1999 Income Tax School

LIMITED LIABILITY COMPANIES AND PARTNERSHIPS

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This chapter treats limited liability companies as if they were partnerships. There are really only a few exceptions to this rule. First, a limited liability company may have one or more owners, referred to as "members." A partnership, by contrast, must have at least two owners. Therefore, a one-owner limited liability company cannot be a partnership. Second, as discussed below under "Elections," a limited liability company can elect to be treated as an association (corporation) for federal income tax purposes

The following topics concerning partnerships and limited liability companies are discussed:

- Partnership elections
- Distributions and retirement of a partner
- Precontribution gains and losses
- Basis and hot assets, after the Taxpayer Relief Act of 1997
- Worksheets to keep track of outside basis

A. ELECTIONS

1. "CHECK THE BOX" ELECTION

Federal income tax law provides default classifications for limited liability companies.

- In general, an unincorporated domestic organization with two or more owners receives a default classification as a partnership. The proper reporting is on Form 1065, with a Schedule K-1 for each member.
- A domestic organization with only one member is not regarded as a separate organization for tax purposes. It is treated as a proprietorship if it is owned by an individual. Thus all income, deductions, etc., are reported on Schedule C (Form 1040) or Schedule F (Form 1040).
- If a single-member limited liability company is owned by a corporation or other business entity, it is treated as a branch or division [Treas. Reg. §301.7701-3(b)].

Any unincorporated organization may elect out of its default status. Thus, a domestic organization may elect to be classified as a corporation for tax purposes, and a foreign organization could go either way. The election must be filed on Form 8832 within 75 days following the date on which the status is to be effective [Treas. Reg. §301.7701-3(c)(1)(i)]. An entity may not file an election to change its status until 60 months have expired since the last election [Treas. Reg. §301.7701-3(c)(1)(ii)].

Observation. It is a rare instance in which a domestic limited liability company will not want to be treated as a partnership for federal income tax purposes, if it has more than one member. Accordingly, this possibility is not discussed any further in this chapter.

2. I.R.C. §754 BASIS ADJUSTMENT ELECTION

A partnership or limited liability company can make a special election to adjust the basis of its assets (referred to as "inside basis") after certain events:

- The sale of an interest from one owner to another, where the new owner takes on a basis different from that of the seller. It also applies where a partner or member dies, and the deceased person's estate (or other successor) takes on a new basis equal to the value of the interest for estate tax purposes.
- Distribution situations in which a partnership or limited liability company may adjust the basis of its assets following a distribution of partnership property. These occur when a partner or member recognizes gain or loss as a result of a distribution, or when the company distributes noncash property to an owner and the property takes a new basis to the recipient.

a. Need for the Election

Example 1 begins the explanation of the problem surrounding a sale of an interest in a limited liability company (partnership for tax purposes).

Example 1. Sam sells his one-third interest in Jaguar, LLC. Jaguar conducts a service operation on the cash basis. Sam's basis in the limited liability company interest is $46,000, after adjustment for all items of income, loss, and distributions to the date of the sale.

The company's balance sheet immediately before the sale shows the following.

Assets	Basis	FMV
Cash	$ 30,000	$ 30,000
Receivables	0	60,000
Equipment	63,000	72,000*
Land	45,000	87,000
	$138,000	$249,000
Liabilities	0	15,000
Capital, Sam	46,000	78,000
Capital, Terry	46,000	78,000
Capital, Zoe	46,000	78,000
	$138,000	$249,000

*All of the difference between basis and fair market value is depreciation recapture.

Sam receives $78,000 cash from Alice, the buyer. Alice also assumes Sam's share of liabilities, or $5,000. Alice's basis becomes $78,000, which is exactly one-third of the fair market value of the company's assets, net of the company's unbooked liabilities. This is her **outside basis** at the date of acquisition. In essence, Alice has purchased one-third of the assets at their fair market value.

Sam will report a gain on the sale, which will be allocated between ordinary income and capital gain (see discussion of "hot assets," below). His gain will be the $32,000 difference between the $78,000 amount received from Alice and his $46,000 outside basis at the time of sale.

Assume that the company does not have an election in effect under I.R.C. §754. If the company should immediately sell all of its assets at their fair market value and paid its cash-method liabilities, the company would report $96,000 of gains and income ($249,000 fair market value, less $138,000 adjusted basis of assets, less payment of the $15,000 liabilities). Alice's share would be $32,000. Thus the gain, which was already reported by Sam on the sale of the partnership interest to Alice, is again reported by Alice when the company sells its assets.

An I.R.C. §754 election would allow Jaguar to adjust the basis of its assets for the benefit of Alice, following her admission to the company. Therefore, the gain would not be taxed twice.

b. Procedures for the I.R.C. §754 Election

The partnership or limited liability company must file an election with Form 1065 for the first year in which it is to take effect [Treas. Reg. §1.754-1(b)(1)]. The Form 1065 must be filed timely, including extensions. There is no prescribed form, but a written statement must be included with the return.

Statement of I.R.C. §754 Election

The Jaguar limited liability company (a partnership for federal income tax purposes), FEIN #########, elects under Internal Revenue Code section 754 to apply the provisions of section 734(b) and section 743(b) to make special basis adjustments for the transfer or liquidation of an interest in the company, or for certain distributions of property to a member.

The election is binding on all future years. It may be revoked only with permission of the IRS. The IRS lists the conditions under which it will normally grant a revocation in Treas. Reg. §1.754-1(c). The partnership or limited liability company must demonstrate that retention of the I.R.C. §754 election will result in an increased administrative burden due to one of the following conditions:

- A change in the nature of the business
- A substantial increase in the assets
- A change in the character of the assets, or an increased frequency of retirements or shifts of ownership interests

The IRS will not grant a revocation if the primary purpose of the revocation is to avoid stepping down the basis of assets.

c. Adjustment Following Sale or Exchange or Transfer at Death

Code §754 provides no mechanism for actually achieving its results. Code §743(b) governs the basis adjustment following the sale of an interest or death of an owner. There is a bit of logical inconsistency in the basis adjustments following sale or death. The adjustments are made by the partnership or limited liability company, but they affect only the incoming partner or member.

The I.R.C. §743(b) adjustments focus on the difference between the new owner's outside basis and the new owner's share of inside basis of the assets of the partnership or limited liability company. If the new owner's outside basis exceeds his or her share of inside basis, the entity adjusts the inside basis of its assets upward, so that the new owner's share of inside basis is the same as his or her outside basis.

Conversely, if the new owner's outside basis is less than his or her share of inside basis, the entity must reduce the basis of its assets, so that inside and outside bases to the new owner are equalized. [If the entity has a mix of assets that have appreciated and depreciated at the time of a transfer, the rules for allocation need further explanation (see Treas. Reg. §1.755-1 and Prop. Reg. §1.755-1).] When all of the assets have depreciated or all of the assets have appreciated, however, the entity merely adjusts each asset's basis. The continuation of Example 1 shows the effect of a basis adjustment after the sale of an interest in a partnership or limited liability company.

Example 1 (continued). After the admission of Alice as a member, Jaguar's balance sheet, at tax basis, would appear as follows, without an I.R.C. §754 election in effect.

