

**TAX IMPLICATIONS OF LIQUIDATION OF PARTNERSHIPS
AND FAMILY LIMITED PARTNERSHIPS**

**Eugene F. Pollingue, Jr.
Wagner Law Group
Boston, MA
Palm Beach Gardens, FL**

I. General Rules

A. §731

There is no gain or loss to partner on distribution from the partnership, except gain is recognized to the extent cash distribution to partner exceeds partner's basis in the partnership, and loss is recognized if no property other than cash or §751 property is received and the basis of the partner in the partnership is greater than the partner's basis in the property received from the partnership. The partnership has no gain or loss.

B. §732

In the case of a liquidation of Partner's partnership interest, the partner's basis in the distributed property is the partner's basis in the partnership reduced by cash received.

Other than in liquidation, the partner takes partnership's basis in the property, limited by partner's basis in the partnership.

C. §735(b)

There is a tacking of the holding period to the partner receiving the distribution.

Example 1

ABC partnership owns raw land with a basis of 70.

<u>Partners</u>	<u>Partners' interest in P/S</u>	<u>Partner's Basis in P/S</u>
A	1/3	50
B	1/3	20
C	1/3	10

ABC liquidates. Each Partner receives a 1/3 interest in the raw land.

<u>Partners</u>	<u>Partner's interest in asset distribution</u>	<u>Partner's Basis in distributed asset</u>
A	1/3	50
B	1/3	20
C	1/3	10

The partnership's 70 basis in assets becomes irrelevant. A, B and C's holding period in the property includes the Partnership's holding period in the property.

Example 2

Same as 1 except in addition to the raw land, ABC Partnership has cash of 60 that is also distributed equally to A, B and C. After liquidation:

<u>Partner</u>	<u>Partners' original basis in Partnership</u>	<u>Less cash Received</u>	<u>Remaining Basis after cash</u>
A	50	20	30
B	20	20	0
C	10	20	0

A receives a 30 basis in his 1/3 interest in the land and has no gain.

B receives a 0 basis in her 1/3 interest in the land and has no gain.

C receives a 0 basis in her 1/3 interest in the land and has a 10 gain because she received cash in excess of her basis.

Example 3

Same as Example 2 except property is distributed as follows:

<u>Partner</u>	<u>Original Basis in P/S</u>	<u>Property distributed</u>	<u>Remaining Basis after cash</u>
A	50	40 cash	10
B	20	10 cash ½ land	10
C	10	10 cash ½ land	0

A recognizes a 10 loss because he only received cash which was 10 less than his basis in the partnership.

B has no gain or loss and gets a 10 basis in land.

C has no gain or loss and gets a 0 basis in land.

Example 4

Nonliquidating Distribution

Partnership A B C D

<u>Partners</u>	<u>Partner's Basis</u>	<u>Partners' Interest in P/S</u>
A	30	1/4
B	20	1/4
C	10	1/4
D	40	1/4

Partnership distributed an asset in which it has a basis of 20 to C and an asset in which it has a basis of 20 to D, not as a liquidating distribution. After the distributions the Partners have the following basis and interest in the Partnership.

<u>Partner</u>	<u>Partners' Predistrib. Basis</u>	<u>Partners' post Distrib. Basis</u>	<u>Partners' post Distrib. Interest in P/S</u>
A	30	30	3/8
B	20	20	3/8
C	10	0	1/8
D	40	20	1/8

Since this was a nonliquidating distribution, C would take the distributed property at the partnership's basis of 20, but since C's basis in the partnership was only 10, his basis in the distributed property is limited to 10 and he has a 0 basis remaining in the partnership.

D takes his distributed property at the partnership's basis of 20, and his basis in the partnership is reduced from 40 to 20.

Note planning opportunities for deferring gain if non-appreciated assets are taken out first in a nonliquidating distribution, and the partnership later liquidates in an unrelated transaction.

D. §732(c)

Allocation of Basis among assets received in Distribution:

In a liquidating distribution the partner's basis in the partnership is reduced by cash received.

