Chapter 4: Partnership Terminations

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Note. Corrections were made to this workbook through January of 2025. No subsequent modifications were made. For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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This chapter builds upon the "Select Topics for Partnership Operations" chapter in the 2023 *University of Illinois Federal Tax Workbook*, and the "Partnership Basics" chapter in the 2022 *University of Illinois Federal Tax Workbook*.

> **Note.** For the purposes of this chapter, assume a limited liability company (LLC) is a multi-member LLC (MMLLC) being taxed as a partnership. An MMLLC may elect to be taxed as a C corporation or an S corporation. For more information on these "check the box" rules, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Partnership Basics. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

In the partnership taxation realm, there are three types of capital accounts.

1. Tax basis, which reflects the partners' adjusted inside tax basis in the entity
2. Book basis (IRC §704(b)), which reflects the fair market value (FMV) of assets and related adjustments
3. Generally accepted accounting principles (GAAP) or other financial reporting basis, which reflects the partnership's activity as reported in its financial statements

For the purposes of this chapter, references to capital accounts represent book basis. Tax basis is distinguished from "tax capital accounts," which generally reflects an adjusted basis. Unless explicitly identified, GAAP or other financial reporting basis is not discussed in this chapter.

BASIC CONCEPTS OF PARTNERSHIP TERMINATION

Partnerships may terminate for a variety of reasons, some voluntary and some involuntary. A partnership may terminate voluntarily by ceasing operations, agreement of the partners, merging, incorporating into a C or S corporation, partners withdrawing, or entering a qualified joint venture (QJV). Additionally, a partnership could terminate involuntarily through bankruptcy or a judicial dissolution.

Regardless of the reason for their termination, partnerships nearing the end of their existence create numerous tax issues. Most of these issues pass through to the partners on their Schedules K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.* This is because partnerships do not pay federal income tax, except in unusual situations.[1]

Sometimes, federal tax law is guided by **partnership agreements** or state law. For example, the Code allows the partnership agreement to define a partner's distributive share of income, gain, loss, deduction, or credit.[2] The Code looks to partnership agreements to govern whether a retiring or deceased partner can receive payments for goodwill.[3] Similarly, treasury regulations contain many references to partnership agreements.[4]

State law may play an important role in governing the termination of partnerships. State law generally controls when partnership agreements do not exist or are silent on an issue.[5] However, partnership agreements are limited in some ways, as they generally cannot alter statutory provisions that concern judicial dissolutions, as discussed later. State law may also affect the distribution of assets, the satisfaction of liabilities, or the resolution of disputes among the partners arising during termination.

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1. IRC §701. The *Bipartisan Budget Act of 2015*, PL 114-74, established a centralized partnership audit regime, under which tax associated with an adjustment to a partnership item must be paid by the partnership unless an election can be and is made.
2. IRC §704(b)(1).
3. IRC §736(b)(2).
4. For example, Treas. Reg. §1.702-1(a)(8)(i) provides for partners calculating their distributive shares to take into account various items of income, gain, loss, etc. that may differ from the allocation of partnership taxable income.
5. For an Illinois example, see the *Illinois Uniform Partnership Act*, 805 ILCS 206 §103(a), which provides generally for the governance of a partnership agreement unless it is silent on an issue addressed by state's Uniform Partnership Act.

DETERMINING IF AND WHEN A PARTNERSHIP HAS TERMINATED

A partnership terminates when its partners and officers wind up its affairs.[6] This criterion is satisfied when neither the partnership, acting as an entity, nor any of its partners, engages in any of the following.[7]

- Any business of the partnership
- Any financial operation of the partnership
- Any venture of the partnership

Under IRC §708, when these activities have all ended, the partnership has terminated.

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Liquidation of All Partnership Assets[8]

A partnership is terminated when it discontinues its operations, and no partner carries on any part of its business. **The liquidation of all partnership assets by itself does not terminate a partnership.**

> **Example 1.** Rare Earth Partners, LP, is a partnership formed in 2020 under Texas law to own royalty-producing real estate. The partnership's manager, Todd, is particularly interested in financing the development of real estate that produces rare earth minerals in west Texas. Its two properties are ranchland in central Texas, and oil-producing land in west Texas. Todd accepts an offer to purchase both properties in 2024. The proceeds of the sale are enough to pay off the debt and the attorneys, but the sale produces no additional cash.
>
> Thus, with no land and no cash, Rare Earth has no assets. Nevertheless, its partners still believe in the prospect of producing rare earth minerals, and all want to continue the venture. Todd and one other partner actively seek new properties in which to invest. For this reason, Rare Earth continues as a partnership because one requirement for partnership termination, that no partner carries on operations, is **not satisfied.**

SELECTED TERMINATION RULINGS AND CASES

Although the Code and associated regulations define the rule of when a partnership is considered terminated, there is ambiguity in the practical application of the winding up process. Additionally, the courts have not applied a standard approach, which leads to litigation to determine when a partnership is truly terminated.[9] Many of these cases concern whether the complete distribution of partnership assets is necessary before a partnership can be considered terminated.

- In a 2004 case, the Tax Court required all partnership assets to be liquidated before considering the partnership as having terminated.[10] However, the managing partner of the partnership attempted to establish that the partnership was terminated in the year before the liquidating distributions.
- In a 2008 memorandum decision, the Tax Court found the presence of dormant foreign currency in a bank account was enough to delay the termination of the partnership.[11]

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6. IRS Pub. 541, *Partnerships*.
7. Treas. Reg. §1.708-1(b)(1); IRC §708.
8. IRC §708(b)(1); Treas. Reg. §1.708-1(b)(1).
9. *When does a partnership terminate under Sec. 708?* Steitz, Timothy. Jul. 1, 2021. The Tax Adviser. [www.thetaxadviser.com/issues/2021/jul/partnership-terminate-sec-708.html] Accessed on Dec. 8, 2023.
10. *Harbor Cove Marina Partners Partnership v. Comm'r,* 123 TC 64 (2004).
11. *7050, Ltd. v. Comm'r*, TC Memo 2008-112 (Apr. 23, 2008).

- A 2012 letter ruling suggests a more flexible approach in the winding up period for a terminating partnership.[12] This opinion allowed the partnership to terminate before contingent liabilities were fully resolved. This ruling cited *Goulder v. U.S.*, which permitted a partnership to terminate before contingent security deposit obligations were fully settled.[13]

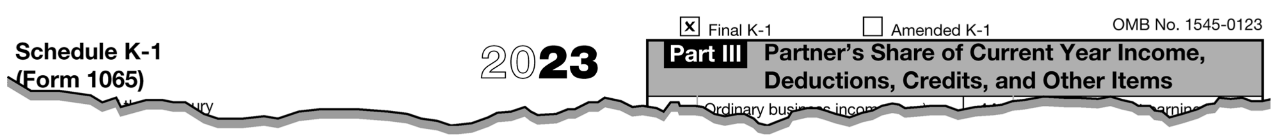
  The 2012 letter ruling[14] used *Goulder* to conclude that a limited partnership would be terminated when it had distributed its assets to its partners and a liquidating trust, and dissolved the limited partnership under state law. Although the letter's text cites cases in which a partnership was deemed to have continued despite the fact that it was in the process of winding up,[15] it advised the letter's requester that its limited partnership would terminate when it no longer conducted business and it had distributed assets to its partners and to the liquidating trust.

> **Caution.** Legal issues like these point to the critical role attorneys skilled in partnership law provide. Attorneys with experience interpreting legal precedents play an invaluable role. In some circumstances, the tax practitioner may also wish to involve an accountant skilled in applying partnership accounting rules in light of the wording of partnership agreements. Additionally, the partnership may have payroll issues that warrant the involvement of a payroll specialist.

TYPES OF PARTNERSHIP TERMINATION

Partnerships can terminate in various ways, but this text divides them into two broad categories. A tax practitioner should already understand when advising their client whether the client is terminating their partnership voluntarily or if a judicial act or bankruptcy is forcing them to involuntarily end the partnership's existence.

Regardless of how the partnership is terminated, the termination is reported to the partner on Schedule K-1 (Form 1065) by marking the box identified as Final K-1, as shown next.


☒ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) 2023

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

VOLUNTARY TERMINATION

If a client's reason for the termination is one of their own choosing or that of the partners collectively, they are opting for a voluntary termination. Even if market forces have made the partnership unprofitable and impaired its viability, the decision to terminate it is still one that the partners make.

Ceasing Operations

Partners may decide to close the business. This occurs if the partnership no longer meets the partners' business goals or if they want to scale back their commitments.

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12. Ltr. Rul. 201244004 (Jun. 29, 2012).

13. *Goulder v. U.S.*, 64 F.3d 663 (6th Cir. 1995).

14. Ltr. Rul. 201244004 (Jun. 29, 2012).

15. *Harbor Cove Marina Partners Partnership v. Comm'r*, 123 TC 64 (2004); *Baker Commodities, Inc. v. Comm'r*, 415 F.2d 519 (9th Cir. 1969), *aff'g* 48 TC 374 (1967); *Estate of Aaron Levine v, Comm'r*, 72 TC 780 (1979), *aff'd* 634 F.2d 12 (2nd Cir. 1980).

Practitioner Planning Tip

Because the criterion for a business termination is the cessation of business and financial operations, it is likely that this event does not coincide with the end of the entity's tax year.[16] Therefore, extensions of the filing date (usually the 15th day of the third month following the termination)[17] may be particularly useful for terminating partnerships. No cost is associated with them, and they provide additional time to gather needed information regarding the disposition of assets, distributions, and other components of Schedule K-1 (Form 1065). They also extend the time that a superseding Form 1065, *U.S. Return of Partnership Income,* can be filed if the original filing must be corrected.[18]

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Example 2. At a New Year's Day party in 2024, Bob and Lewis announced their retirement plans, both having reached age 70 in the previous months. Their produce distributorship, B&L Produce, LP (B&L), is organized as a partnership. Because it has numerous customers who must find alternate sources for the produce they buy from B&L, Bob and Lewis estimate they cannot cease operations until sometime in March. Fortunately, their tax practitioner, Julienne, also learns of their plans.