	Basis	FMV
Assets		
Cash	$ 30,000	$ 30,000
Receivables	0	60,000
Equipment	63,000	72,000
Land	45,000	87,000
	$138,000	$249,000
Liabilities	0	15,000
Capital, Alice	46,000	78,000
Capital, Terry	46,000	78,000
Capital, Zoe	46,000	78,000
	$138,000	$249,000

Note that Alice's capital account remains at $46,000 – the same as Sam's. This is true even though she just paid $78,000 for Sam's interest. With an I.R.C. §754 election in effect, however, the company will adjust the basis of each appreciated asset and liability to bring the basis in line with the member's capital at book value. The aggregate adjustment is $32,000. In this example, Jaguar would increase the basis by one-third of the difference between the old basis and the fair market value of each asset, since Alice has purchased a one-third interest in each asset. The balance sheet, shown using tax basis, after the I.R.C. §754 election follows:

	Basis	FMV
Assets		
Cash	$ 30,000	$ 30,000
Receivables	0	60,000
I.R.C. §743 (b) adjustment	20,000	
I.R.C. §743 (b) adjustment	(5,000)*	
Equipment	63,000	72,000
I.R.C. §743 (b) adjustment	3,000	
Land	45,000	87,000
I.R.C. §743 (b) adjustment	14,000	
	$170,000	$249,000
Liabilities	0	15,000
Capital, Alice	78,000	78,000
Capital, Terry	46,000	78,000
Capital, Zoe	46,000	78,000
	$170,000	$249,000

*This negative adjustment to the cash method receivables reflects Alice's share of the cash method liabilities. When the company pays the liabilities, this adjustment will have the effect of disallowing the deduction to Alice.

The basis adjustments posted to the receivables, equipment, and land would only be for the benefit of Alice. For example, when Jaguar collects the receivables, it will post ordinary income of $60,000, in total, to the members' capital accounts, and report the same on each Schedule K-1, Form 1065. Thus Alice will be allocated $20,000 ordinary income from the receivables, along with each of the other

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members. Alice, however, will also be allocated an ordinary deduction of $20,000 resulting from the I.R.C. §743(b) adjustment, which will offset her income from these receivables in full.

Jaguar would also allocate the $3,000 adjustment to the equipment entirely to Alice. Thus, if the company sold the equipment immediately, Alice would be able to offset her share of the gain (or increase her share of the loss) from the sale with the $3,000 basis adjustment. If the company did not sell the equipment, it would depreciate the $3,000 basis adjustment as if it were depreciable property placed in service on the date of Alice's purchase from Sam. The depreciation on this "asset" would be allocated entirely to Alice.

d. Basis Adjustments Following a Distribution

The I.R.C. §754 election also covers basis adjustments following certain distributions of property to partners or limited liability company members. The procedures are somewhat different from those shown above. They are covered in a later portion of this chapter.

3. OTHER PARTNERSHIP OR LIMITED LIABILITY COMPANY ELECTIONS

Among the permanent elections that must be made by the entity are the overall accounting method (cash or accrual) and the inventory method (FIFO, LIFO, etc.). The partnership or limited liability company will be treated in the same manner as any other taxpayer, and will not generally be allowed to change accounting methods without permission.

From year to year, there are other elections that any taxpayer must make. These elections include:

- Electing out of the installment method on applicable sales
- Deferral of gain on involuntary conversions
- Treatment of income from discharge of indebtedness

These elections are all made by the entity itself, and thus govern the income and deductions reported by each partner or member. There are a few owner-level elections with respect to items that flow through from the business entity. Each owner can elect (or not elect):

- The optional 10-year write-off of tax preferences [I.R.C. §59(e)(4)]
- Treatment of any foreign income tax paid by the business, as a credit or as a deduction on the owner's tax return
- To itemize deductions, which allows the owner to deduct his or her share of LLC or partnership items that are treated as itemized deductions

B. DISTRIBUTIONS TO RETIRING PARTNER OR DECEASED PARTNER'S SUCCESSOR

1. NONRECOGNITION OF GAIN OR LOSS ON DISTRIBUTIONS

In most cases, a partnership or limited liability company does not recognize any gain on the distribution of property to an owner [I.R.C. §731(b)]. Similarly, the owner who receives the distribution recognizes no gain on the distribution, even if the fair market value of the property exceeds the owner's basis in his or her company interest [I.R.C. §731(a)(1)]. This is in marked contrast to the S corporation rules, which require the corporation to recognize gain on the distribution of appreciated property in the same manner as a C corporation. The owner who receives the distribution takes the company's predistribution basis in the property into account [I.R.C. §732(a)(1)]. The owner reduces basis in the company interest by this amount, unless the owner's predistribution basis in the company interest was less. In that case, the owner reduces his or her basis in the company interest to zero [I.R.C. §733(2)]. There are several exceptions to the general nonrecognition rules for partnership and limited liability company distributions.

2. EXCEPTIONS TO NONRECOGNITION RULE

a. If a partner or member receives cash, and the cash exceeds the recipient's predistribution basis in the business, the recipient must recognize gain [I.R.C. §731(a)]. Note that a "receipt of cash" includes a reduction of the partner's or member's share of the business debts [I.R.C. §752(b)]. This may be termed a "phantom distribution," since it does not result in the distribution of a tangible asset. Note that the term "cash" generally includes marketable securities distributed to the partner or member, although there are some exceptions to this rule in I.R.C. §731(d).

b. If the partner or member receives cash, accounts receivable, or inventory of the business (including any combination of these properties) and the entity's basis in these assets was less than the owner's basis in his or her interest, the recipient may recognize loss. However, this applies only if the recipient receives no other property from the business, and the distribution is in complete liquidation of the owner's interest in the business.

c. If a partner or member contributes property and receives a distribution of cash or property from the partnership or limited liability company within two years, and if the contribution of property and the distribution to the owner are essentially two legs of one transaction, the contribution and distribution are a "disguised sale" [I.R.C. §707(a)]. There are rather complicated amplifications, exceptions, and limitations to this rule in the regulations under I.R.C. §707.

d. If a partner or member contributes property to the company, and within seven years this same property is distributed to another partner or member, the person who contributed the property may be required to recognize gain or loss at the time of the distribution [I.R.C. §704(c)(1)(B)].

e. If a partner or member contributes property to the organization and the same person receives other noncash property from the business within seven years, the recipient may be required to report some or all of the deferred gain on the original contribution [I.R.C. §707(a)].

f. If a distribution to a partner or member alters that person's share of "hot assets," also known as I.R.C. §751 property, the portion of the distribution attributable to the alteration of this interest is treated as a fully taxable sale between the recipient and the business [I.R.C. §751(b)]. This is an inordinately complex set of rules that requires many assumptions.

There are special rules covering distributions to a retired partner or deceased partner's successor in interest. This is one of the few areas in the tax law where it may be necessary to distinguish a general partner from a limited partner. This is also one of the areas where the status of a member in a limited liability company is not clearly defined. These areas of uncertainty are dealt with directly next, along with some suggestions for defensible positions on the tax returns of the various parties involved.

3. WHO IS A RETIRED PARTNER?

A partner is retired when he or she is no longer a partner under local law [Treas. Reg. §1.736-1(a)(1)(ii)]. Under I.R.C. §736, however, that person is considered a partner, rather than an outsider, until his or her interest in the partnership has been completely liquidated. Until that time, the person is still treated as a "partner" for tax purposes. In essence, a retiring partner is somewhere between a partner and a nonpartner.