Any remaining basis is allocated to unrealized receivables (§751(c)) and inventory (§751(d)) equal to the partnership's basis in those assets. Any remaining Basis is then allocated to other assets.

If the remaining basis of the partner to be allocated is less than the basis of those properties to the partnership then the difference decreases the basis of those assets as follows:

1. First to unrealized depreciation in proportion to their respective amounts of unrealized depreciation.
2. Then in proportion to their basis as adjusted in step 1, above.

Example 5

Partner A has a 10 basis in Partnership.

In liquidation she receives

	<u>Basis to Partnership</u>	<u>FMV</u>	<u>Unrealized loss</u>
Unrealized Receivable	0	5	
Inventory X	5	10	
Inventory Y	10	5	5
Inventory Z	<u>10</u>	5	5
	25		

Partner A will take a 10 basis in the assets. Partnership's Basis of 25 must be reduced by 15 to 10.

	<u>Partnership's Basis</u>	<u>Step 1 adjusted</u>	<u>After Step 1 adjusted</u>
Unrealized Receivable	0	-0	0
Inventory X	5	-0	5
Inventory Y	10	-5	5
Inventory Z	10	-5	<u>5</u>
			15

Step 2

Reduces from 15 to 10 in proportion to Adjusted Basis under Step 1.

	<u>Adjusted per Step 1</u>	<u>Step 2 adjusted</u>	<u>Adjusted Basis to Prtner A</u>
Unrealized Receivable	0	-0	0
Inventory X	5	-1.66	3.33
Inventory Y	5	-1.66	3.33
Inventory Z	5	-1.66	<u>3.33</u>
			10

If Basis of partner's interest exceeds the sum of money and partnership basis of unrealized receivables and inventory distributed, the excess is allocated to other distributed assets as follows:

1. Each other asset is allocated the predistribution basis that the partnership had in the assets.
2. If the basis under 1 is greater than the remaining basis to be allocated, the shortfall is allocated first to reduce the basis of depreciated assets in proportion to their

unrealized depreciation, but only to the extent of each property's unrealized depreciation.

3. Any remaining shortfall is allocated to all of the other assets to reduce their basis proportionately. The reduction is allocated in proportion to the basis of the assets determined under 2. This is the same method reflected in Example 5.
4. If the basis under 1 is less than the remaining basis to be allocated, the excess basis is first allocated to increase the basis of appreciated assets in proportion to their respective amounts of unrealized appreciation (but only to the extent of each property's unrealized appreciation), and any remaining basis to be allocated is allocated to all of the other assets in proportion to their fair market values.

Example 6

Partnership is liquidated

	<u>Partner's Basis in Partnership</u>	<u>FMV of Partner's Interest</u>	
Partner B	55	50	
Assets received by B	<u>Partnership's Basis</u>	<u>FMV</u>	<u>Appreciation</u>
Asset Y	5	40	35
Asset Z	10	10	0

Partner's basis is 55.

Partnership's basis in assets is 15.

So we have to write up the basis by 40.

Step 1 – write up to FMV

	<u>Basis</u>	<u>FMV</u>	<u>Appreciation</u>
Asset Y	5	+35 =	40
Asset Z	10	+0 =	<u>10</u>
			50

Step 2 – allocate remaining basis of 5 based on FMV

	<u>Step 1 Basis</u>	<u>Step 2 Adjusted</u>	<u>Final Basis</u>
Asset Y	40 +	5 x 4/5 =	44
Asset Z	10 +	5 x 1/5	<u>11</u>
			<u>55</u>

II. Mixing Bowl:

A. §737 can cause a partner to recognize gain on the receipt of a distribution of property (other than money) which he did not contribute to the partnership. It operates in conjunction with 704(c).

§704(c)(1)(A) provides that income, gain, loss and deductions with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take into account the variations between the basis of the property to the partnership and the fair market value at the time of contribution.