The plans become the main point of their previously scheduled January meeting, where Julienne tells them they should meet with their attorney to discuss the legal aspects of winding up their business. She informs them that the business's final tax return is due the 15th day of the third month following the winding up of the business, so they should advise her promptly when this occurs.

Julienne explains to Bob that the partnership is terminated when all partners cease to carry on any part of the business. She adds that if they are not in regular communication, it can easily cause their final tax return to be filed late. Consequently, Julienne asks Bob to send her a weekly sales report every Friday with a sales forecast for the following week. She asks Bob if this approach is a workable approach to define the cessation of B&L's business operations. Bob confirms that this is a valid approach because their produce cannot be sold if it is older than a week. In addition, he has already told his produce providers that he expects to stop purchases in early March.

On March 11, Bob visits Julienne's office to sign off on the 2023 tax return and to advise her that the partnership has ceased operations as of March 4. Although the business no longer distributes produce and has cleared out its warehouse, it still has financial assets that have not been distributed or liquidated.

On March 31, Bob calls Julienne to inform her that both partners have received final distributions as of the previous day. She schedules a meeting with them on April 22 to review the partnership's books for 2024 and to discuss the preparation of the final short period tax return. As the phone conversation ends, Julienne reminds Bob that the final tax return is due on June 15. Nevertheless, she receives approval from Bob to file an extension, and does so as soon as the phone conversation ends, allowing them to file the tax return as late as December 16, 2024.

16. IRS Pub. 541, *Partnerships*.

17. IRC §6072(b).

18. Rev. Proc. 2019-32, 2019-33 IRB 659.

Practitioner Planning Tip

Partners should be advised of any delay in the partnership return filing for their tax planning and estimated payment purposes.

Agreement of the Partners

Partners may agree to dissolve the partnership. Partnership agreements may have language to govern the entity's dissolution, but if not, state partnership law provides some guidelines. Forty-five states and territories[19] have adopted a form of the Uniform Partnership Act (1997), which has a section titled "Dissolution and Winding Up."[20]

The partnership agreement of a partnership likely contains language that guides the dissolution of a partnership. When a partnership terminates, the agreement may contain language guiding the distribution of assets, satisfaction of liabilities, and resolution of disputes to which the partners have already agreed.

Example 3. XYZ, LP, is a real estate venture authorized by its Secretary of State. XYZ's partnership agreement provides for a dissolution of the partnership when all partners vote to do so. The partners vote unanimously on March 31, 2024, to wind up the partnership.

In May, a buyer offers to purchase XYZ's remaining asset, a rented building. The sale of the building closes on June 3, 2024, at which time the mortgage is paid off, and XYZ receives $90,000. By June 10, this amount is distributed to the partners in accordance with the partnership agreement and each partner's percentage ownership of the entity's capital and profits. The partnership's business and financial affairs are wound up by this act and the partnership is voluntarily terminated.

Merger with Another Partnership[21]

A partnership may terminate if it merges with another partnership. Generally, the partnership having partners who own more than 50% of the interest in the resulting (merged) partnership is considered the **surviving partnership.** If more than one partnership meets this threshold, the surviving partnership is the one that contributes assets having the greatest FMV **net of liabilities** to the merged partnership. Any partnerships other than the surviving partnership are terminated with a tax year closing on the date of the merger.

In some circumstances, a merger of partnerships takes place that results in no partnership having partners who represent more than 50% of the consolidated partnership's capital. In such circumstances, none of the merging partnerships survives the merger. Instead, a new partnership is established, and each of the prior partnerships is terminated.

19. *Partnership Act*. 2024. Uniform Law Commission. [www.uniformlaws.org/committees/community-home?communitykey=52456941-7883-47a5-91b6-d2f086d0bb44] Accessed on Nov. 9, 2023.

20. *Uniform Partnership Act (1997),* Article 8.

21. IRC §708(b)(1); Treas. Reg §1.708-1(c).

Example 4. Peter and Sarah are equal members of the PS partnership, which has total capital of $100,000. Quinn and Sue are equal members of the QS partnership, which also has total capital of $100,000. Robert and Sophia are equal members of the RS partnership, also with total capital of $100,000. The six partners jointly decide to merge their three partnerships, with the resulting entity having partnership capital of $300,000 ($100,000 PS capital + $100,000 QS capital + $100,000 RS capital) and named the PQRS partnership. Each of the initial partnerships has contributed one-third of the capital in the PQRS partnership ($100,000 capital contributed ÷ $300,000 total capital in the new organization). Because the partners of **none** of the predecessor partnerships contributed more than 50% to PQRS's capital, PQRS is a new partnership, and all three of its predecessors are terminated.

Example 5. The JK Limited Partnership (JK) and LMN, LLC execute a merger on July 5, 2024. JK was formed by Joe and Kim, who are still partners. The entity owns real estate free of debt; the real estate has a value of $400,000, as appraised shortly before a merger. JK owns no other assets apart from $1,000 operating cash. Joe owns 60% of the capital interest in the partnership, with Kim owning the remaining 40%. Thus, the value of its assets net of liabilities contributed to the surviving partnership is $401,000 ($400,000 real estate FMV + $1,000 cash).

LMN owns real estate appraised at $600,000, but it is subject to a $400,000 mortgage. It also has $1,000 in operating cash. Thus, the value of its assets net of liabilities is $201,000 ($600,000 real estate FMV – $400,000 mortgage + $1,000 cash).

JK is the surviving partnership because its assets net of liabilities is $401,000, which is more than 50% of the FMV of the assets net of liabilities of the merged partnership's assets (66.61% = $401,000 JK assets ÷ ($401,000 JK assets + $201,000 LMN assets net of liabilities)). Thus, even though JK's assets have an FMV less than LMN's assets, it is the surviving entity. LMN, LLC terminates as a partnership on July 5, 2024.

The terminated partnership(s) may treat the merger of the entity's assets and liabilities using either of two forms. The **assets-over form** occurs when the terminated partnership is treated as contributing the **assets and liabilities** in exchange for an ownership interest in the surviving partnership. It then distributes the ownership interests to its partners in the liquidation of the terminated partnership.

The **assets-up form** accomplishes the same result in the opposite order. In this case, the terminated partnership is considered to have distributed all of its **assets** to the partners in the termination of the partnership. The partners are then treated as having contributed the same assets to the surviving partnership immediately after receiving them in distribution.

Incorporation

A partnership's incorporation results in the termination of that partnership.[22] Rev. Rul. 84-111 provides that a transfer of assets to a corporation under IRC §351 terminates the partnership.[23] This treatment assumes that all the stock of the receiving corporation is distributed to the partners. In addition, it assumes that all the liabilities of the partnership become the corporation's liabilities. This form of conversion is accomplished as assets are retitled in the name of the corporation.[24]

22. IRC §708(b)(1).

23. Rev. Rul. 84-111, 1984-2 CB 88.

24. Metrejean, Cheryl and Nash, Claire (2005, Feb.) Tax Consequences of a Formless Conversion Following Rev. Rul. 2004-59. *TAXES*, 83, 43–48.

Rev. Rul. 84-111 looks at three situations that accomplish the conversion from a partnership to a corporation.[25]

1. With the **assets-over** approach to incorporation, the partnership transfers assets to the corporation, which assumes the partnership's liabilities. All the corporation's stock is transferred to the partnership, which then distributes it to the partners proportionately. The partnership is then terminated, as it no longer has assets or a continuing business.
2. With the **interests-over** approach, the partnership distributes assets and liabilities to its partners, who then transfer them to the corporation in exchange for all of its stock.
3. With the **assets-up-and-over** approach, the partners transfer their partnership interests to the new corporation, which issues them stock.

With each of these approaches, the entity does not retain ownership of its assets but instead transfers ownership to a new entity.

Withdrawal of All Partners Except One[26]

A partnership is terminated if all partners except one withdraw from the partnership. Generally, this results in a partnership becoming a sole proprietorship. Its remaining partner is now a sole proprietor or property owner who reports income on their Form 1040, *U.S. Individual Income Tax Return,* Schedule C, *Profit or Loss from Business*, Schedule E, *Supplemental Income and Loss*, or Schedule F, *Profit or Loss From Farming*.

By definition, a partnership is "a business entity… that is not a corporation and that has at least two members."[27] Thus, a partnership cannot exist if only one person owns its equity. If the entity was organized as an LLC, with only one member, it becomes a single-member LLC (SMLLC), thereby establishing a disregarded entity.[28] The remaining member of an LLC can file Form 8832, *Entity Classification Election*, to elect treatment as a corporation.[29]

> **Example 6.** Allen and Betty have operated the AB partnership since 2010. On February 1, 2023, Betty purchases Allen's interest in the entity for $10,000, making her the only partner. The AB partnership terminates on this day. AB has a taxable year ending on that date and must file a final Form 1065 showing February 1, 2023, as its yearend. It must also provide final Schedules K-1 to Allen and Betty. The final Form 1065 is due by May 15, 2023, unless AB files an extension.
>
> As AB was a partnership, it is now Betty's sole proprietorship, and she reports its income on her Schedule C. If AB had been an LLC, it would be a disregarded SMLLC unless Betty files Form 8832 to elect to be treated as a corporation.
>
> The termination of a partnership is reported on Form 1065 by marking box G (2), *final return*, as shown next.

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25. *Incorporating a Partnership or LLC: Does Rev. Rul. 84-111 Need Updating?* Gruidl, Nick. Apr. 1, 2007. The Tax Advisor. [www.thetaxadviser.com/issues/2007/apr/incorporatingapartnershiporllcdoesrevrul84-111needupdating.html] Accessed on May 21, 2024.
26. Rev. Rul. 99-6, 1999-6 IRB 6.
27. Treas. Reg. §301.7701-2(c)(1).
28. Treas. Reg. §301.7701-3(f)(2).
29. Treas. Reg. §301.7701-3(c)(1)(i).

For Example 6

Form **1065** — Department of the Treasury, Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2023, or tax year beginning Jan. 1, 2023, ending Feb. 1, 20 23.

