary under §735(a)(2).

22-6d. Gain from the receivables will be ordinary even after five years.