Example 7

A B partnership contributions

	<u>FMV</u>	<u>Basis</u>
A	100	100
B	100	0

Property contributed by B is sold for 100. All of the gain is allocated to B under §704(c)(1)(A). §704(c)(1)(B) provides that if any property so contributed is distributed (directly or indirectly) by the partnership (other than to the contributing partner) within 7 years of being contributed, the contributing partner shall be treated as recognizing gain or loss from the sale of such property in an amount equal to the gain or loss which would have been allocated to such partner under §704(c)(1)(A) if the property had been sold at its fair market value at the time of the distribution.

Example 8

ABC partnership: each Partner contributed

<u>Partner</u>	<u>FMV</u>	<u>Basis</u>
A	100	50
B	100	20
C	100	100

Property contributed by B is distributed to A in complete liquidation of A's interest in the partnership. B incurs a gain of 80 under §704(c)(1)(B).

B. §737 was added to the Internal Revenue Code as a back-up to §707(c)(1)(B).

If in example 8, B's interest were redeemed, and at a later date the property contributed by B were distributed to one of the other partners, it is no longer possible to allocate the gain attributable to the property contributed by B to B under §707(c)(1)(B).

§737 provides that if a partner contributes appreciated property to the partnership and within 7 years of the contribution he receives a distribution of other property, he must recognize gain (but not loss) equal to the lesser of:

1. The excess of the FMV of property other than money received over his adjusted basis in the partnership immediately before the distribution reduced by money received; or
2. The net precontribution gain of the partner which is defined as the net gain that the partner would have recognized under §704(c)(1)(B) if at the time of the §737 distribution all §704(c) property contributed by the partner within 7 years of the distribution that is still held by the partnership were distributed to another partner.

Example 9

Partnership ABC

On formation, they contribute the following property

	<u>Basis</u>	<u>FMV</u>
A	10	90
B	90	90
C	90	90

Within 7 years of the formation, A's interest is redeemed with an asset which has a FMV of 100. At the time of the redemption A's basis in the partnership is 40. At the time the partnership still holds the property contributed by A.

§737

Gain is lesser of:

1. Excess of FMV of distributed property, over A's basis in partnership:

FMV	100
A's basis	<u>40</u>
	60

2. Net Precontribution Gain (assumes property is non-depreciable).

FMV at time of Contribution	90
Basis at time of Contribution	<u>10</u>
	80

The §737 gain is 60.

C. Liabilities and cash are taken when into account in calculating the excess of the FMV of the distribution over partner's basis in the partnership.

Example 10

ABC Partnership

<u>Partner</u>	<u>Contribution</u>	<u>FMV</u>	<u>Basis</u>
A	land	10,000	4,000

ABC acquires property X, with FMV of 9,000 and is subject to non-recourse liability of 9,000.

Within 7 years

A receives X in partial liquidation, which has a FMV of 9,000, subject to 9,000 liability which A assumes, and cash of \$2,000.

A's basis in Partnership

<u>Original Basis</u>	<u>A's Share of P/S Liability</u>	<u>A's Share of P/S Liability</u>	<u>Liability</u>	<u>Cash</u>	
4,000	+3,000	-3,000	+ 9,000	- 2,000	= 11,000

Since his 11,000 basis is greater than FMV of distributed property of 9,000, A has no distribution of property with a FMV in excess of his partnership basis.

D. Net Precontribution Gain when depreciable Property is contributed is calculated by taking into account differences between book value and tax basis.

Example 11

ABC Partnership

A contributed for a 1/3 interest:

<u>Description</u>	<u>FMV</u>	<u>Basis</u>
Dep. prop X	30,000	20,000

Depreciation over the next three years:

Book Depreciation: 9,000 (3,000/yr)

Tax Depreciation: 6,000 (2,000/yr)

Under §704(c), A's allocation of depreciation is book depreciation of 1,000/yr, or 3,000 but he receives no tax depreciation.

At the end of three years, A's partnership interest is redeemed with a property Y with FMV of 30,000 and tax basis of 30,000.

Prior to the liquidation, A's basis in the partnership was 20,000.