Go to *www.irs.gov/Form1065* for instructions and the latest information.

OMB No. 1545-0123 — **2023**

A Principal business activity: Retail Trade	Type or Print	Name of partnership: AB	**D** Employer identification number: 78-9999999
B Principal product or service: Men's Clothing		Number, street, and room or suite no. If a P.O. box, see instructions.: 1000 N Main St	**E** Date business started: 1/2/2010
C Business code number: 458110		City or town, state or province, country, and ZIP or foreign postal code: Galena, IL 61036	**F** Total assets (see instructions): $ 0

G Check applicable boxes: **(1)** ☐ Initial return **(2)** ☒ Final return **(3)** ☐ Name change **(4)** ☐ Address change **(5)** ☐ Amended return

H Check accounting method: **(1)** ☒ Cash **(2)** ☐ Accrual **(3)** ☐ Other (specify):

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year: 2

J Check if Schedules C and M-3 are attached . . . ☐

K Check if partnership: **(1)** ☐ Aggregated activities for section 465 at-risk purposes **(2)** ☐ Grouped activities for section 469 passive activity purposes

Caution: Include **only** trade or business income and expenses on lines 1a through 23 below. See instructions for more information.

Death. If one partner of a 2-member partnership dies, the partnership does not terminate if it continues operating, provided that the deceased partner's estate continues to receive the deceased partner's profits or losses.[30] However, the partnership terminates if the deceased partner's estate or any successor does not succeed to the deceased partner's interest.

Qualified Joint Venture

When a married couple shares a business enterprise but has not yet elected QJV status, they must treat their business as a partnership, requiring the preparation and filing of Form 1065.[31] The spouses can terminate their partnership by electing to be treated as a QJV.[32] Making an election under IRC §761(f), their partnership terminates on the last day of the calendar year.

> **Note.** For more information about QJVs, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 6: Schedule E. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

INVOLUNTARY TERMINATION

Under unfavorable circumstances, the application of law may force a partnership to dissolve involuntarily. The provisions for technical terminations of partnerships before the Tax Cuts and Jobs Act (TCJA) became law were the usual cause of involuntary terminations, such as when the retirement of partners representing more than 50% of the total capital and profits interests could trigger these provisions.[33] The TCJA eliminated the technical termination provisions.[34] Bankruptcy and a court order dissolving a partnership are common methods of involuntary terminations.

30. Treas. Reg. §1.708-1(b)(1)(i).
31. IRC §761(f).
32. IRC §761(f)(2)(C).
33. *Questions and Answers about Technical Terminations, Internal Revenue Code (IRC) Sec. 708*. May 1, 2023. IRS. [www.irs.gov/newsroom/questions-and-answers-about-technical-terminations-internal-revenue-code-irc-sec-708] Accessed on Nov. 10, 2023.
34. *TCJA*, PL 115-97, §13504.

Bankruptcy

Some states may require partnerships to terminate when they file for bankruptcy protection under Title 11.[35] However, a bankruptcy filing does not terminate their existence under the Code. In fact, IRC §1399 specifically states that a bankruptcy filing does not create a separate taxable entity, as it would for an individual.

Thus, although the bankruptcy of a partnership may eventually result in a partnership termination, the bankruptcy itself does not cause the termination of a partnership under federal tax law. However, it may lead to the eventual termination of a partnership because bankruptcy may force it to cease operations.

Judicial Dissolution

A court may order the dissolution of a partnership based on its interpretation of the partnership agreement or state partnership law or for another legal reason. The Code does not specifically cite judicial decisions as a reason for dissolving a partnership.[36] However, a court order for a partnership to cease operation necessarily triggers the general rule for termination.[37]

CAPITAL ACCOUNT ISSUES

Partnerships use **§704(b)** capital accounts to track the partners' economic and financial interests within the partnerships, as distinguished from the partners' tax investments. Partnership capital accounts are commonly referred to as **"book"** accounts. When a partner contributes a noncash asset to a partnership, the partner's book capital account is generally increased by the asset's FMV.[38] Book capital accounts are essential for allocating profits, losses, distributions, and credits among partners based on their contributions to the partnership and the provisions of partnership agreements. When a partnership terminates, these accounts usually determine the final allocations due to a partner.

In contrast, partnerships use **tax-basis** capital accounts for tax reporting purposes.[39] Beginning with 2020 tax returns, partnerships are required to report capital accounts under tax basis, "using the transactional approach for the tax basis method."[40] When a partner contributes a noncash asset to the partnership, their tax-basis capital account is generally increased by the asset's basis in the partner's hands. Thus, these accounts reflect the partners' tax positions and help to determine the tax consequences, such as their share of taxable income, tax deductions, or taxable amount of any distribution. When a partnership terminates, tax-basis capital accounts and qualifying debt determine a partner's **tax** gain or loss on the disposal of partnership assets and the winding down of its affairs.

> **Note.** For more information about book capital accounts and tax-basis capital accounts, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 4: Select Topics for Partnership Operations.

35. *Tax Geek Tuesday: When Does a Partnership Terminate for Tax Purposes?* Nitti, Tony. Apr. 12, 2016. Forbes Magazine. [www.forbes.com/sites/anthonynitti/2016/04/12/tax-geek-tuesday-when-does-a-partnership-terminate-for-tax-purposes/] Accessed on Nov. 13, 2023.

36. IRC §708.

37. IRC §708(b)(1).

38. See Treas. Regs. §§1.704-1(b)(2)(iv)(b) and (g).

39. IRS Notice 2019-66, 2019-52 IRB 1509.

40. IRS Notice 2021-13, 2021-06 IRB 832.

DISTINCTIONS BETWEEN PROFITS AND CAPITAL INTERESTS

Proper bookkeeping for partnership capital accounts depends on whether partners have profits interests or capital interests. The type of interest that a partner holds governs how their investment in the partnership is maintained.

A **profits interest** entitles the partner to share only in the future profits of the partnership.[41] The profits interest provides the partner with a distributive share of the partnership's net income for a particular tax year. This depends on how the partnership agreement or operating agreement establishes this interest, but it likely includes a proportionate share of separately disclosed items and possibly special allocations. The partnership may allocate to a partner owning a profits interest a portion of special items under IRC §§704(b), (c), and (e), 736, and 743. A profits interest is a partnership interest that is not a capital interest.[42]

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A **capital interest** entitles the partner to share in a distribution of partnership assets upon the partnership's termination or when they withdraw from the partnership.[43] Assuming the partnership maintains capital accounts in line with Treas. Reg. §1.704-1(b)(2)(iv), the partnership can assume that a particular partner's proportionate capital interest is their capital account divided by the capital accounts of all partners. In a particular tax year, this is measured on the first day of that tax year.[44]

Aligning Book Capital Accounts with Tax Basis Capital Accounts

With §704(c), Congress created rules to prevent partnerships from shifting tax benefits from one partner to another when the only reason for the transfer was tax avoidance. This can readily happen when a partnership allocates income or expenses disproportionately to the partners' relative interests. It can also happen when one partner contributes property with a built-in gain, but the property is then distributed to another partner. The incentive for these allocations is particularly strong when partnerships terminate.

Substantial Economic Effect.[45] Properly maintaining partners' capital accounts is not just good practice; it is required by the regulations. Their importance is paramount during partnership termination, but special allocations can complicate the maintenance of capital accounts throughout the partnership's existence. By ensuring the allocations meet the substantial economic effect test, the Code aligns tax benefits with actual economic effects rather than minimizing one partner's tax liability.

Special allocations arise from the disproportionate allocation of partnership items of income, deduction, or credits, not based on partners' capital contributions or the ratio established for sharing partnership items. The purpose of the regulations is to ensure that the **income tax consequences** of an allocation follow the **economic consequences.** For a special allocation to be considered to have substantial economic effect, three requirements must be met.[46]

1. The partners' capital accounts must be properly maintained, following rules in Treas. Reg. §1.704-1(b)(2)(iv).
2. A liquidating distribution must be made from a **positive** capital account. This applies to either a complete partnership liquidation or the liquidation of a partner's interest. The alternative, a distribution from a negative capital account, infers that a partner receives a distribution despite having no investment in the partnership.
3. The partnership agreement or LLC operating agreement must contain a **deficit restoration obligation (DRO).** This provision obligates a partner to restore their capital account to at least a $0 value by the end of the partnership's tax year or within 90 days after its liquidation. The partner may give the partnership a promissory note to satisfy this obligation, provided that the maker of the promissory note is the partner or a person related to them under Treas. Reg. §1.752-4(b).

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41. Treas. Reg. §1.706-1(b)(4)(ii)(A).

42. Rev. Proc. 93-27, 1993-2 CB 343; Rev. Proc. 2001-43, 2001-2 CB 191.

43. Treas. Reg. §1.706-1(b)(4)(iii).

44. Ibid.

45. Treas. Reg. §1.704-1(b)(2).

46. Treas. Reg. §1.704(b)(2)(ii)(b).

Instead of a DRO, the partnership agreement can provide for a qualified income offset (QIO). This is a provision in the partnership agreement that satisfies the following requirements.[47]

- No allocation can be made to a partner with a QIO that causes or increases a deficit balance in that partner's capital account as of the end of the partnership tax year to which the allocation relates.
- The partnership agreement must provide that a partner who unexpectedly receives allocations or distributions resulting in a deficit capital account is allocated pro rata items of partnership income and gain in an amount and manner sufficient to eliminate the deficit balance as quickly as possible.

In determining the capital account of a partner with a QIO at the end of a tax year for allocation purposes, the regulations require the capital account to be reduced first to reflect the following adjustments that are **reasonably expected** at the end of the year to be made in subsequent years.[48]

- Oil and gas depletion
- Losses and deductions allocated to the partner under the family partnership rules, the rules governing retroactive allocations, and the rules governing disproportionate distributions of unrealized receivables and substantially appreciated inventory
- Distributions the partner will receive that exceed reasonably expected increases in the partner's capital account in the same year as the subsequent distribution

Note. For more information about the substantial economic effect rules, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 4: Select Topics for Partnership Operations.