Example 2. Phil ceases to be a partner, under local law, in the JKP partnership on April 22, 1999. The partnership will buy out his interest in several installments, which will end on April 22, 2005. Up to April 22, 1999, Phil is a partner for all purposes. After April 22, 2005, Phil is not a partner in any sense of the word. Between the two dates, he is a retiring partner.

4. WHO IS A SUCCESSOR IN INTEREST?

A deceased partner's successor in interest is one who has rights to the deceased partner's partnership profits or capital, but is not a partner under local law [Treas. Reg. §1.736-1(a)(1)(i)]. This event may occur when a member of a professional partnership dies. The estate or other successor may have no desire, and may lack the professional qualifications, to be a full-fledged member of the partnership. However, this person is treated as a partner for federal income tax purposes, if he or she has an enforceable economic right to an interest in partnership property.

5. HOW ARE THE DISTRIBUTIONS TREATED?

In general, I.R.C. §736 covers distributions by a partnership to a retiring partner or a deceased partner's successor in interest. This rule allows a certain amount of flexibility in designing retirement arrangements for partners. However, the partnership must observe some rather simple rules.

First, the partnership must satisfy the retiree's interest in partnership assets. Any distribution to the partner that does not exceed this amount will be subject to the regular partnership distribution rules, including all of the exceptions mentioned in Section 2, above.

Only if there are any additional payments to the partner do the parties get special treatment, as follows:

- If the partnership uses the cash method of accounting, the retiree's share of the partnership's accounts receivable is not treated as partnership property. The payments that represent this value are guaranteed payments and therefore treated as ordinary income to the recipient, and are deductible to the partnership.
- If the payments exceed the partner's interest in partnership property, plus the retiree's share of accounts receivable, the excess is "unstated goodwill." The treatment of the parties depends on whether the partnership is in a service business or uses capital investment (including inventories) to produce income. They also depend on whether the recipient is a general partner or a limited partner.
- If the partnership is in a service business (capital is not a material income-producing factor for the partnership), any payments for unstated goodwill are ordinary income to the recipient and deductible to the partnership when paid.
- If the partner is a limited partner, or capital is a material income-producing factor of the partnership, the payments for unstated goodwill will be additional payments for the retiree's share of partnership property. Therefore, the retiree may report capital gain, but the partnership does not get an immediate deduction. Instead, it must capitalize the payments as goodwill. Subject to the antichurning rules of I.R.C. §197, the partnership may be able to amortize the goodwill payment over 15 years.

Observation. As of the middle of 1999, the IRS has not issued any clarification as to the treatment of a member of a limited liability company who receives payments as a retired member of a professional firm. In 1994 the IRS proposed regulations that would have defined general partners and limited partners as these terms relate to limited liability companies. In 1997 Congress prohibited the IRS from adopting these rules until the middle of 1998. As of the middle of 1999, the IRS has not adopted any final regulations on this matter. Therefore, the most recent authority is Rev. Proc. 89-12, 1989-1 C.B. 798, in which the IRS defines a general partner as one who has management rights. Pursuant to this revenue procedure, it seems possible that a member in a limited liability company could be either a general partner or a limited partner. Under this rationale, a member's share of income from a limited liability company could be self-employment income if the member had management rights. Thus, limited liability companies in service businesses may be able to take advantage of the special rules available for payments to general partners.

Many partnership agreements provide payments of a percentage of profits for many years, or high payments for a few years, followed by reduced payments for the partner's lifetime. The basic rules are that payments to a retiring partner are treated as distributions in exchange for his or her share of partnership assets, to the extent of the fair market value of that person's share.

6. APPLICATION OF I.R.C. §736 TO A GENERAL PARTNER IN A SERVICE PARTNERSHIP

Example 3. Gerri is retiring from the Falcon partnership. Prior to her retirement, Gerri was a general partner who owned 10% of the partnership's capital, profits, and losses. Capital is not a material income-producing factor to Falcon, which provides consulting services. The balance sheet immediately before Gerri's retirement follows:

	Adjusted Basis	Fair Market Value
Assets		
Cash	$ 21,000	$ 21,000
Accounts receivable	0	120,000
Furnishings and equipment	15,000	24,000
Land and building	64,000	95,000
	$100,000	$260,000*
Liabilities and capital		
Accounts payable	$ 0	$ 40,000
Capital, Gerri	10,000	22,000
Capital, other partners	90,000	198,000
	$100,000	$260,000

* There is no recapture of depreciation under either I.R.C. §1250 or I.R.C. §1245 on the building. However, there is I.R.C. §1245 depreciation recapture on the furnishings and equipment. If the partnership were to sell these assets at fair market value, the recapture would be $9,000.

Gerri's share of partnership property excludes her portion of the unrealized accounts receivable. Therefore, her share of partnership property is:

Total value of partnership assets	$260,000
Less partnership unrealized receivables	(120,000)
Total value of partnership property	$140,000
Gerri's share (10%)	$ 14,000

The first $14,000 of payments Gerri receives from the partnership will be treated as payments received for her interest in partnership property. She will treat that portion of the payment in the same manner as any other distribution. Although Gerri's outside basis is $10,000, she would report no gain on this portion of the distribution, unless the distribution alters her interest in inventory items of the partnership [I.R.C. §751(b)].

The continuing partnership would not deduct any of the first $14,000 of payments to Gerri. The partnership would adjust its basis in the assets it retained, but only under one of two conditions:

1. Any portion of the distribution that was treated as a taxable transaction under I.R.C. §751(b) would result in a cost basis for the assets deemed purchased by the partnership in this portion of the transaction.
2. The partnership could adjust basis for any gain or loss recognized by Gerri, but only if it had an I.R.C. §754 election in effect for the year.

Any payments in excess of $14,000 would be ordinary income to Gerri as a guaranteed payment and deductible (directly or indirectly) to the continuing partnership.

There are three basic agreement patterns for the retirement of a partner:

- The total amount of payment is fixed.
- Payments for partnership property are fixed, plus an additional payment will be made to the partner that will vary with income, sales, or some other factor in the future.
- The total payment is subject to some future variable, such as sales or income.

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Each one of these patterns has a different treatment to both the retiree and the continuing partnership. The continuation of Example 3 demonstrates an agreement where all payments are fixed.

Example 3 (continued). Assume that Gerri is to receive $7,000 per year over the next three years rather than one $14,000 payment. The $21,000 total payments must be allocated to payments for property as follows:

Payments for property	$14,000
Total payments	21,000
Percent of all payments to be treated as property payments	.6667

Note that the cash-method receivables are not treated as "property" for this purpose. The cash-method payables, of which Gerri is relieved, are not treated as payments, even though the reduction of her share of these debts would normally be considered an additional payment under I.R.C. §752(b).

The year-by-year breakdown is as follows:

	Payment for		
Year	Property	Other	Total
1	$ 4,667	$2,333	$ 7,000
2	4,667	2,333	7,000
3	4,667	2,333	7,000
Total	$14,000	$7,000	$21,000

Gerri must determine the basis and gain to be reported from the $14,000 payments for her interest in partnership property.

Total property payments	$14,000
Her share of partnership basis (10% of $100,000)	(10,000)
Gain	$ 4,000

Of this gain, there are two components. The reduction in Gerri's share of the partnership's depreciation recapture is treated as a fully taxable sale of this asset by Gerri under I.R.C. §751(b). Thus, conceptually, her first gain is ordinary income. The remaining gain is capital gain under I.R.C. §742.