1. The excess of FMV over basis in Partnership is

30,000
<u>20,000</u>
10,000

2. Net precontribution gain under §704(c)(1)(B) in contributed property is equal to the difference between the book value and tax basis after depreciation:

At the time of contribution, precontribution gain was 10:

Book value		30,000
Tax basis		<u>20,000</u>
		10,000

After 3 years, precontribution gain:

Original Book Value		30,000
Less Book Depreciation		<u>9,000</u>
Book Value at end of 3 years		21,000
Original basis	20,000	
Tax depreciation		<u>6,000</u>
Tax Basis at end of 3 years	<u>14,000</u>	
Difference is the Precontribution gain		7,000.

A's §737 gain is lesser of:

1. Excess of FMV over basis in partnership, 10,000.
2. Net Precontribution gain of 7,000.

Property Y in hands of A has a basis of 27,000:

A's Basis in P/S at redemption	20,000
A's §737 gain	<u>7,000</u>
	27,000

If the property had been fully depreciated for both book and tax purposes, then no §737 gain:

1. Original Book Value	30,000	
Book Dep.	<u>30,000</u>	
Book value at redemption		0
2. Original basis	20	
Dep.	<u>20</u>	
Basis at redemption		<u>0</u>
Net Precontribution gain		0

E. If the partnership distributes contributed property to a non-contributing partner, and other property to the contributing partner such that both §704(c)(1)(B) and §737 apply, apply §704(c)(1)(B) first.

Example 12

A contributes to the Partnership properties X1 and X2:

<u>Partner</u>	<u>Contribution</u>	<u>FMV</u>	<u>Basis</u>
A	X1 (nondep.)	10,000	6,000
	X2 (nondep.)	10,000	6,000

His basis in the partnership is 12,000 and his precontribution gain is 8,000 (4,000 + 4,000).

Within 7 years A receives Y with a FMV and basis of 20,000 in liquidation of his interest and at the same time X1 is distributed to another partner.

First, 704(c)(1)(B) gain to A of 4,000 due to distribution to the other partner.

A's partnership increases from 12,000 to 16,000.

Then A's net precontribution gain is reduced from 8,000 to 4,000.

Second, apply §737.

A's §737 gain is lesser of:

1. FMV of prop received	20,000
A's partnership basis	<u>16,000</u>
	4,000
2. Net Precontribution gain	
Value of X2 at contribution	10,000
Basis of X2	<u>6,000</u>
	4,000

A has gain of 4,000.

A's basis in Partnership becomes 20,000 (12,000 + §704(c)(1)(B) gain of 4,000 + §737 gain of 4,000).

Upon redemption, he receives 20,000 basis in Y.

F. Exception to Mixing Bowl Rules: Previously Contributed Property

§737(d) – Previously Contributed Property

If property contributed by a partner is distributed to that same partner, that property is not taken into account in applying §737(a), regardless of whether such property was contributed within 7 years.

Example 13

A contributes

	<u>Value</u>	<u>Basis</u>
X1	20,000	10,000
X2	10,000	6,000

Within 7 years A is redeemed with X2 and Y. Y has a value of 20,000. Because X2 was contributed by A, it is disregarded for purposes of §737.

The basis of X2 to A is determined independently of the rest of the distribution.

A receives a 6,000 basis in X2. A's basis in partnership is reduced from 16,000 to 10,000.

The §737 gain is the lesser of:

1. 20,000 (value of Y) less
10,000 basis in partnership, or 10,000 or
2. X1 20,000 (value) less 10,000 (basis), or 10,000.

G. Anti-Stuffing Rule (Reg §1.737-2(d)(2))

If a partner contributes an entity to the partnership and the partnership contributes additional property to the entity, the additional property contributed by the partnership to the entity is not subject to the previously contributed property exception, unless the contributed property to the entity was contributed by the partner who contributed the entity to the partnership.

Example 14

A contributes:

	<u>Value</u>	<u>Basis</u>
X	10,000	5,000
Stock in M	500	500

Partnership contributes property with value and basis of 10,000 to M in a §351 transaction.

A receives stock in M in liquidation of his interest.