Property Contributions on Book Capital Accounts at Termination[49]

IRC §704(c) allocations generally concern **continuing** partnerships. However, they can affect partnership termination when a partner receives a distribution of property that has been contributed to the partnership with a built-in gain. Even though the difference between the book value of the contributed property and its basis is reduced over time,[50] the partnership may terminate before these values become equal. In this event, a partner (other than the contributing partner) may receive as a distribution the property with the remaining portion of the built-in gain.[51]

Note. Only the traditional method for making allocations is discussed here. For more information about §704(c) allocations, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 4: Select Topics for Partnership Operations.

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47. Ibid.
48. Ibid.
49. Treas. Reg. §1.704-1(b)(2)(iv)(d)(3).
50. Treas. Reg. §1.704-3(a)(3)(ii).
51. Treas. Reg. §1.704-3(a)(8)(i).

Schedule K-1 (Form 1065) provides sections to report information for capital accounts, built-in gain, and unrecognized §704(c) items, as shown next.

L	**Partner's Capital Account Analysis**	23 ☐ More than one activity for passive activity purposes*
	Beginning capital account . . . $	*See attached statement for additional information.
	Capital contributed during the year . . $	For IRS Use Only
	Current year net income (loss) . . . $	
	Other increase (decrease) (attach explanation) $	
	Withdrawals and distributions . . . $ ( )	
	Ending capital account . . . . $	
M	Did the partner contribute property with a built-in gain (loss)? ☐ **Yes** ☐ **No** If "Yes," attach statement. See instructions.	
N	**Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**	
	Beginning . . . . $	
	Ending . . . . $	

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R **Schedule K-1 (Form 1065) 2023**

Traditional Method of Making §704(c) Allocations.[52] If a partnership has received contributions of §704(c) property, the associated depreciation is generally incurred over several years. However, the total income, gain, loss, or deduction allocated to the partners for a tax year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction for that property for the tax year. Referred to as the "ceiling rule," this causes adjustments over a number of years if the allocation is sufficiently large.

Cost Recovery with Built-In Gain at Termination. When a partner contributes property having an FMV greater than their basis in the asset, the asset's built-in gain could affect the partnership's termination for years into the future; this makes it §704(c) property. The asset's built-in gain is reduced every year by the decrease in the difference between the two following amounts.

- Property's §704(b) or book value (FMV)
- Property's adjusted tax basis (carryover basis)

If straight-line deprecation is used for tax purposes, the difference between the two becomes smaller because the depreciation associated with the book value is greater than the tax depreciation. The same percentage is used to depreciate both amounts, but the book value of the property having a built-in gain is greater.

However, when the modified accelerated cost recovery system (MACRS) is used, this may not be the case. This is because, for tax purposes, the percentage of an asset's value that is recovered through depreciation declines yearly. It is further complicated because the recovery period started when the asset was still the contributing partner's property.

Eventually, the asset's built-in gain should be zero because the depreciation has reduced the noncontributing partner's capital account associated **with the asset** to the contributing partner's tax basis.

The period for reducing the asset's built-in gain generally lasts for the balance of the asset's cost recovery period. This is because the asset's depreciation is preferentially allocated to the **noncontributing** partner during the asset's recovery period.

When the partnership dissolves, the price realized for the asset may still include some built-in gain. In that event, the contributing partner recognizes a taxable **gain** equal to the portion of the built-in gain that has not depreciated at the time of disposition.

52. Treas. Reg. §1.704-3.

When the terminating partnership sells an asset with a built-in gain, the first amount of gain must be allocated to the contributing partner. If the taxable gain at disposition exceeds the built-in gain at the time of contribution, the excess is allocated among the partners in proportion to their ownership interests.

Note. It is imperative that a practitioner construct both a book and tax balance sheet to assist with this process of accounting for adjustments in the partnership's basis in its assets.

Example 7. On January 1, 2022, Chuck and Diane formed the CD, LP, partnership. Its partnership agreement states that Chuck and Diane are both 50% partners and that the partnership must make allocations under §704(c) using the traditional method when permitted by the Code and regulations.

Upon the partnership's formation, Chuck contributes a machine to the partnership, which has an FMV of $20,000, an adjusted tax basis of $8,000, and has 10 years of its recovery period remaining. The rules for §704(c) property require that Chuck's contribution results in a $20,000 credit to his partnership book capital account. The partnership also elects to use straight-line depreciation. However, because his basis in the machine is only $8,000, the partnership's tax records must show a book-tax disparity of $12,000 ($20,000 machine's FMV – $8,000 Chuck's tax basis), equal to Chuck's built-in gain on the machine. Diane contributes $20,000 of cash, which has no §704(c) consequences.

The machine that was contributed has the following financial characteristics.

	Book Value	Adjusted Tax Basis	Adjusted Built-In Gain
Jan. 1, 2022	$20,000	$8,000	$12,000
2022 Depreciation	(2,000)	(800)	
Dec. 31, 2022	$18,000	$7,200	10,800
2023 Depreciation	(2,000)	(800)	
Dec. 31, 2023	$16,000	$6,400	9,600

The partners have tax basis capital accounts and book capital accounts as follows.

	Chuck		Diane	
	§704(b) or Book Capital Account	Tax Basis Capital	§704(b) or Book Capital Account	Tax Basis Capital
Jan. 1, 2022 capital	$20,000	$8,000	$20,000	$20,000
2022 Depreciation	(1,000)	(0)	(1,000)	(800)
2023 Depreciation	(1,000)	(0)	(1,000)	(800)
Dec. 31, 2023 capital	$18,000	$8,000	$18,000	$18,400

If the CD partnership owns the machine until the end of 2032, the 10 years of depreciation will have reduced Diane's tax basis capital to $12,000 ($20,000 on January 1, 2022 – (10 years × $800 per year)), while Chuck's remains at $8,000.

The traditional method of making §704(c) allocation is to regain parity of book capital and tax capital accounts. In this example, having been allocated no tax depreciation during the 10-year period, Chuck's tax basis capital equals $8,000, as expected among 50-50 partners. Both partners have book capital accounts equal to $10,000 ($20,000 on January 1, 2022 – (10 years × $1,000 depreciation per year)). At this point, the total book capital in the partnership is $20,000 ($10,000 Chuck's book capital + $10,000 Diane's book capital). The CD partnership's total tax basis capital is also $20,000 but is divided among the partners differently (Chuck's $8,000 tax basis capital in contrast with Diane's $12,000 tax basis capital). Thus, the book-tax disparity has been eliminated, but this parity has required the contributed asset's entire cost recovery period (10 years in this example) to accomplish this.

Consequently, if Chuck and Diane decide to terminate the CD partnership at the end of 2023, Chuck has a December 31, 2023, tax basis capital of $8,000, but Diane's tax basis capital is $18,400. The partnership has a total tax basis capital of $26,400 ($8,000 Chuck + $18,400 Diane). However, it has a total book capital of $36,000 ($18,000 Chuck + $18,000 Diane). Thus, at the end of two years, a book-tax disparity of $9,600 ($36,000 book capital – $26,400 tax basis capital) still exists.

The termination of the CD partnership after two years must take this disparity into account. If the machine is sold for $18,000 in the liquidation of the partnership, it will **have realized** a tax gain of $11,600 on its disposition ($18,000 value allocated to machine at liquidation – (8,000 Chuck's basis in the machine – (2 years × $800 per year tax depreciation))). Although Chuck and Diane are 50-50 partners in the CD partnership, Chuck must be allocated more gain than Diane in the entity's termination.

In this instance, the entire amount of gain is allocated to Chuck to account for the built-in gain on the machine when he contributed it. None of the loss on the sale of the machine is allocated to Diane because she has already received depreciation deductions for the machine.

TAX CONSIDERATIONS

Taxpayers must consider the characteristics of the assets disposed when determining the tax considerations of a terminating partnership.[53] Terminating partnerships must consider adjusted basis issues, the "mixing bowl" transaction requirements,[54] holding periods, and the special considerations that accompany the distributions of marketable securities.[55]

A partnership distributing assets in liquidation that readily generate ordinary income, such as inventory and unrealized receivables, have unique treatments in a partnership termination. These assets are not treated as capital assets but instead continue to be treated as assets potentially generating ordinary income. There are specific rules covering liquidating distributions of IRC §751 hot assets.

Another consideration at termination is for partnerships that use **debt** as a source of capital.[56] The way a partnership satisfies a debt affects the partners' tax consequences, particularly basis, when the partnership terminates. A partnership's financial operations have not ceased until its debt is either discharged by payment or until it is irrevocably assumed by another party, such as a partner.[57]

53. IRC §§731–733, 735.

54. IRC §704(c).

55. IRC §731(c) and supporting regulations.

56. *Equity Financing vs. Debt Financing: What's the Difference?* Maverick, J.B. Oct. 10, 2023. Investopedia. [www.investopedia.com/ask/answers/042215/what-are-benefits-company-using-equity-financing-vs-debt-financing.asp] Accessed on Nov. 27, 2023.

57. See *In re Samoset Associates, Debtor*. 14 B.R. 408 (Bankr. D. Me. 1981).

CHARACTERISTICS OF PARTNERSHIP ASSETS

The characteristics of a partnership's assets rise in significance when the entity disposes of them. The partners share a gain or loss when an asset is sold to an unrelated party. Although a partner does not necessarily recognize a gain or loss on an asset when the partnership distributes an asset to a partner,[58] a gain or loss would be recognized when the asset is sold to an unrelated party. In determining the tax effects of a distributed asset, the partnership must consider the following characteristics of the asset.

- Basis
- Source
- Holding periods
- Whether marketable securities are distributed

Basis

A partner has an **outside basis** in a partnership that is established when they make an initial contribution to the partnership's capital, adjusted by additional contributions and partnership income, gains, losses, and distributions.[59] The partnership itself has a basis in each of its assets. Because each partner has an interest in the partnership as a pass-through entity, they also have a basis in each of the partnership's assets as seen from inside the entity. This is termed the partnership's **inside basis.**[60]

Inside and outside basis has an immediate effect on a partner's tax position at **liquidation.** In a termination of a partnership, all partner's interests are liquidated. IRC §732(b) provides that the basis of property (other than money) distributed by a partnership to a partner is equal to the adjusted basis of the partner's interest in the partnership but reduced by money the partner receives.