Ordinary income (10% of partnership depreciation recapture)	$ 900
Capital gain	3,100
Total	$4,000

The partnership regulations are specific on how the retiree reports the gain from the distributions in exchange for partnership property. When the payments occur over more than one year, the retiree first recovers basis.

However, the regulations under I.R.C. §751(b) treat the partner's reduction of the proportionate share of I.R.C. §751 property as if the partner had received the property in a nonliquidating distribution and then sold it back to the partnership.

The I.R.C. §736(a) payments, for unstated goodwill and for cash-method accounts receivable, are ordinary income. With this information, it is now possible to complete the example from the retiree's perspective.

Example 3 (continued). Gerri treats her payments as follows:

Year	Return of Basis	Capital Gain	Ordinary Income
1	$ 4,667		$3,233*
2	4,667		2,333
3	667	$3,100	2,333
Total	$10,000	$3,100	$7,900

* $900 of depreciation recapture plus $2,333 of unstated goodwill.

Falcon would need to report this information to Gerri on her Schedule K-1 each year. Since the payments for unstated goodwill and accounts receivable are fixed in nature, they are treated as guaranteed payments of $2,333 each year. The remaining amounts are treated as cash distributions and disclosed appropriately on Schedule K-1.

The partnership parallels the timing of the retiree's reporting. There are some additional complications. First, the ordinary income payments for accounts receivable and unstated goodwill are deductible as guaranteed payments when paid. The distributions in exchange for the partner's share of partnership property are not deductible. These payments cause no basis adjustment or any other tax effect until the retiree begins to report gain. At that time, the partnership may begin to adjust the basis of its assets. Any depreciation recapture reported by the retiree allows the partnership to step-up the basis of the depreciable asset in which the retiree has relinquished an interest. This step-up is treated as newly purchased depreciable property. The partnership need not have an I.R.C. §754 election in effect for this basis adjustment to occur. When the partner reports capital gain from the distribution, the partnership may adjust the basis of its other assets, but only if the partnership has an I.R.C. §754 election in effect.

Example 3 (continued). Falcon treats its payments to Gerri as follows:

Year	No Effect on Basis	Basis Adjustment	Ordinary Deduction
1	$ 3,767	$ 900*	$2,333
2	4,667		2,333
3	1,567	$3,100**	2,333
Total	$10,000	$4,000	$7,000

* $900 adjustment to depreciable assets, regardless of any I.R.C. §754 election for year 1.

** $3,100 would be allowed as a basis adjustment to the land and building if the partnership had an I.R.C. §754 election in effect for year 3.

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7. APPLICATION TO LIMITED PARTNER(S) IN CAPITAL-INTENSIVE PARTNERSHIP

Before 1993, all retiring partners and the partnership making the payments were subject to the treatment shown above for general partners in service-oriented partnerships. However, Congress now prevents these partnerships from claiming an ordinary deduction. Any payment for a limited partner's share of unrealized receivables or goodwill will be treated as a payment in exchange for partnership property. The same treatment governs a payment to a retiring member of a limited liability company. Similarly, any payment in exchange for a general partner's share of unrealized receivables or goodwill will be treated as a payment in exchange for partnership property, if capital is a material income-producing factor of the partnership.

Observation. The committee reports for the Revenue Reconciliation Act of 1993 do not define the term "material income-producing factor." They refer to I.R.C. §401(c)(2), which governs contributions to Keogh plans, and I.R.C. §911, which allows an exclusion for earned income from foreign sources by foreign residents. The committee reports specifically state that capital is not a material income-producing factor in a partnership engaged primarily in providing personal services. The Code does not define the term "general partner." By inference, the term probably excludes any person who is a limited partner, according to a state's limited partnership act. As was discussed above, a member of a limited liability company would probably be classified as a general partner or as a limited partner based on his or her rights to participate in management [see Rev. Proc. 89-12].

Example 4. Susan, Tammy, and Vern are equal general partners in the STV partnership. Capital is a material income-producing factor to STV. In 1999, the partnership agreed to liquidate Tammy's interest in the partnership. The partnership has the following identified assets:

	Adjusted Basis	Fair Market Value
Assets		
Cash	$ 3,000	$ 3,000
Accounts receivable	12,000	12,000
Franchise name	0	6,000
Inventory	30,000	60,000
I.R.C. §1245 property (cost > FMV)	15,000	24,000
Securities	12,000	15,000
	$72,000	$120,000
Liabilities and capital		
Note payable	$12,000	$ 12,000
Capital, Susan	20,000	36,000
Capital, Tammy	20,000	36,000
Capital, Vern	20,000	36,000
	$72,000	$120,000

The partnership and Tammy have agreed that Tammy will retire. She will immediately cease to be a partner under local law. Her interest in partnership property, within the meaning of I.R.C. §736(b), is computed as follows:

Total value of partnership property	$ 120,000
Tammy's share (1/3)	$ 40,000

Tammy's basis is $24,000, which consists of her capital account plus her share of partnership liabilities.

Assume that the payments are $25,000 per year for three years. Since there are no cash-method accounts receivable (this partnership uses the accrual method of accounting) and since this is not a service partnership, none of the payments will be treated as ordinary income to Tammy for accounts receivable or goodwill.

In the case of a distribution that alters a partner's interest in "hot assets," or I.R.C. §751 property, the partnership must calculate the fair market value of those assets. It must calculate the partner's share of this value both before and after the distribution in order to determine the amount of change caused by the distribution.

For purposes of the distribution test, the hot assets consist of "unrealized receivables" and "inventory items" (a confused term), but only if the inventory items have substantially appreciated in value.

Caution. The tax effects of a sale of a partnership interest must take into account inventory items, whether or not they have substantially appreciated in value. The effects of a distribution, however, disregard the change in interest in inventory unless the inventory items have substantially appreciated. A later part of this chapter deals with the sale of a partnership interest. This portion of the discussion is concerned only with distributions.

For distribution purposes, unrealized receivables include cash-method accounts receivable, a definition that makes sense to accountants. However, the term also includes depreciation recapture under I.R.C. §1245 (or §1250) and a few other ordinary income items, such as mining property and franchise names. It does not generally include capital assets or I.R.C. §1231 property, except for special components of the gain that would be recognized if the partnership were to dispose of these assets at fair market value.

Example 4 (continued). The partnership has the following unrealized receivables:

	Adjusted Basis	Fair Market Value
Franchise name	–0–	$ 6,000
I.R.C. §1245 property (to the extent of recapture)	–0–	9,000
Total	–0–	$15,000

For the inventory items to have substantially appreciated in value, those items must have a fair market value that exceeds 120% of the partnership basis. However, to further confuse the entire term, inventory items also include the unrealized receivables. Thus, the appreciation in the unrealized receivable is used to measure the appreciation for the 120% test. Finally, any inventory items that were purchased in order to bring the appreciation down to below 120% are disregarded.

Example 4 (continued). The partnership has the following inventory items:

	Adjusted Basis	Fair Market Value
Franchise name	–0–	$ 6,000
I.R.C. §1245 property (to the extent of recapture)	–0–	9,000
Inventory	$30,000	60,000
Total	$30,000	$75,000
Fair market value as % of basis		250%

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Thus the inventory items are clearly "substantially appreciated," within the meaning of I.R.C. §751.