Without the exception to the exception, there would be no §737 gain to A. However, the 10,000 contributed to M is ignored, for purposes of the exception, and A has §737 gain of 5,000.

H. The Partner's Basis in distributed property is increased by the §737 gain and the basis of the §704(c) property remaining in the partnership is increased by the §737 gain.

Example 15

A contributes:

	<u>FMV</u>	<u>Basis</u>
X	10,000	5,000

A receives Y, value of 10,000, in liquidation of his interest.

A has §737 gain of 5,000 and 10,000 basis in property Y (5,000 basis and 5,000 gain).

The basis of §704(c) property remaining in the partnership after a §737 gain is increased under §737(c)(2) to reflect the §737 gain. The §704(c) property is eligible for the increase in basis if:

1. It was included in the computation of net precontribution gain.
2. It has a FMV at the time of the §737 distribution that exceeds its basis.

3. It would produce the same character of gain on a sale by the partnership to an unrelated party as the character of any of the gain recognized by the distributee partner under §737, and
4. It is not distributed to another partner as part of the same plan as the §737 distribution.

Treas. Reg. §1.737-3(c)(2).

Reg. §1.737-3(c)(3) provides the method of allocating the adjustment among §704(c) properties. In example 13, the basis of the 704(c) property, X, is increased by the 5,000 §737 gain, in the hands of the partnership.

I. Reg. §1.737-4(a) contains anti-abuse rules. If a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of §737, the Service can recast the tax results as appropriate to achieve the purpose of §737. For example, as per legislative history, if prior to a §737 distribution, a partner attempts to inflate his partnership basis by contributing property to the partnership to eliminate an excess distribution (FMV of property received over partner's basis in partnership) and all economic risks of newly contributed property are retained by the contributing partner under the partnership agreement, then the Commissioner can disregard the contribution.

J. How do we avoid §737?

1. Wait 7 years.
2. Previously contributed property exception.

Can this exception be used by a transferee or a decedent's heirs? Reg §1.737-1(c)(2)(iii)

– “The transferee of all or a portion of a contributing partner's partnership interest succeeds to the transferor's net precontribution gain, if any, in an amount proportionate to

the interest transferred. See §1.704-3(a)(7) and §1.704-4(d)(2) for similar provisions in the context of Section 704(c)(1)(A) and Section 704(c)(1)(B).”

Reg. §704-4(d)(2) – “The transferee of all or a portion of the partnership interest of a contributing partner is treated as the contributing partner for purposes of section 704(c)(1)(B) and this section to the extent of the share of built-in gain or loss allocated to the transferee partner; See §1.704-3(a)(7).”

3. It has been suggested that a §754 election will reduce net precontribution. If this is the case, after death of partner, §754 election may alleviate the problem but may not eliminate it due to the valuation discount of the partnership interest of the deceased.

Example 16

Father, son and daughter form partnership. At the time of formation they each contribute an undivided interest in property which they previously owned:

<u>Partner</u>	<u>% Int.</u>	<u>FMV of Contributed Property</u>	<u>Basis</u>	<u>Pre Cont. Gain</u>
father	(2/3)	133,333	66,666	66,666
son	(1/6)	33,333	16,666	16,666
daughter	(1/6)	<u>33,333</u>	<u>16,666</u>	<u>16,666</u>
	100%	200,000	100,000	100,000

Father dies. The property is still worth 200,000. With discount, his Partnership interest is valued at 80,000 (40% discount from 133,333). The §754 election is made and previously contributed property exception does not apply to father’s heirs per literal language of the regulations.

After death

	<u>% Int.</u>	<u>FMV of Property</u>	<u>§754 Adj. Basis</u>	<u>Pre Cont. Gain</u>
Father's Estate	2/3	133,333	80,000	53,333
Son	1/6	33,333	16,666	16,666
Daughter	<u>1/6</u>	<u>33,333</u>	16,666	16,666
	<u>100%</u>	<u>200,000</u>		

§754 election reduced father's estate's pre-contribution gain from 66,666 to 53,333. Children can use previously contributed property exception for their 1/6 interest.