In contrast, if the partner's interest in the partnership is **not** being liquidated, the property's basis is generally equal to the property's adjusted basis to the partnership immediately before the distribution.[61]

Source and Mixing Bowl Transactions

The contribution of nonmonetary property from a partner generally does not result in gain or loss at the time of contribution.[62] Appreciated property contributed by one partner may be either distributed to other partners or sold outright as a result of the partnership termination. A partnership termination may accelerate the application of the so-called "mixing bowl" transaction provisions of §704(c)(1)(B) or IRC §737. Because the ownership of an appreciated asset transfers to another partner, these distributions are referred to as "mixing bowl transactions."[63] Such distributions within seven years of the contributing partner contributing the property to the partnership result in the following consequences.[64]

1. The property is deemed to have been sold by the partnership for its FMV on the day it is distributed to another partner or otherwise disposed of.
2. The gain or loss resulting from the deemed sale is allocated to the contributing partner.
3. The outside basis of the contributing partner is adjusted to reflect the gain or loss.
4. The basis of the asset in the partnership is adjusted for the gain or loss effective immediately before the distribution. As a result, the receiving partner receives the property with its basis also adjusted for the gain or loss.

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58. IRC §731.
59. Treas. Reg. §1.705-2(a).
60. Ibid.
61. IRC §732(a)(2).
62. IRC §721.
63. *A practical guide to partnership division planning.* Dalton, Corey. Jul. 1, 2022. The Tax Adviser. [www.thetaxadviser.com/issues/2022/jul/partnership-division-planning.html] Accessed on May 7, 2024.
64. IRC §704(c)(1)(B).

Assets having built-in losses cannot be aggregated with other assets having built-in gains.[65] Thus, if a partner contributes two assets, one with a gain and the other with a loss, upon termination (or other disposition), the gain and the loss are considered separately in determining the contributing partner's gain or loss.

Holding Periods

When a terminating partnership distributes an asset to a partner, the partner's holding period includes the time the partnership owned the asset.[66] Also, when a partner contributes an asset to the partnership, the partnership's holding period includes the partner's holding period. However, if the asset is inventory in the hands of a contributing partner, it is not eligible for capital gain treatment in the partnership.[67]

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A gain or loss from an asset's sale can be treated as a long-term gain or loss on the day after the anniversary of its acquisition.[68] Because the partnership can include the time an asset was held by a contributing partner, this longer holding period requirement is more easily met.

> **Example 8.** Jerome purchased a 2-acre parcel of land on February 28, 2023, for $20,000 with the hope of using it for his farming operations. In September 2023, the QRT partnership expresses an interest in acquiring the parcel even though it is not in the real estate business. It offers Jerome a partnership interest in exchange for the parcel. He accepts this offer, becoming a partner of QRT on September 30, 2023, and contributes the land to the partnership on the same day. Because the land's value has not changed since Jerome purchased it, his tax basis capital account and book capital accounts are both $20,000.
>
> In March 2024, QRT's partners decide to terminate the partnership, and offer the land for sale. Within a month, Boone County Developers, Inc. purchases the land from QRT for $40,000. With no other assets, QRT terminates in June 2024. Although QRT owned the land for less than one year, the land's sale is eligible for treatment as a long-term capital gain. This result comes from Jerome's ownership of it during the 7-month period prior to contributing it to QRT. Thus, its holding period satisfies the holding period for long-term capital gains.

Inventory

If the property distributed is considered inventory to the partnership, it is not a capital asset.[69] A partner selling an inventory item that has been distributed to them must include its sale as ordinary income, regardless of how long they have owned the asset.[70]

Disguised Sales[71]

If a contributing partner subsequently receives another asset as a distribution,[72] even if the partnership is in the process of terminating, the disguised sales provisions in IRC §§707, 704, and 737 apply.

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65. Treas. Reg. §1.704-3(a)(2).

66. IRS Pub. 541, *Partnerships*; IRC §735(b).

67. IRS Pub. 544, *Sales and Other Dispositions of Assets*, p. 20 (2022).

68. *Topic No. 409, Capital Gains and Losses*. Oct. 17, 2023. IRS. [www.irs.gov/taxtopics/tc409] Accessed on Nov. 29, 2023.

69. IRC §1221(a)(1).

70. IRC §735(c)(1).

71. IRC§707(a)(2)(B).

72. *Basic Partnership Tax II: Sales, Disguised Sales & Terminations*, p. 3. Jan. 22, 2016. Wagner, Kirkman, Blaine, Klomparens & Youmans, LLP. [www.wkblaw.com/wp-content/uploads/Basic-Partnership-Tax-II-Sales-Disguised-Sales-Termination.pdf] Accessed on Nov. 29, 2023.

IRC §707 provides the general rules for disguised sales of assets. If a partner contributes property to a partnership and receives a distribution of money or other property within a specified period, the transaction will be recharacterized as a sale or exchange. If the transfer of an asset takes place within two years, the transaction is **presumed to be a disguised sale.**[73] Furthermore, the transaction must be disclosed to the IRS following the provisions of Treas. Reg. §1.707-8. If the distribution is made within two years of the original contribution, it is presumed to be a disguised sale of the property contributed to the partnership, although facts and circumstances may indicate otherwise.[74]

IRC §704(c)(1)(B) provides guidance on disguised sales that are also part of the mixing bowl transaction provisions discussed previously.

IRC §737 identifies complications that arise from distributions of property that were previously contributed with precontribution gain. Although contributions of property generally do not cause gain or loss to the partner,[75] §737 requires the contributing partner to recognize some gain. This amount is the lesser of the following two amounts.[76]

1. Any excess distribution, which is the amount by which the FMV of the property distributed to the partner exceeds their adjusted tax basis in their partnership interest
2. Any net contribution gain, which is the amount of net gain that the partner would have realized if all the property they had contributed within the previous five years and held by the partnership immediately before the distribution had been distributed to another partner who does not hold a controlling interest in the partnership

In this manner, §737 coordinates with §704(c)(1)(B) to tax at least some of the built-in gain that a partner may have contributed within the past seven years.

Example 9. On January 1, 2021, Nancy, Oscar, and Peter form the NOP partnership, each with a one-third interest. Nancy contributes depreciable real estate in Adams County with an FMV of $300,000 and an adjusted tax basis of $200,000. Oscar contributes land in Boone County, having an FMV and an adjusted basis of $300,000. Peter contributes $300,000 of cash to the partnership.

The real estate Nancy contributed has another 10 years remaining on its depreciation schedule and is depreciated using the straight-line method. The partnership uses the traditional method for allocating items for the Adams County property. NOP has $30,000 of annual **book** depreciation on this property ($300,000 book basis × 10%). The partnership has **tax** depreciation of $20,000 per year ($200,000 adjusted tax basis × 10%), which is evenly split between Oscar and Peter, the noncontributing partners.

At the end of 2023, the book value of the Adams County real estate is $210,000 ($300,000 initial book value – (3 years × $30,000 annual book depreciation)). This property's adjusted tax basis is $140,000 ($200,000 initial adjusted basis at time of contribution – (3 years × $20,000 annual tax depreciation)).

On December 31, 2023, the partners terminate the NOP partnership. Nancy receives the land in Boone County as a liquidating distribution. Her adjusted tax basis in NOP is still $200,000 because she was not allocated any of the depreciation on the Adams real estate. The $300,000 cash is distributed equally to Oscar and Peter, and each receives an undivided interest in the depreciable real estate in Adams County. The distributions of real estate are presumed not to be disguised sales because more than two years have passed since the real estate was contributed.

Nancy's excess distribution is $100,000 ($300,000 FMV of the land – $200,000 adjusted basis in NOP).

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73. Treas. Reg. §1.707-3(c).

74. See Treas. Reg. §1.707-3(c)(2) for three broad conditions requiring disclosure.

75. IRC §721(a).

76. Treas. Regs. §§1.737-1(a)–(c).

Nancy's net precontribution gain is $70,000 ($210,000 book value of the Adams County real estate she contributed in 2021 – $140,000 adjusted tax basis when she received it as a distribution). Nancy must recognize the gain on receipt of the distribution of $70,000 (lesser of the excess distribution ($100,000) and the net precontribution gain ($70,000)).

Caution. A liquidating distribution can trigger a disclosure requirement under the disguised sale requirements.[77] If a partnership distributes property to a partner who has contributed noncash property within the past two years, and the partnership within two years makes a distribution to the partner, both are required to disclose the event to the IRS. The partnership and the partner must each file a Form 8275, *Disclosure Statement*, containing the following information.[78]

- A caption that identifies the statement as a disclosure under §707
- A description of the property or money transferred to the partner, including its value
- A description of facts that are potentially useful to determine if the transfer of property is a disguised sale

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Distributions of Marketable Securities[79]

When a partnership owning marketable securities terminates, it may distribute the securities, rather than sell them, to generate cash that it could distribute instead. Generally, marketable securities, such as publicly traded stocks, are treated as **money** when distributed to partners. This treatment reflects the ability of a partner who receives the security to sell it and thereby convert it to cash. To the extent that the distribution of the marketable security is treated as a distribution of money, a partner's interest in the partnership as well as their outside basis in the partnership may be reduced.

Example 10. Jack, Ian, and Kathy have jointly owned a partnership, JIK, LP, for 10 years, and each owns a one-third interest in the entity. JIK is not an investment partnership. In December 2024, they wish to terminate the partnership, whose sole assets are 30 bonds of Corporation Z, each bond having an FMV of $1,000. These bonds are widely traded and are considered marketable securities.

On December 19, JIK terminates and transfers 10 of the Corporation Z bonds into the personal accounts of each partner. Each partner's interest in JIK is reduced by $10,000 (10 bonds distributed × $1,000 FMV per bond).