With the change in the distributee partner's share of hot assets measured, it is a relatively simple matter to determine the nature of the partner's receipts. The partner first recovers basis, then ordinary income to the extent of the relinquishment of his or her share of hot assets, and finally capital gain.

Example 4 (continued). Tammy's share of hot assets, at fair market value, is:

Before distribution	
Franchise name	$ 2,000
Inventory	20,000
Depreciation recapture	3,000
Total	$25,000
	0

Before distribution	
After distribution	
Decrease in hot assets	$25,000
Basis in hot assets	$10,000*

* One-third of the partnership's inventory basis.

Tammy's ordinary income as a result of the distribution is $15,000.

The tax treatment of the $75,000 of payments to Tammy is:

	I.R.C. §751 Assets	Other	Total
Amount realized	$ 25,000	$ 50,000	$ 75,000
Adjusted basis	(10,000)	(14,000)	(24,000)
Gain (loss)	$ 15,000	$ 36,000	$ 51,000

The partnership may adjust the basis of its inventory, I.R.C. §1245 property, and franchise name in the same amount as the gain reported by Tammy. In addition, it may adjust the basis of other assets, provided it has an I.R.C. §754 election in effect. In this example, the capital gain recognized by Tammy is primarily attributable to goodwill. The regulations under I.R.C. §§754 and 755 require that the partnership determine the amount of goodwill due to such an arrangement. Then the partnership may elect to amortize the goodwill over 15 years.

8. TREATMENT OF DEFERRED PAYMENTS

The partnership and the retiree may agree upon the allocation of each payment received under I.R.C. §736 between payments for partnership property and other payments [Treas. Reg. §1.736-1(b)(5)(iii)]. If they do not agree, the allocation will depend on whether the total payments are fixed in amount or may vary with partnership income.

9. FIXED PAYMENTS

Fixed payments must be apportioned between I.R.C. §736(b) property payments and I.R.C. §736(a) income payments (in the case of a general partner in a service partnership), based on the percentage each type bears to the total to be received [Treas. Reg. §1.736-1(b)(5)(i)].

- If payment in any one year does not exceed the portion allocated to I.R.C. §736(b), treat the entire payment for that year as a payment under I.R.C. §736(b).
- All payments received under I.R.C. §736(b) are treated in the normal manner for partnership distributions [Treas. Reg. §1.736-1(b)(6)].
- Accordingly, the recipient first recovers basis and then reports gain.

Example 5. Ken, Lynne, Michelle, and Norman have been equal partners in the KLMN partnership. The parties have agreed to retire Ken's interest in the partnership. The agreed fair market value of Ken's interest in partnership property is $30,000. Ken's basis in his partnership interest is $18,000. The fair market value of Ken's share of substantially appreciated inventory items is $6,000, Ken's share of basis in the inventory is $4,800, and the gain treated as ordinary income under I.R.C. §751(b) is $1,200. The payments will be exactly $10,000 per year for three years. Since the total of Ken's payments do not exceed the $30,000 value of his interest in the partnership, they are all payments under I.R.C. §736(b). Ken must treat the payments as follows:

	Inventory Items		*Other Property*		
Year	**Basis**	**Gain**	**Basis**	**Gain**	**Total**
1	$4,800	$1,200	$ 4,000	$ 0	$10,000
2	0	0	9,200	800	10,000
3	0	0	0	10,000	10,000
Totals	$4,800	$1,200	$13,200	$10,800	$30,000

Example 6. Assume the same facts as in Example 5, except that the total payments are $12,000 per year and do not vary with partnership income during the three-year period. Ken will treat $2,000 of each year's payment as ordinary income under I.R.C. §736(a), and the remaining $10,000 will be treated in the same manner as in Example 5.

The parties could, by mutual agreement, alter the timing of the treatments. For example, they could state that the first $6,000 received in the first year are treated as I.R.C. §736(a) payments. Alternatively, they could agree that the last $6,000 received in the last year are treated as I.R.C. §736(a) payments.

10. VARIABLE PAYMENTS

The partner and partnership must follow the general rules of I.R.C. §731 for each payment [Treas. Reg. §1.736-1(b)(6)]. Accordingly, the payments are all treated as I.R.C. §736(b) payments in exchange for property until the partner has received all such payments. Any payments remaining after recovery of the value of the partner's interest in partnership property are I.R.C. §736(a) payments.

11. EFFECTS OF I.R.C. §752

Any partner's reduction of a share of liabilities is treated as a distribution of cash [I.R.C. §752(b)]. A reduction of a partner's share of partnership liabilities in connection with a sale or exchange of a partnership interest is treated as an additional part of the sales price [I.R.C. §§752(d), 1001]. These rules apply to payments under I.R.C. §736. The distribution that results from the application of I.R.C. §752 is treated in the same manner as other distributions. It must be properly allocated between property payments under I.R.C. §736(b) and income payments under I.R.C. §736(a) [Treas. Reg. §1.736-1(a)(2)]. 10

The problem in connection with a retiring partner is to identify when the retiree's share of partnership liabilities is reduced. In most, if not all, circumstances, the retiree’s share of partnership nonrecourse liabilities would be eliminated as soon as the person is no longer a partner under local law. The reduction of recourse liabilities, however, may be a more complicated problem. To the extent that the remaining partners, with the consent of the creditors, relieve the retiree of his or her risk of loss, the reduction in liabilities would be immediate. If the retiree remains liable for those debts that exist on the date of retirement, the liability relief would occur when the partnership pays the liabilities. The retiree, the partnership, and the tax advisor should be careful to ascertain the timing and amount of the reduction of the retiree's share of partnership liabilities.

C. PARTNERSHIP'S BASIS AND OTHER ATTRIBUTES IN CONTRIBUTED PROPERTY

In general, the transfer of property to a partnership in exchange for an interest therein is a tax-deferred transaction. Therefore, the partnership will continue the tax basis and all other attributes of the transferred property.

1. ALLOCATIONS WITH RESPECT TO PRECONTRIBUTION GAINS, LOSSES, AND RELATED ITEMS

Under general rules of partnership taxation, there is no gain or loss on the contribution of property to a partnership [I.R.C. §721(a)]. When property is contributed to a partnership, the partnership retains a carryover basis in the property [I.R.C. §723]. Before the 1984 amendments to I.R.C. §704(c), a partnership could allocate the gain or loss from the subsequent sale of contributed property in one of two ways: in accordance with the partnership agreement or to the contributing partner. Allocation of precontribution gain or loss to partners other than the contributing partner provided a legitimate method of income shifting.

For property contributed after March 31, 1984, the partnership must allocate precontribution gains and losses to the partner who contributed property, and must allocate any depreciation or other adjustments accordingly. In December 1992, the IRS issued Prop. Reg. §1.704-3, which interprets the 1984 revisions to the allocation of precontribution gains and losses. The proposed regulation referred to precontribution gains and losses and **built-in gains** and **built-in losses**. The proposed regulation allowed a partnership to use "any reasonable method in allocating the built-in gains, built-in losses, and resultant basis adjustments, such as depreciation." In general, a partnership must apply the allocation methods on a consistent basis among properties subject to the rules.

The proposed regulation specifically allowed the use of the **traditional method** of allocation. If the partnership disposed of property with built-in gains or built-in losses in a nontaxable exchange, the gain or loss was carried to the new property. The proposed regulation also provided for a **curative allocation** of gain or loss on the disposition of partnership property, if the tax depreciation allocated to noncontributing partners was less than the book depreciation allocated to the same partners. The proposed regulation also permitted use of the deferred-sale method of accounting, which could simplify record- keeping requirements.

