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.

Prior to the distribution, A's share of the partnership's §751(b) ordinary income was one third of $300,000, or $100,000. After the liquidation of A's interest, her share is $0. Accordingly, she recognizes $100,000 of ordinary income and increases her outside basis to $150,000. The partnership also increases its inside basis in the receivables to $80,000 and in the inventory to $50,000.

The distribution of $200,000 in cash then triggers a capital gain under §731(a)(1) of $50,000, so that A's total recognition is $150,000, of which $100,000 is ordinary.

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 amounts 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 $40,000 of ordinary income from the first and second payments as well as $20,000 from the third payment. The other $20,000 of the third payment will be tax-free as a recovery of basis as will $30,000 from the fourth payment. The remaining $10,000 of the fourth payment as well as all of the fifth payment then will be capital gain.**

Under the second, pro rata method, presumably A will treat $10,000 of each payment as nontaxable return of capital, $10,000 as capital gain, and $20,000 as ordinary income. The government might seek to accelerate the ordinary income and then divide the remaining payments between basis recovery and capital gain.

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 **ordinary--income** 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(b) 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**. The proposed regulations would not change that result although they exclude unrealized receivables from the computation of substantial appreciation.**)

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 is allocated to the statutory**

"inventory" which includes the inventory and the realized receivable (realized receivables are still inventory for basis allocations under §732(c)(1)(A)(i)), 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(b) 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).

25-8. The transfer by X and Y of their interests in LLC-XY is treated to X and Y (under Rev. Rul. 99-6) in accordance with its form; i.e., as a sale of LLC interests. This sale is fully taxable to X and to Y, who receive in exchange interests in disregarded entity LLC-Z. This is treated under Rev. Rul. 99-5 as receipt by X and by Y of an interest in Whiteacre followed by the immediate formation of a new partnership (LLC-Z), and that formation is tax-free under §721.

Z is treated under Rev. Rul. 99-6 as transferring Whiteacre (because LLC-Z is a disregarded entity) in exchange for the assets of LLC-XY, so that to Z the transaction can qualify as a tax-free exchange under §1031 as an exchange of Blackacre for Whiteacre. LLC-XY is now treated as a disregarded entity.

25-9. Rev. Rul. 99-6 did not overrule Rev. Rul. 84-111. Rev. Rul. 84-111 addressed three ways of incorporation the assets of a partnership. In situation 1, the partnership transfers its assets to a new corporation in exchange for all of its stock, and then that stock is distributed to the partners, ending the existence of the partnership. This is called an "assets over" incorporation.

In situation 2, the partnership distributes all of its assets to its partners in proportion to their interests in the venture, terminating the partnership. As part of the same plan, the partners then contribute the distributed assets to the newly formed corporation in exchange for its stock. This is called an "assets up" incorporation.

In situation 3, the partners transfer their partnership interests to the newly formed corporation in exchange for stock of the corporation. The partnership ceases to exist for tax purposes for want of two owners, but the partnership remains in existence for non-tax purposes as a disregarded entity. This is called an "interests over" incorporation.

In each of the three situations, we assume that both capital and ordinary income assets are owned by the partnership, that the partnership's indebtedness is less than the aggregate inside basis of the partnership's assets, and that no partner receives a distribution of cash in excess of outside basis.

In general, each of the three transactions is taxed in accordance with its form. In situation 1 (assets over), the transfer of the partnership's assets for stock is tax-free under §351 and the corporation continues the partnership's basis in the assets under §362(a). The distribution of stock by the partnership is a termination of the partnership under §708(b)(1) and the partnership's basis in the stock equals the corporation's adjusted basis in the contributed assets pursuant to §358(a), though reduced by the amount of the transferred liabilities under §358(d)(1). When the stock is then distributed by the partnership, the former partners push their outside basis into the distributed stock under §732(b) and tack their holding periods under §§735(b) and 1223(1).

In situation 2 (assets up), the distribution of assets from the partnership to the partners is tax free under §731(a) and the partners push their outside basis into the distributed assets pursuant to §732(b). The distributed assets are then transferred to the corporation in a tax-free transaction pursuant to §351(a), and the corporation continues the partners' basis in the assets under §362(a). The former partners take a basis in the stock equal to their basis in the contributed assets less the amount of liabilities assumed by the corporation, §358(d)(1). Tacking of holding period is permitted to the former partners pursuant to §1223(2) except to the extent the transferred assets are neither capital assets nor assets described in §1231.

In situation 3 (interests over), the partnership terminates since upon receipt by the corporation there will be only one "partner". The partners basis in the stock received in the exchange will be the basis for their partnership interests, reduced by any liabilities assumed. §358. The corporation's basis for the partnership assets will be each partner's basis in the partnership interest transferred. § 362. Tacking of holding period is permitted for the stock received holding period to the extent that the assets in the partnership are neither §751 or ordinary income assets. The corporation's holding period in the assets received in the exchange includes the holding period of the partnership in the assets transferred. § 1223(2).