If at father's death FMV of partnership's property increases to 400,000:

	<u>% Int.</u>	<u>FMV of Property at Time of Contribution</u>	<u>§754 Adj. Basis</u>	<u>Pre Cont. Gain</u>
Father's Estate	2/3	133,333	159,999*	0
Son	1/6	33,333	16,666	16,666
Daughter	1/6	<u>33,333</u>	16,666	16,666
		200,000		

In this case, nobody has §737 gain. Children have previously contributed property exception.

*400,000

x 2/3 (father's interest in partnership)

x.6 (40% disc)

159,999

III. Distributions of Marketable securities - §731(c).

A. Marketable securities are treated as money for purposes of §731(a), unless one of the exceptions applies.

B. Marketable securities are defined in §731(c)(2) to include financial instruments and foreign currencies, which are as of the date of the distribution actively traded within the meaning of section 1092(d)(1). The code then provides that the following are also marketable securities:

- Interests in a common trust fund or regulated investment company.
- Any financial instrument that, pursuant to its terms or any other arrangement, is readily convertible into or exchangeable for, money or marketable securities.
- Any financial instrument the value of which is determined substantially by reference to marketable securities.
- Interests in precious metals that are actively traded unless produced, used, or held in the active conduct of a trade or business of the partnership.
- Interests in any entity if 90% or more of the assets of the entity consist of marketable securities, money, or both.
- Any interest in an entity in which at least 20%, but less than 90%, of the entity's assets consist of marketable securities, money, or both – but only to the extent of the value of the interest that consists of marketable securities, money, or both.

C. Exceptions under §731(c)(3):

1. Distributions of a security to a partner who contributed the security to the partnership.
2. Security acquired by a partnership in a nonrecognition transaction in which less than 20% of the value of the property given up consisted of marketable securities and money, and

the marketable securities are distributed within 5 years of the date of the nonrecognition transaction or if later, the date on which the securities became actively traded.

3. The distributed security was not marketable on the date acquired by the partnership and the entity to which the security relates had no outstanding marketable securities on that date, the security was held by the partnership for at least 6 months before it became marketable, and the security was distributed within five years of the date it became marketable.

Under Reg §731-2(d)(2) the above 3 exceptions are subject to an anti-stuffing rule. They do not apply to the extent that 20% or more of the value of the distributed security is attributable to marketable securities or money contributed, directly or indirectly, by the partnership to the entity to which the distributed security relates after the security was acquired by the partnership (other than marketable securities contributed by the partnership that were contributed to the partnership by the partner receiving the distribution of marketable securities).

4. A distribution of a marketable security acquired by the partnership in a nonrecognition transaction in exchange for another security to the extent that that other marketable security would have come under any of the above 3 exceptions immediately prior to the nonrecognition transaction.
5. A distribution from an investment partnership to an eligible partner. An investment partnership is one which has never been engaged in a trade or business and substantially all of its assets have always been investment assets as specified in §731(c) (3) (C) (i). An eligible partner is one who did not make any contributions to the partnership other than investment assets.

6. §731(c) will not apply to the extent the partner receives his or her distributive share of the partnership's gain in marketable securities. Partner's distributive share of gain is equal to:

- a. Partner's share of net gain that would be recognized if the partnership sold all of its marketable securities immediately before the distribution, minus
- b. Partner's share of net gain attributable to the marketable securities that continue to be held by the partnership immediately after the distribution.

Example 17

Partnership owns

	<u>Basis</u>	<u>FMV</u>	<u>Gain in stock</u>
Marketable securities	3,000	30,000	27,000

Partner is a 1/3 partner.

Partner's partnership basis is \$5,000.

He receives all of the marketable securities, which do not come within any of the first 5 exceptions in complete liquidation of his partnership interest.

Partner gain:	Cash	30,000
	Basis in Partnership	<u>5,000</u>
		25,000

Partner is a 1/3 partner.