The final Treas. Reg. §1.704-3 was adopted in December 1993. The final regulation kept the traditional method, curative allocations, and most other rules contained in the proposed regulation. The final regulations did not adopt the deferred sale-method. At the same time that Treas. Reg. §1.704-3 was adopted, the IRS also adopted Temp. Reg. §1.704-3T, which contains a remedial allocation method.

2. ALLOCATION OF PRECONTRIBUTION GAINS AND LOSSES

Under general capital accounting rules, the book value of contributed property is its fair market value at the date of contribution [Treas. Reg. §1.704-1(b)(2)(iv)]. Under this principle, all gains, losses, income, and deductions with respect to contributed property are allocated to take into account the difference between the property's basis and book value (fair market value) at the time of contribution. The rationale is that partners other than the property contributor have purchased a proportionate share of the fair market value of the property by agreeing to admit the contributing partner, or by allowing him or her an increase in partnership capital due to the contribution of the property.

3. TRADITIONAL METHOD OF ALLOCATION

This method of allocating built-in gains or losses from a contributing partner requires separate tracking of precontribution and postcontribution gains or losses on each item of contributed property. The 1993 regulations refer to this method as the "traditional method" [Treas. Reg. §1.704-3(b)].

Example 7. George contributes property to a partnership in exchange for a 25% interest in capital, profits, and losses. On the date of the contribution, George's basis was $4,480 and the fair market value of the property was $10,000. Under the capital account rules of Treas. Reg. §1.704-1(b), the book value is $10,000. According to I.R.C. §723, however, the partnership's basis is $4,480. The partnership's precontribution gain in the property is the difference between the book value and the adjusted basis of the property, or $5,520, computed as follows:

FMV at time of contribution	$10,000
Adjusted basis	(4,480)
Precontribution gain	$ 5,520

If the partnership were to sell the property at its fair market value at the time of contribution, the allocation of gain would depend on the date of contribution. All of the precontribution gain of $5,520 must be allocated to George.

- The separate tracking is done individually for each property [Treas. Reg. §1.704-3(a)(1)].
- If the gain recognized by the partnership exceeds the precontribution gain, the postcontribution gain is allocated to partners in accordance with normal ratios.

Example 8. Refer to Example 7. Assume the partnership sells the property for $12,000. The precontribution gain on the sale would be $5,520, as shown above. The total gain is:

Amount realized	$12,000	
Adjusted basis	(4,480)	
Gain		$7,520

	To George	To Others
Precontribution gain ($10,000 – $4,480)	$5,520	$ 0
Postcontribution gain ($12,000 – $10,000 = $2,000)		
George (25% × $2,000)	500	
Others (75% × $2,000)		1,500
Total	$6,020	$1,500

4. THE "CEILING RULE"

In concept, the noncontributing partners should be able to deduct any postcontribution losses on contributed property, since they purchased proportionate shares in the FMV of the property at the time of contribution. However, under the so-called ceiling rule, the total amount of gain (or loss) that can be allocated to the contributing partner cannot exceed the total amount allowed to the partnership (e.g., actual gain or loss realized). If the partnership sells contributed property and recognizes less than the precontribution gain or loss, the partnership must allocate all of the recognized gain or loss to the contributing partner.

Example 9. Refer to Example 7. Assume that the contribution occurred in 1993, and the partnership sold the property later for $9,000, or $1,000 less than its FMV at the time of contribution. The partnership recognizes a gain of $4,520, computed below:

Amount realized	$ 9,000
Adjusted basis	(4,480)
Gain realized	$ 4,520

Although the precontribution gain was $5,520, the amount of gain that can be allocated to the property contributor is limited to the ceiling amount, that is, the actual gain recognized by the partnership, $4,520. Thus the entire $4,520 must be allocated entirely to George. Notice that this does not reflect the economic reality of the original arrangement, which assumed that the property was worth $10,000. For book purposes, the partnership suffers a $1,000 loss ($9,000 – $10,000), $250 to George and $750 to the other partners. To obtain this result for tax purposes, George should receive the entire $5,520 built-in gain and then share in the $1,000 loss, but the traditional method with the ceiling rule prohibits this approach (but see the curative and remedial methods below).

Example 10. Refer to Example 7. Assume the contribution occurred in 1993, and the partnership sold the property later for $3,480. The partnership recognizes a loss of $1,000, computed below:

Amount realized	$ 3,480
Adjusted basis	(4,480)
Loss realized	$(1,000)

This is not a precontribution loss, so none is specially allocated to George. It is allocated to each of the partners in accordance with the partnership agreement.

Observation. The disparities caused by the ceiling rule can be overcome by use of a curative allocation or a remedial allocation. These methods are discussed below.

5. CURATIVE ALLOCATIONS

Until the 1992 proposed regulations, there was no expressly permitted way to overcome the limitations of the ceiling rule. The regulations, however, provide for curative allocations. A curative allocation allows the partnership to allocate other items of income or deductions to compensate for the ceiling rule [Treas. Reg. §1.704-3(c)]. This rule allows a partnership allocation to make economic sense when the ultimate gain realized by a partnership is less than the precontribution gain, or when the ultimate loss for tax purposes is less than the precontribution loss.

Example 11. Refer to Example 9. The partnership could allocate $750 of income to George, above and beyond his normal share of partnership income. This allocation would charge him with $5,270 in the year of sale, which represents his $5,520 precontribution gain reduced by his $250 share of the partnership loss. The other partners would have $750 less income or effectively receive the $750 loss allocated to them for book purposes.

- A curative allocation may specifically alter the allocation between book and taxable income.
- A curative allocation must be of the same character of income or loss as the subject of the ceiling rule.

Example 12. Refer to Example 10. Assume that the loss on the contributed property was capital loss. The curative allocation of $750 to George must be an allocation of capital gain. It cannot be an allocation of income of any other character.

- If the partnership has insufficient items for the year of sale to make a curative allocation, it can make the curative allocation in the next taxable year. There is no limit on the number of years a suspended curative allocation can be carried forward.
- If a partnership makes curative allocations, it must do so consistently [Treas. Reg. §1.704-3(c)(2)].
- A partnership may not use curative allocations if the principal purpose is to alter the partners' tax liabilities.

6. REMEDIAL ALLOCATION METHOD

The remedial allocation resembles the traditional method with curative allocations [Temp. Reg. §1.704-3T(d)]. In essence, this method allows the partnership to create phantom income or deductions to avoid the ceiling limitations. The phantom income or deduction must be of the same character as the income or deduction that was limited by the ceiling rule [Temp. Reg. §1.704-3T(d)(1)].

Example 13. Refer to Example 10. The book loss is computed as follows:

Amount realized	$ 3,480
less book value	(10,000)
Book loss	$ (6,520)

The partners other than George should be able to report a loss of 75% of the book loss, or $4,890, on their tax returns. The tax loss, however, is limited to $1,000 ($3,480 sale price less adjusted basis of $4,480). The remedial allocation is accomplished in two steps. **First,** the actual tax loss is allocated to the partners who should receive the book loss. **Second,** there is a "plug," or phantom loss, allocated to these partners in sufficient amount to make their tax loss equal to their book loss. This phantom loss is then treated as income to the contributing partner.