Note. An investment partnership is any partnership that has never been engaged in a trade or business and substantially all of its assets have always consisted of money, stock in a corporation, notes, bonds, debentures, or other evidences of indebtedness, etc.[80] Discussion of these partnerships is beyond the scope of this chapter.

77. IRS Pub. 541, *Partnerships,* p. 8 (2022); Treas. Reg. §1.707-3(c)(2).

78. Treas. Reg. §1.707-8(b).

79. Treas. Reg. §1.731-2.

80. IRC §731(c)(3)(C).

Marketable Securities Defined. Marketable securities are traded on a national securities exchange when they are distributed. The marketable securities themselves include the following.[81]

- A financial instrument that can be exchanged for money or other marketable securities
- Common trust fund
- Regulated investment company
- Any interest in a precious metal, unless the partnership uses precious metals in its business
- The partnership's interest in any other entity whose assets are primarily marketable securities, money, or both

For these purposes, a financial instrument is one of the following.[82]

- Stock
- Evidence of indebtedness, such as a bond or note
- Options
- Forward contracts
- Futures contracts
- Derivatives
- Notional principal contracts

Exceptions. The Code and the supporting regulations provide three exceptions to treating the distribution of marketable securities as money.

1. A partner may contribute a marketable security to a partnership. In this event, the distribution of the same security back to the same partner does not result in any change in basis. The distribution itself is not treated as the distribution of money.[83]
2. If the security was not considered marketable when the partnership accepted its contribution, it is not considered money if:[84]
    - At the time the partnership acquired the security, the issuing entity had no outstanding marketable securities,
    - The partner held the security for at least six months before the security became marketable, and
    - The partnership distributed the security within five years of when the security became marketable.
3. A partnership may be considered an investment partnership under IRC §731(c)(3)(C).

If any of these exceptions is met, the partnership's distribution of marketable securities to its partners is not considered a distribution of money. However, this exception only applies to distributions made to eligible partners, who are defined as those who have contributed only marketable securities to the partnership and are not involved in a transfer of an interest in the partnership that results in a transfer of a partnership interest having no taxable income recognized.[85]

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81. IRC §731(c)(2)(B).
82. IRC §731(c)(2)(C).
83. IRC §731(c)(3)(A)(i).
84. Treas. Reg. §1.731-2(d)(1)(iii).
85. IRC §731(c)(3)(C)(iii).

Reduction of Amount Treated As Money.[86] When a partner receives a distribution of marketable securities, they can reduce a fraction of the securities' FMVs that they treat as money. This reduction permits the receiving partner to treat the remaining portion as distributed property. This results in the partner receiving some of the securities with their carryover basis from the partnership.

The calculation considers the receiving partner's share of **net gain** on all the marketable securities. The net gain is the gain the partnership would recognize if it sold all of the marketable securities in its possession at their FMVs. Thus, this necessarily considers the partnership's basis in the securities. The partnership must apply the §743(b) adjustments to the securities' bases. However, it should exclude securities that the receiving partner contributed.[87]

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The fraction of the distributed securities' FMVs considered as money is the difference between the following two amounts.

1. The receiving partner's distributive share of net gain is what they would recognize if the partnership sold all its marketable securities held immediately **before** distributing the securities to the partner.
2. The receiving partner's distributive share of the marketable securities held by the partnership immediately **after** distributing the securities to the receiving partner.

The difference cannot be less than zero, so this provision is not applicable if the FMV of the securities after the distribution is greater than the FMV of the securities before the distribution.

Example 11. Sarah and Ted are equal partners in the ST Partnership, which is not an investment partnership but generates significant cash flow.[88] To prudently invest excess cash, they purchase the following widely traded stocks in the name of the partnership.

	FMV on December 28, 2023	Basis	Gain/(Loss)
A common stock	$10,000	$ 7,000	$3,000
B common stock	10,000	8,000	2,000
C common stock	10,000	11,000	(1,000)

On December 29, 2023, ST distributes the A stock to Sarah.

If ST had sold the securities at FMV immediately before distributing them to Sarah, the partnership would have realized $4,000 of net gain ($3,000 on A stock + $2,000 gain on B stock – $1,000 loss on C stock). Sarah's distributive gain would have been $2,000 (50% × $4,000 net gain).

If ST had sold the balance of the securities on the open market immediately **after** distributing only A stock to Sarah, the partnership would have $1,000 of net gain ($2,000 of unrealized gain on B stock – $1,000 unrealized gain on C stock). Sarah's share of the distributive gain on just B and C stock would have been $500 ($1,000 of net gain on B stock and C stock × 50%).

As a result, the distribution of only A stock to Sarah caused a decrease of $1,500 in Sarah's share of the net gain in the ST Partnership's securities ($2,000 net gain before distribution – $500 net gain after distribution).

The amount of the distribution of A stock that is treated as a distribution of money is reduced by $1,500. Thus, the distribution of A stock is treated as a distribution of $8,500 to Sarah ($10,000 FMV – $1,500 reduction)

86. Treas. Reg. §1.731-2(b).

87. Treas. Reg. §1.731-2(d)(1).

88. Based on Treas. Reg. §1.731-2(j), example 2.

Practitioner Planning Tip

Just because cryptocurrencies are not explicitly listed in §731(c)(2)(C), tax practitioners should not assume they are not included. In fact, by their very nature, cryptocurrencies are currencies that are traded on a financial market. The appearance on the 2023 Form 1065 of questions relating to virtual currency underscores the importance of asking partnership clients these questions.

LIQUIDATING DISTRIBUTIONS OF ASSETS

The tax treatment of a distribution of an asset depends on whether it entirely liquidates a partner's interest in the partnership.[89] If a distribution does not liquidate a partner's interest, it is considered a current distribution, and the partnership may not be terminated, as discussed previously.[90] IRC §732(a) provides that the basis of property other than money distributed as part of a **current distribution** is its adjusted basis to the partnership immediately prior to the distribution. However, this inside basis may not exceed the distributee-partner's outside basis in the partnership immediately prior to the distribution and after the reduction for any money distributed.[91]

However, if a partnership distributes property to liquidate a partner's **entire** interest, the partner's basis in the assets distributed is calculated differently.[92] The basis of the distributed property is the partner's outside basis **reduced** by any money the partnership distributes.

Liquidating Distributions of Assets Not Subject to IRC §751

Although constrained by the disguised sale regulations, partnerships can generally transfer assets to partners, who can subsequently sell them as assets subject to capital gains rates. However, the Code provides for an exception for "hot" assets, which are subject to §751.

Liquidating Distributions of Assets Subject to IRC §751(b)[93]

The purpose of §751(b) is to ensure that each partner reports their share of the partnership's ordinary income for distributions. For example, when a partner sells their interest in the partnership, IRC §741 treats it as a sale of a capital asset resulting in either capital gain or loss to the partner. In effect, the partner is selling their indirect ownership percentage in each asset the partnership holds. Instead of using capital gains rates on any recognized gain, the partner must recharacterize this gain as being subject to other possible income tax rates (e.g., 25% for unrecaptured IRC §1250 gain, 28% for collectibles,[94] or up to 37% for certain ordinary income assets). Assets subject to ordinary income recharacterization under §751(b) are unrealized receivables, substantially appreciated inventory, and depreciation recapture. These are commonly referred to as **hot assets.** The sale of a partnership interest that includes hot assets requires the partnership to file Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests,* as discussed later.

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89. IRC §§732(a)–(b).
90. Treas. Reg. §1.761-1(d).
91. Treas. Reg. §1.732-1(a).
92. IRC §732(b).
93. IRC §751.
94. IRC §§1(h)(1)(E) and (F).

Even distributions that rearrange the partners' indirect interest in certain ordinary income assets (unrealized receivables and appreciated inventory items) are taxed as a sale or exchange between the distributee-partner and the partnership.[95] Consequently, either the partner or the partnership may recognize gain or loss on the recharacterized transaction.

The §751(b) hot asset rules can apply with both **nonliquidating and liquidating distributions**. However, this is true only to the extent that a partner receives:

- Hot assets in exchange for any part of their interest in other property,
- Other property, or
- Non-hot assets in exchange for any part of their interest in hot assets.[96]

IRC §751 **does not apply** to the following situations.[97]

- Distributions of property that the distributee-partner originally contributed to the partnership
- Payments to a retiring partner or a deceased partner's successor interest made under §736(a)
- Draws or advances against a partner's distributive share
- Distributions treated as gifts
- Payments for services
- Payments for the use of capital

Unrealized Receivables. Unrealized receivables are **not exclusively** limited to cash basis receivables in a service-type partnership. The Code uses a broad definition of the term to mean the right to payment for goods or services that have been delivered or rendered, or that will be.[98] The term also extends to the rights of a cash method partnership to a payment that results from a contract or agreement that is in existence at the time a partnership interest is sold or a distribution of partnership property is made.

Within the broad scope of unrealized receivables, the partnership can still have unaccrued contract rights for services to be performed and goods to be delivered in the future. Any ordinary income depreciation recapture is also included.[99] However, any unrecaptured §1250 is separately accounted for, as it is taxed at its own rate.[100]

The total gain must be computed first to determine the portion of gain associated with unrealized receivables. Next, the portion of the gain associated with the partnership's hot assets must be computed. This total amount to be allocated among all partners is the ordinary gain or loss associated with §751 assets immediately prior to the termination of the partnership.[101]

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95. IRC §751(b).
96. Treas. Reg. §1.751-1(b)(1)(i).
97. Treas. Reg. §1.751-1(b)(1)(ii).
98. IRC §751(c).
99. Generally, IRC §§1245 or 1250, but also includes several other ordinary income items under IRC §§1252, 1253, and 1254.
100. IRC §1(h)(6).
101. Treas. Reg. §1.751-1(a)(2).

Substantially Appreciated Inventory.[102] Substantially appreciated inventory is treated as a hot asset and receives ordinary income treatment when distributed by any partnership, including terminating partnerships.[103] Inventory includes any partnership assets held for sale to customers in the normal course of its trade or business. It also includes all partnership property that, if sold or exchanged, is considered a noncapital asset or property not used in the partnership's trade or business.