The 25,000 gain is reduced by:

1. Partners' share of gain before distribution $1/3 \times 27,000 = 9,000$, minus
2. Partner's post distribution share of gain

(He is no longer a partner and has no	
share of post-distribution gain)	<u>-0</u>
	9,000

Partner's gain on liquidation is

25,000

-9,000

16,000

Partner's Basis in securities: 5,000 (original basis in partnership)

+16,000 (gain)

21,000

If distribution involves §731(c) and §704(c) and/or §737 apply those sections in the following order:

1. §704(c)(1)
2. §731(c)
3. §737

Reg §1.731-2(g) (1) (i)

D. Anti-Abuse Rule

Reg 1.731-2(h) provides that if a principal purpose of a transaction is to avoid §731(c), the Service can recast the transaction as appropriate.

IV. Hot Assets:

A. §751(b) applies to distributions that alter the partner's interest in unrealized receivables and substantially appreciated inventory. Substantially appreciated inventory is an inventory item where the fair market value exceeds 120% of the adjusted basis to the partnership.

The point of reference is the value, not the basis of the §751 property. Reg §1.751-1(b)(1)(ii). If §751 assets are distributed to two equal partners, with one partner receiving a §751 asset with a value of 100 and basis of 5, and the other partner receiving a §751 asset with a value of 100 and a basis of 100, §751 does not apply. For §751(b) to apply, the change in the partner's interest in §751 property must result in a corresponding change in his interest in other partnership assets.

B. Exceptions for §751(b):

- §736(a) payments to a retiring partner (guaranteed payments or payments for distributive share of partnership income).
- Distribution of property which the partner contributed to the partnership.
- Current drawings or advances against the partner's distributive share, or a distribution which is a gift or payment for services or for the use of capital. Reg Sec. 1-751-1(b)(1)(ii).

C. Unrealized receivables are defined in §751(c) to include:

1. Receivables not previously included in income for goods that are not capital assets or for services.
2. Depreciation recapture under §1245.
3. Excess depreciation recapture under §1250.
4. Mining exploration recapture under §617(d).
5. Recapture of soil and water conservation expenditures under §1252.
6. DISC income recapture under §995(c).
7. Recapture of accumulated earnings and profits with respect to controlled foreign corporations under §1248(a).
8. Gain treated as ordinary income from franchise, trademark or trade name under §1253(a).

9. Recapture with respect to oil, geothermal or other mineral properties under §1254(a).
10. Accrued market discount under §1276 on market discount bonds.
11. Ordinary income attributable to short term obligations under §1283.

D. Inventory Items are defined in §751(d).

1. Stock in trade, inventory and property held primarily for sale to customers in the ordinary course of partnership business.
2. Any other property, which on its sale or exchange would be considered property other than a capital asset and other than as described in §1231.
3. Any other partnership property which if held by the selling or distributee partner would be property of the type described in 1 or 2, above. Thus inventory includes accounts receivable. Reg §1.751-1(d)(2)(ii). This would mean that unrealized receivables are taken into account in determining whether inventory is substantially appreciated, but the validity of the regulation has been questioned by commentators.

In order for inventory to come within §751(b), it must be substantially appreciated which means that its fair market value must be 120% of its adjusted basis. There is no similar substantially appreciated requirement for purposes of §751(a). Section 751(b) contains an anti-abuse rule under which an inventory acquired for a principal purpose of avoiding the 120% requirement is excluded from the 120% computation. §751(b)(3)(B).

§751(b) converts distributions into taxable exchanges of §751(b) property for other partnership property through a deemed distribution of the §751 assets followed by a deemed exchange.

Example 18

ABC Partnership

<u>Assets</u>	<u>FMV</u>	<u>Basis</u>
Cash	90,000	90,000
Inventory	90,000	45,000

C has a 45,000 basis in his partnership interest and he is redeemed for 60,000 cash. He has a 1/3 interest in the partnership.