The allocation method for this example would be:

	George	Others	Total
Actual tax loss	$ 0	$ (1,000)	$ (1,000)
Remedial income and loss	3,890	(3,890)	0
Net (total)	$3,890	$ (4,890)	$ (1,000)

George's schedule K-1 would show income of $3,890, whereas the other partners collectively would report $4,890 of loss from the disposition of the property.

7. CONSISTENCY RULES

In general, built-in gains and losses must be tracked on each property contributed to the partnership [Treas. Reg. §1.704-3(a)(2)]. The partnership may aggregate certain properties contributed by any one partner [Treas. Reg. §1.704-3(e)(2)]:

- Depreciable personal property
- Zero-basis personal property
- Inventory, other than securities

There is no requirement that the partnership use the same method (traditional, curative, remedial) for all items of contributed property [Treas. Reg. §1.704-3(a)(2)]. The partnership must use the same method from year to year on each item of property.

D. BASIS IN PROPERTY DISTRIBUTED FROM A PARTNERSHIP TO A PARTNER, AFTER THE TAXPAYER RELIEF ACT OF 1997

When a partner receives property in a liquidating distribution and the property is not cash, a receivable, or an inventory item, the partner's bases in the assets received are equal to the partner's predistribution basis in the partnership interest (the substituted basis rule) [I.R.C. §732(c)].

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1. PRIOR TO AMENDMENT BY THE TAXPAYER RELIEF ACT OF 1997

Prior to amendment by the Taxpayer Relief Act of 1997, the basis assigned to these assets was in proportion to their adjusted basis to the partnership immediately prior to the distribution.

Example 14. (Adapted from the committee reports to the Taxpayer Relief Act of 1997.) A partnership with two assets, real estate and goodwill, distributes them both in liquidation to a partner whose basis in its interest is $750,000. The distribution does not alter the distributee partner's interest in I.R.C. §751 property. The goodwill has a basis to the partnership of $50,000 and a fair market value of $400,000 and the real estate has a basis to the partnership of $100,000 and a fair market value of $100,000. The partner plans to sell the real estate. The partner is a real estate dealer.

Prior to the Taxpayer Relief Act of 1997, the partner would allocate basis as follows:

Asset	Partnership Predistribution Basis	Percent	Partner Predistribution Basis
Goodwill	$ 50,000	33 1/3	$250,000
Real estate	100,000	66 2/3	500,000
Total			$750,000

An immediate sale of the real estate would result in an ordinary loss deduction of $400,000.

The basis rules demonstrated above were the cause of the "million-dollar paper clips" and other items Congress believed were abusive. The reason for this abuse was often the existence of unrecorded goodwill, which had a zero basis but significant fair market value. On a termination of a partnership, the goodwill received no basis, and the basis of other assets were stepped up to fair market value.

2. EFFECTS OF THE TAXPAYER RELIEF ACT OF 1997

The Taxpayer Relief Act of 1997 changed the rule so that postdistribution basis is allocated by means of a three-step process:

1. Carry the individual asset basis over to the partner.
2. Allocate in accordance with appreciation (or depreciation) in the assets in the hands of the partnership, up to the fair market value of the assets.
3. Allocate any remaining predistribution basis in accordance with the fair market value of each asset.

This rule is effective for distributions after enactment of the Taxpayer Relief Act of 1997 (August 5, 1997) [§1061(b)].

Example 15. Refer to Example 14. If the distribution occurs after August 5, 1997, the allocation of basis is:

Step 1: Carryover of partnership basis:

Asset	Basis
Goodwill	$ 50,000
Real estate	100,000
Total	150,000
Remaining basis to be allocated ($750,000 – $150,000)	$600,000

Step 2: Proportionate appreciation:

Asset	Basis	FMV	Appreciation
Goodwill	$ 50,000	$400,000	$350,000
Real estate	100,000	100,000	0
Total			350,000
Remaining basis to be allocated ($600,000 – $350,000)			$250,000

Step 3: Relative fair market value:

Asset	FMV	Percent	Basis
Goodwill	$400,000	80	$200,000
Real estate	100,000	20	50,000
Total			$250,000

Total basis allocation:	Goodwill	Real estate

Step 1	$ 50,000	$100,000
Step 2	350,000	0
Step 3	200,000	50,000
Total	$600,000	$150,000

A sale of the real estate for its fair market value of $100,000 would result in a loss of $50,000, in contrast to the $400,000 that would have been allowed under prior law.

The new rules are more complicated than the old. In perspective, however, they are more consistent with basis allocations required following an I.R.C. §754 adjustment due to a distribution of partnership property [see I.R.C. §§734(b) and 755, as well as the regulations thereunder].

E. RULES GOVERNING SALES OF PARTNERSHIP INTERESTS AND HOT ASSETS, AFTER THE TAXPAYER RELIEF ACT OF 1997

Unrealized receivables and inventory items received some discussion above. For a sale or exchange of a partnership interest, before August 5, 1997, there was no special treatment for inventory items unless they were substantially appreciated. Note that the substantial appreciation test remains in the law for **distributions** (discussed above), although any inventory items will be treated as ordinary assets on a **sale** of a partnership interest. Code §751(a) treats a partner's share of hot assets as an asset sold separately from the rest of the partnership interest.

1. APPLICATION OF THE RULES TO THE SELLING PARTNER

The amount realized for these assets may be negotiated between the buyer and the seller. Such an arm's-length agreement will generally be respected [Treas. Reg. §1.751-1(a)(2)]. Unrealized payables attributable to the partner's interest are treated as basis in unrealized receivables [Treas. Reg. §1.751-1(c)(2)]. A partner's basis in other inventory items is the amount that would have been the partner's basis in those assets had he or she received them in a nonliquidating distribution immediately before the sale [Treas. Reg. §1.751-1(a)(2)].

Example 16. Carrie sells her one-third interest in the CDE limited liability company. CDE sells inventory and uses the accrual method of accounting. Carrie's basis in the partnership interest is $66,000, after adjustment for all items of income, loss, and distributions to the date of the sale. None of the inventory items was acquired by the partnership in an attempt to avoid I.R.C. §751(a).

The balance sheet immediately before the sale shows the following:

	Basis	FMV
Assets		
Cash	$ 30,000	$ 30,000
Receivables	60,000	60,000
Inventory	63,000	72,000
Equipment	15,000	48,000
Land	30,000	87,000
	$198,000	$297,000
Liabilities	15,000	15,000
Capital, Carrie	61,000	94,000
Capital, Darrin	61,000	94,000
Capital, Emmett	61,000	94,000
	$198,000	$297,000

Carrie receives $94,000 cash from Fiona, the buyer.

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Steps:

1. Determine the amount realized and gain or loss realized by Carrie.

Cash from buyer		$94,000
Liability reduction		5,000
		$99,000
Adjusted basis		
Capital	$61,000	
Liabilities	5,000	(66,000)
Gain (loss)		$33,000

2. Determine any unrealized receivables. Depreciation recapture is treated as an unrealized receivable [I.R.C. §751(c)]. This is the only unrealized receivable in this problem.

Fair market value of equipment	$48,000	
Less basis	(15,000)	$33,000
Carrie's share		$11,000

3. Inventory items of the partnership do not need to be substantially appreciated. The basis counts against the fair market value in determining the ordinary income or loss recognized on the sale of the partnership or limited liability company interest.