To be "substantially appreciated," the total FMV of all the partnership's inventory items must exceed 120% of the aggregate adjusted bases of those items. The "unrealized receivables" as well as "realized receivables" (most likely in an accrual partnership) are both included in the definition of "inventory" when ascertaining whether the 120% mark was passed.

> **Observation.** If an accrual basis partnership has significant realized receivables, it is less likely that the substantially appreciated test will be met because receivables are included in the aggregate adjusted bases for all inventory items.

> **Note.** IRC §751(**a**) pertains to sales or exchanges of partnership interests and includes **all** inventory in the calculations involving hot assets. IRC §751(**b**), in contrast, applies to **distributions** that must be treated as sales or exchanges; the calculation of hot assets under this subsection of the Code is only concerned with **substantially appreciated** inventory.

Calculating Ordinary Gain on Hot Assets.[104] This critical calculation is made by first computing the **total** gain on a distribution, separately determining the amount of gain on each hot asset, classifying those hot assets, and assigning gain to each classification. Any difference between the total gain reduced for the gain associated with hot assets is attributable to capital gain on the transaction. This sometimes has the counterintuitive result of producing a capital **loss** when a partner experiences an overall total gain.

Identify and Classify Hot Assets. Hot assets must be classified according to the tax rate applied to each type. For example, recaptured depreciation is generally taxed at ordinary rates when it is recovered. Some assets, such as §1250 real estate, are taxed at a maximum rate of 25%, so they must be categorized differently.

In addition, the partnership should distinguish §751 gain from the sale or exchange of partnership interests from the §751 gain arising from the **distribution** of partnership assets. A partnership must report any gain or loss generated by the distribution of partnership property as other income on Form 1065, Schedule K, *Partner's Distributive Share Items,* line 11.[105] In contrast, the gain generated by the **sale or exchange** of partnership interests should be reported on Form 1065, line 6, because it originates on Form 4797, *Sales of Business Property,* line 10, and is included in the total on line 17.

When a partnership terminates, if one partner acquires the partnership interests of all others, both scenarios may occur on the same Form 1065. Only the §751(a) gain that arises from the sale or exchange of partnership interests is reported on Schedule K-1 (Form 1065), part III, box 20 with code AB.[106]

> **Note.** Any gains taxed at ordinary rates also increase the qualified business income deduction (QBID). For more information on how hot assets generate QBID, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 5: Partners Terminating Their Interest in a Partnership.

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102. IRC §751(d)(2); Treas. Reg. §1.751-1(d).

103. Treas. Reg. §1.751-1(a)(1).

104. Treas. Reg. §1.751-1(a)(2).

105. 2023 Instructions for Form 1065, page 38.

106. 2023 Instructions for Schedule K-1 (Form 1065), page 29.

Determine the Total Gain. Taxpayers determine total gain by adding the total sales proceeds from the transaction for the partner. This sum must consider marketable securities distributed and the relief from any responsibility for indebtedness that the taxpayer has received. The taxpayer subtracts their basis in the partnership interest from this amount to determine their total gain.

Example 12. Alethia Printing, LP, purchased a printing press for $300,000 in 2021, and since then has claimed $80,000 of ordinary depreciation. Alethia's four equal partners have each voted to terminate the partnership, with Vera, the only general partner, purchasing the other partners' interests in the partnership for $85,000 each. Vera receives the press as a distribution. An appraiser estimated the press's FMV at $360,000. Each partner has an outside basis in the partnership equal to $58,000.

Prior to the press's distribution, Alethia had a hot asset, the accumulated depreciation, with an FMV of $80,000. This asset has a $0 basis. Of the $85,000 that each exiting partner receives from Vera, $20,000 ($80,000 accumulated depreciation ÷ 4 partners) is considered an unrealized receivable under **§751(a).**

Each exiting partner realizes a total gain of $27,000 ($85,000 realized price – $58,000 basis in the partnership). Of this amount, $20,000 is treated as **§751(a)** ordinary gain. The remaining $7,000 ($27,000 total gain – $20,000 ordinary gain) is treated as a capital gain. Vera receives a liquidating distribution under **§751(b).** The §751 gain may result in a QBID deduction for the partners.

Determine the Gain or Loss on Each Hot Asset by Category.[107] After determining the total gain, that gain is partitioned into different categories based on asset class. Hot assets that generate **ordinary income** must be reviewed for the gain they produce. For example, if the disposal of depreciable assets triggers ordinary income following the rules of IRC §1245, a portion of the total gain is set aside for the recapture of this gain. Generally, the amount of recapture is a gain because the partnership's basis in it is $0. However, the disposal of inventory generally involves computing the partnership's basis in that inventory.

A portion of the total gain is set aside for the remaining asset classes, including collectibles gain, §1250 capital gain, and residual long-term capital gain or loss. The most likely source of this is §1250 property, which is taxed at a maximum rate of 25%.

These amounts are subtracted from the total gain to determine the capital gain or loss on the total disposition of all partners. If this amount is positive, the former partner can report a capital gain, which is taxed at lower rates than the other asset classes mentioned. If this amount is negative, the former partner can report a capital loss. Unless there are other capital gains that the capital loss can offset, an individual partner can deduct only $3,000 of capital loss each year ($1,500 if the partner is married filing a separate return).[108]

Allocate a Portion of the Gain or Loss on Each Hot Asset to the Partners Involved. The allocation of each asset class for each partner can then be determined. In many partnerships, the partnership agreements allocate the same percentage of all assets to partners. Partnerships with more complex partnership agreements may allocate gain associated with certain assets differently. Because hot assets are subject to higher tax rates, there may be an incentive to allocate gain from these assets differently. However, §751(b) provides for the deemed sale of non-§751 assets to counteract this incentive.

107. Treas. Reg. §1.1(h)-1(a).

108. IRC §1211.

Example 13. Carl and Barb formed the Salmon Partnership many years ago. On November 1, 2023, Carl told Barb that he wanted to retire. Barb told Carl she would purchase his 40% interest in the partnership for $240,000 with a closing on December 31. On that date, Carl's outside basis in Salmon is $360,000.

The partnership's balance sheet follows.

		Inside Basis	FMV
Cash		$ 5,000	$ 5,000
Accounts receivable		41,000	25,000
Inventory		40,000	50,000
Equipment (IRC §1245 asset)	$ 50,000		
Accumulated depreciation	(26,000)		
	$ 24,000	24,000	35,000
Building	$780,000		
Accumulated Depreciation	(40,000)		
	$740,000	740,000	830,000
Land		50,000	55,000
Total assets		$900,000	$1,000,000
Debt		$400,000	$400,000
Partner capital (Barb)		300,000	360,000
Partner capital (Carl)		200,000	240,000
Total liabilities and capital		$900,000	$1,000,000

The $240,000 that Carl receives on December 31 indicates that the FMV of the partnership is $600,000 ($240,000 ÷ 40%). Combined with the $400,000 debt, this means that the partnership's total assets are $1,000,000 ($600,000 partnership FMV + $400,000 debt).

Because every partnership must have at least two partners, Salmon terminates on December 31 when Carl ceases to be a partner. Because he is relieved of his obligation for his share of Salmon's $400,000 of debt, Carl receives a total consideration of $400,000 for the sale of his interest in the partnership ($240,000 + 40% × $400,000).

Carl's outside basis is approximately $360,000, the inside basis of his partner capital account plus his share of the liabilities ($200,000 + $160,000). Thus, Carl's projected total gain on the entire sale is $40,000 ($400,000 consideration received – $360,000).

To determine the gain associated with partnership §751 assets, the following spreadsheet is constructed to calculate the partnership's gain from §751 assets.

Asset	Inside Basis	FMV	Difference	Carl's Share	Carl's Share of §751 Gain/(Loss)	Carl's Share of Unrecaptured §1250 Gain/(Loss)	Carl's Share of Capital Gain
Accounts receivable	$ 41,000	$ 25,000	($16,000)	($ 6,400)	($6,400)	$ 0	$ 0
Inventory	40,000	50,000	10,000	4,000	4,000	0	0
Equipment	24,000	35,000	11,000	4,400	4,400	0	0
Building	740,000	830,000	90,000	36,000	0	16,000	20,000
Land	50,000	55,000	5,000	2,000	0	0	2,000
Total					$2,000	$16,000	$22,000

The breakdown of the gain for the building requires additional explanation. Because the building was purchased for $780,000, the partnership has already taken $40,000 of depreciation on it. Unlike the equipment, however, the partnership termination does not trigger ordinary income for the building but rather unrecaptured §1250 gain. Carl's share is $16,000 ($40,000 partnership unrecaptured §1250 gain × 40%). The appreciation of the building means that the rest of Carl's gain is $20,000 capital gain ($36,000 total gain on building – $16,000 uncaptured §1250 gain).

Thus, Carl must recognize $2,000 of ordinary income as his share of §751 gain. IRC §751 converts what would have been a capital gain or unrecaptured §1250 gain into ordinary income with its higher tax rate.

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Example 14. The Trout Partnership has the following assets.

Asset	FMV	Adjusted Tax Basis	Gain
Cash	$50,000	$50,000	$ 0
Receivables	80,000	0	80,000
Inventory	20,000	10,000	10,000
Land	50,000	30,000	20,000
Total			$110,000

The total FMV of all inventory items, which includes receivables, is $100,000 ($80,000 + $20,000), and the adjusted basis of all inventory items is $10,000. Because the total FMV of all inventory items ($100,000) is more than 120% of the adjusted basis of all inventory items ($10,000), the partnership's inventory is considered substantially appreciated. As a result, both Trout's inventory and receivables are treated as hot assets. When Trout terminates, the partnership will allocate a portion of the total gain to the deemed disposition of hot assets.

Observation. This increases their effective tax rate on the termination because hot assets are taxed at a higher rate than capital assets.