Under §751(b), the following steps are deemed to have taken place:

1. C is deemed to have received a current distribution of 1/3 of the inventory, with a 15,000 basis and FMV of 30,000.
2. C is deemed to have sold his inventory back to the partnership for 30,000 cash and realizes ordinary income of 15,000.
3. Partnership is treated as having purchased C's share of inventory for 30,000 and receives a 15,000 step up in its basis in the inventory from 45,000 to 60,000.
4. C's basis in his partnership interest is now 30,000 (45,000 original basis less 15,000 basis in inventory).
5. C receives a cash distribution of 30,000 and has no further gain.
6. If ABC owned cash and unrealized receivables instead of cash and inventory, the distribution of cash will be treated as §736(a) payment if C was a general partner and capital was not a material income producing factor, §751(b) will be inapplicable and the portion of the distribution in exchange for C's interest in the receivables is a guaranteed payment under §736(a)(2), includable in C's ordinary income and deductible by the

partnership. §736(b)(2) and (3). Under §736(b)(2) & (3), payments for unrealized receivables are §736(a) payments if the partner is a general partner and capital is not a material income-producing factor for the partnership.

E. Any gain realized by the partnership on the deemed sale is allocated only to the partners other than the distribute-partner and separately taken into account under Section 702(a)(8). Reg Sec. 1-751-1(b)(2)(ii) & (3)(ii).

F. Relationships of §751 to §704(c) and §737.

Since the §751 regulations were published in 1956, well before §704(c) was enacted, they make no reference to §704(c) and provide no guidance as to how §751 should work in relation to §704(c). Presumably, if a partner contributes §751 property to a partnership which is wholly allocated to him, that property should be excluded from the §751(b) exchange since it is taxable to the contributing partner under §704(c). In Notice 2006-14, the IRS invites public comments on potential revisions to the §751(b) regulations, including the interaction between §751(b) and §704(c). The notice suggests that in the case of partial redemptions of a partnership interest, §704(c) principals could be applied to preserve a partner's share of pre-liquidation gain attributable to §751 assets, reducing the application of §751(b).

§737(d)(2) provides that §737 shall not apply to the extent §751(b) applies.

G. Application of §751(b) to complete liquidation of Partnerships.

Literally, language of §751(b) could be read to not apply to complete partnership liquidation because the sale or exchange between the distribution and the partnership (as constituted after the distribution) could not take place because there is no partnership after the distribution. The Service's position is that §751(b) applies to a complete liquidation. Rev. Rul 77-412; Rev. Rul 57-68 (by implication); PLR 90 35040.

However, the regulations do not provide mechanics for a complete liquidation and the exact procedure is uncertain.

Approaches:

1. Assume partners withdraw one at the time. However, this method can lead to different results depending on the order of withdrawal.
 2. Assume each partner receives a proportionate share of partnership assets and then engages in exchanges to the extent necessary to give each partner the property he actually received. However, this method contravenes the express language of the statute which provides for an exchange between the partner and the partnership.
 3. Assume all partners withdraw simultaneously receiving the actual assets they ultimately receive, calculate with respect to each partner the income arising to the partnership from the §751(b) exchange and allocate the §751(b) income to all partners, increase the basis of the partnership interest of the partners and the basis of the assets with respect to which the partnership realized income. Then compute the consequences to the partners of the distributions, giving effect to the basis adjustments. However, this method can cause distortions of income under certain fact situations. For example, a partner receiving a pro rata share of §751 assets can be hit with §751(b) gains from transactions relating to other partners.
- H. §735 – character of gain or loss on sale of §751 property received by the partner.
1. Gain or loss on unrealized receivables – ordinary.
 2. Gain or loss on inventory – ordinary if sold within 5 years of distributions (no substantial appreciation requirement for ordinary income to apply).

III. Conclusion

Taxpayers may find themselves in positions where their limited partnership has outlived its usefulness. As a result of the current \$5 million estate tax exemption, the discounts associated with a limited partnership interest can be a disadvantage if the estate is fully sheltered by the exemption. As a general rule, a limited partnership can be liquidated without the recognition of gain or loss. However, to assume a non-taxable liquidation the taxpayer must be aware of the above exceptions and avoid getting trapped by them.