	FMV	Basis
Receivables	$ 60,000	$ 60,000
Inventory	72,000	63,000
Total	$132,000	$123,000
Carrie's share	$ 44,000	$ 41,000

4. The selling partner must treat the amount realized for his or her share of the I.R.C. §751 assets as if it were a sale of those assets. The sale price is reduced for the seller's basis in those assets, which is the lower of the seller's portion of the partnership's inside basis or the seller's outside basis. Following is the amount realized by Carrie for inventory items and unrealized receivables:

Value of inventory	$ 72,000	
Value of receivables	60,000	
Depreciation recapture	33,000	
Total value of §751 assets	$165,000	
Carrie's share		$ 55,000
Carrie's share of basis in §751 property		(41,000)
Carrie's ordinary income from sale		$ 14,000

5. The remaining amount realized on the sale is treated as an amount realized in exchange for a capital asset. Any of the seller's outside basis, after allocation to inventory items, is treated as basis in a capital asset. Thus the sale is summarized as follows:

	§751	Capital	Total
Amount realized	$ 55,000	$ 44,000	$ 99,000

	§751	Capital	Total
Adjusted basis	(41,000)	(25,000)	(66,000)
Gain (loss)	$ 14,000	$ 19,000	$ 33,000

Carrie reports $14,000 **ordinary income** and $19,000 **capital gain** from the sale.

Perhaps the strangest results occur when there are unrealized receivables and/or inventory items in a partnership that has other assets that have depreciated in value. In this situation, a selling partner might recognize ordinary income and capital loss. Under general tax accounting rules, the partner could not offset the ordinary income with the capital loss, even though they both resulted from the sale of the same asset.

Example 17. Refer to Example 16. Assume the same facts except that the land has a high basis and has depreciated greatly in value. The balance sheet as of the date of Carrie's sale is as follows:

	Basis	FMV
Assets		
Cash	$ 30,000	$ 30,000
Receivables	60,000	60,000
Inventory	63,000	72,000
Equipment	15,000	48,000
Land	144,000	87,000
	$312,000	$297,000
Liabilities	15,000	15,000
Capital, Carrie	99,000	94,000
Capital, Darrin	99,000	94,000
Capital, Emmett	99,000	94,000
	$312,000	$297,000

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Carrie receives $94,000 cash from Fiona, the buyer. Again she follows the same steps as in Example 16, down through the calculation of the ordinary income from the sale of her portion of the unrealized receivables and inventory items.

Steps:

1. Determine the amount realized and gain or loss realized by Carrie (same as in Example 16).

Cash from buyer		$ 94,000
Liability reduction		5,000
		$ 99,000
Adjusted basis (different from Example 16)		
Capital	$99,000	
Liabilities	5,000	(104,000)
Gain (loss)		$ (5,000)

2. Determine any unrealized receivables. Depreciation recapture is treated as a unrealized receivable [I.R.C. §751(c)]. This is the only unrealized receivable in this problem (same as in Example 16).

Fair market value of equipment	$ 48,000	
Less basis	(15,000)	$ 33,000
Carrie's share		$ 11,000

3. Inventory items of the partnership do not need to be substantially appreciated. The basis counts against the fair market value in determining the ordinary income or loss recognized on the sale of the partnership or limited liability company interest (same as in Example 16).

	FMV	Basis
Receivables	$ 60,000	$ 60,000
Inventory	72,000	63,000
Total	$132,000	$123,000
Carrie's share	$ 44,000	$ 41,000

4. The selling partner must treat the amount realized for his or her share of the I.R.C. §751 assets as if it were a sale of those assets. The sale price is reduced for the seller's basis in those assets, which is the lower of the seller's portion of the partnership's inside basis or the seller's outside basis (same as in Example 16).

Following is the amount realized by Carrie for inventory items and unrealized receivables:

Value of inventory	$ 72,000	
Value of receivables	60,000	
Depreciation recapture	33,000	
Total value of §751 assets	$165,000	
Carrie's share		$ 55,000
Carrie's share of basis in §751 property		(41,000)
Carrie's ordinary income from sale		$ 14,000

5. The remaining amount realized on the sale is treated as an amount realized in exchange for a capital asset. Any of the seller's outside basis, after allocation to inventory items, is treated as basis in a capital asset. This is **not** the same as in Example 16, due to the difference in Carrie's outside basis at the time of sale. The sale is summarized as follows:

	§751	Capital	Total
Amount realized	$ 55,000	$ 44,000	$ 99,000
Adjusted basis	(41,000)	(63,000)	(104,000)
Gain (loss)	$ 14,000	$(19,000)	$ (5,000)

Carrie reports $14,000 **ordinary income** and $19,000 **capital loss** from the sale.

2. DISCLOSURE REQUIREMENTS

A partner who disposes of his or her interest in a partnership that has any I.R.C. §751 assets must disclose certain information on his or her tax return for the year of the sale [Treas. Reg. §1.751-1(a)(3)]:

- Date of sale
- Adjusted basis in interest
- Adjusted basis attributable to I.R.C. §751 property
- Amount realized on the sale
- Amount realized attributable to I.R.C. §751 property
- Any I.R.C. §732(d) adjustments
- Any special basis adjustments under I.R.C. §743(b)

These disclosure requirements apply only to the sale of a partnership interest. The partnership must issue the form of the disclosure, but it can be completed only when the partner informs the partnership of the amount of gain recognized on the sale. This disclosure requirement does not apply to distributions. In order to properly comply with these rules, the selling partner must notify the partnership within 30 days of the sale or exchange of an interest in the partnership. The selling partner must notify the partnership of the name(s) and tax identification of the purchaser. The partnership must then provide Form 8308 to both the buyer and the seller by January 31 of the year following the exchange. The partnership must also attach a copy of Form 8308 to its Form 1065 for the year of the transfer.

OUTSIDE BASIS WORKSHEET FOR PARTNER OR LIMITED LIABILITY COMPANY MEMBER

PARTNER'S BASIS IN A PARTNERSHIP, OR A MEMBER'S BASIS IN A LIMITED LIABILITY COMPANY

Item	Amount
1. Basis, beginning of year.	______
2. Add income items from Form 1065, Schedule K-1.	______
3. Add any increase in liabilities, comparing this year's Schedule K-1 with last year's Schedule K-1.	______

4. Add any other contribution of property .... ______
5. Subtotal (lines 1 through 4) .... ______
6. Distributions of cash from the partnership .... ______
7. Reduction in partner's share of liabilities, comparing this year's Schedule K-1 with last year's Schedule K-1 .... ______
8. Add lines 6 and 7. If the total exceeds basis, as computed in line 5, the partner must report gain. .... ______
9. Subtotal (line 5 less line 8, but not less than zero) .... ______
10. Distributions of other partnership property, at partnership basis. If line 10 exceeds line 9, apportion basis among assets received .... ______
11. Subtotal (line 9 less line 10, but not less than zero) .... ______
12. Less nondeductible items, such as 50% meal and entertainment, charitable contributions, foreign income tax, fines, penalties, etc. If line 12 exceeds line 11, excess disappears and is not carried forward. .... ______
13. Subtotal (line 11 less line 12, but not less than zero) .... ______
14. Less deductible losses, such as ordinary loss, capital loss, §1231 loss, investment interest, etc. If line 14 exceeds line 13, apportion among the categories of loss, and carry any excess forward. .... ______
15. Final basis (line 13 less line 14, but not less than zero) .... ______