Disproportionate Distributions of §751 Assets. IRC §751(b) applies when a non pro rata distribution of a partnership's hot assets is made to a partner which has the effect of "rearranging" the partners' shares of §751(b) property. In making this determination for a continuing partnership, the distributee-partners' predistribution interest in hot assets versus non-hot assets is compared with their respective postdistribution interests in such property. If such a shift in the partners' interests in the partnership's hot assets occurs, then the distribution is treated as a sale or exchange of property under §751(b). The purpose of this Code section is:

> *[t]o prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests.*[109]

When a partnership terminates, it may dispose of its hot assets in several ways.

Distributions of Hot Assets Proportionately.[110] Hot assets may be distributed to partners in proportion to their interests in the partnership's capital. Generally, the partnership does not incur reportable income before final distributions because it has distributed the assets, not sold them. Each partner has received a hot asset that reflects their proportionate interest in the partnership, so §751 does not apply.

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109. *Roth v. Comm'r*, 321 F.2d 607 (9th Cir. Aug. 5, 1963), quoting S. Rep. No. 1622, 83rd Cong., 2d Sess. (1954).

110. Treas. Reg. §1.751-1(b)(2)(ii).

Example 15. Larry and Curly form the LAC Law Group, LLC, each owning 50%. After several successful years of working together, they are both interested in retiring. They decide that the easiest way to do this is to divide everything 50-50 and terminate the LLC. First, they use the available cash to pay off all outstanding liabilities. The remaining balance sheet is as follows.

	FMV	Adjusted Tax Basis
Cash	$ 50,000	$50,000
Accounts receivable	50,000	0
Furniture	1,000	0
Computers	500	0
Total	$101,500	$50,000
Partner's capital	$101,500	$50,000

Each partner receives the following in liquidation.

Cash	$25,000
Accounts receivable	25,000
Furniture	500
Computers	250

The furniture and the computers were purchased by the LLC several years ago and have been fully depreciated. They are §1245 property. In addition, the accounts receivable have a zero-tax basis and, therefore, are subject to ordinary income treatment. However, because the assets are divided pro rata, neither Larry nor Curly recognizes any income on the termination. Rather, the basis of their partnership interest is first reduced by the cash distributed. Any remaining balance is allocated to other assets received. However, the accounts receivable, the furniture, and the computers continue to carry the "taint" of ordinary income. As the receivables are collected, the former partners realize ordinary income.

Deemed Sales with Disproportionate Distributions.[111] When a partnership terminates, if one or more of the partners receives a distribution of non-§751(b) property that is greater than their proportionate share of hot assets, they are deemed to have sold their share of the hot assets to the partnership for their FMV. This can result in a series of transactions with cascading effects. Because the partner is deemed to have sold their share of the hot assets, they generally must recognize a taxable gain, although a tax loss may also result.

If a disproportionate distribution of hot assets is made and it results in a deemed sale or exchange under §751(b), both the partnership and the distributee-partner are required to include a statement with their respective returns for the year of the distribution which explains the computation of any resulting income, gain, or loss.[112]

The distributee-partner's statement is also required to include the following information.[113]

1. Date of the distribution
2. Adjusted tax basis of their partnership interest
3. Amount of any money or value of any non-§751(b) property received
4. Election and computation of their adjusted tax basis in §751(b) property under §732(d) (if otherwise applicable)
5. Allocation and computation of special basis adjustments to partnership properties under §743(b) (if otherwise applicable)

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111. Treas. Reg. §1.751-1(b)(3).

112. Treas. Reg. §1.751-1(b)(5).

113. Treas. Regs. §§1.751-1(a)(3) and 1.751-1(b)(5).

Example 16. Scott, Don, and Albert each own a one-third interest in the Eagle Partnership. The partnership has the following assets.

Asset	Basis	FMV
Cash	$ 6,000	$ 6,000
Inventory	6,000	12,000
Land	9,000	18,000
	$21,000	$36,000

Scott's partnership interest has a basis of $7,000 ($21,000 ÷ 3). All inventory is distributed to Scott in the liquidation of his partnership interest. Don and Albert each are distributed $3,000 cash and half the land. This liquidates the partnership's assets.

Scott is treated as having exchanged a one-third interest in the cash and the land for a two-thirds increased interest in the inventory. Scott has a gain of $3,000 because he received $8,000 (⅔ × $12,000) of inventory in exchange for assets with a basis to him of $5,000 (⅓ × ($6,000 cash + $9,000 land)). The $3,000 gain ($8,000 realized – $5,000 basis) would be capital gain if the land was a capital asset. Don and Albert are also each allocated $3,000 of gain.

The partnership is treated as having received $8,000 (FMV of Scott's ⅓ share of cash and land) in exchange for inventory with a basis of $4,000 (basis of inventory distributed in excess of Scott's ⅓ share). Thus, the partnership recognizes ordinary income of $4,000, one-third of which is allocated to each of the three partners.

PARTNERSHIP DEBT ISSUES AT TERMINATION

The distribution of assets becomes more complicated when debts encumber the assets. A terminating partnership may decide to repay its debts and obligations prior to winding up, but it is common for assets to be distributed to partners with debt attached to them. General considerations affect nonrecourse liabilities, recourse liabilities, and debt relief in general.

Debt relief is generally treated as the receipt of cash for income tax purposes. For partnership purposes, **the partner is treated as receiving a cash distribution** to the extent the partner is relieved of or has decreased their share of partnership debt. If this constructive distribution exceeds the partner's outside basis in the partnership, the excess is taxable as a sale or exchange of the partnership interest,[114] resulting in long- or short-term capital gain based on the partner's holding period in the interest.[115]

Nonrecourse and Recourse Liabilities

The general rules applying debt relief to nonrecourse and recourse debt follow. Generally, debt affects basis but not the capital account.

Nonrecourse Liabilities. When a partnership terminates, a partner may receive an asset with the **nonrecourse** debt still attached, as part of the distribution. That partner assumes the portion of the debt for which they were not already accountable.[116] However, nonrecourse liabilities do not provide **at-risk** basis, unless an exception applies.[117] The exception arises from **qualified** nonrecourse debt, which is treated as an amount at risk.[118] A lender may prefer to foreclose on a piece of real estate if they have made a nonrecourse loan to a partnership.

114. IRC §731(a).

115. Treas. Reg. §1.1223-3.

116. IRC §752(a).

117. IRC §465(b)(4).

118. IRC §465(b)(6).

If the lender forecloses on the property secured by nonrecourse debt, partners may realize a taxable **gain** if the amount of recourse debt that is discharged exceeds the adjusted basis of the property secured.[119] Because nonrecourse debt does not provide an at-risk basis, a partner is unlikely to have a taxable loss that they can recognize.

Recourse Liabilities. When a partnership terminates, it is possible for a partner to receive the underlying asset in distribution with the **recourse** liability still attached. The terms of the loan agreement likely control the transfer of the liability, and they may not permit it at all. The lender may not wish the liability to be transferred, particularly if an individual would be liable for the payment of principal, interest, and fees, as they may not have the needed credit capacity. In this event, the creditor may decide its financial position is stronger if it forecloses on the property and either sells it or operates it as a rental.[120]

If the lender forecloses on the property secured by recourse debt, partners may realize a taxable **gain** if the amount of recourse debt that is discharged exceeds the adjusted basis of the property secured.[121] If the adjusted basis of the property securing the recourse debt is greater than the amount of debt extinguished, the possibility exists for the former partner to recognize a loss on the foreclosure of the property.

Basis Issues: Debt Encumbering Assets Distributed at Termination

When a partnership distributes assets to a partner, the distribution of property subject to debt may be treated as a taxable transaction despite the nonrecognition provisions of §731(a).

Disappearing Basis.[122] The adjusted tax basis of the distributed property in the hands of a partner may be less than its tax basis in the hands of the partnership. For example, the partner's outside basis in the partnership immediately before distribution may be less than the partnership's basis in the asset adjusted downward for the debt attached to the asset, assuming this is a liquidating distribution. Therefore, the distribution can cause the taxable gain on a subsequent sale by the partner to be greater or the taxable loss to lessen.

However, the distributed asset may displace some of the partner's gain when their partnership is terminated. Instead of being associated with the partnership interest, making it taxable when the partnership is terminated, the asset is taxed when the taxpayer to whom it is distributed disposes of it. Thus, the asset may be taxed at a later time. In some cases, if the partnership acquired the asset shortly before the partnership termination, a partner waiting a year to sell it may be able to change the character of its gain from a short-term to a long-term capital gain, assuming that the asset was a capital asset.

Deemed Distributions.[123] If the partnership liabilities for which a partner is responsible decrease, the partner is considered to have received a distribution of money, even though they have received no cash. When a partnership distributes assets encumbered with debt for which partners not receiving the property had been responsible, they have received a deemed distribution. This reduces their outside basis in the partnership. If the value of remaining liabilities exceeds the partner's outside basis, they are subject to gain to the extent that the value of the distributed assets exceeds their basis.[124]

Reductions of Partners' Shares of Recourse Liabilities.[125] Assuming that the debt associated with distributed assets continues to encumber those assets, other partners are responsible for a reduced amount of debt.

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119. IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments for Individuals*.

120. *Recourse vs. Nonrecourse Debt and Why It Matters for Taxes.* Yoder, Tim and Smith, Liz. Mar. 19, 2024. Fit Small Business. [fitsmallbusiness.com/recourse-vs-nonrecourse-debt/] Accessed on May 3, 2024.

121. IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments for Individuals*.

122. IRC §732(b).

123. IRC §752(b).

124. IRC §731(a)(1).

125. IRC §752(b).

Netting Liabilities.[126] If the distribution is made by a terminating partnership, the partner must determine whether their net change in liabilities is positive or negative. This evaluation must compare the partner's share of liabilities when the partnership is subject to them with the partner's obligation for the liabilities once the property is distributed. If the net change in liabilities is negative, the decrease is treated by both the partnership and the partner as a distribution of cash. Sometimes, the net change may be greater than the partner's outside basis in their partnership interest. In this event, the partner must recognize gain equal to the amount by which the deemed distribution exceeds their basis. The deemed distribution includes the amount of money and a net decrease in liabilities to the extent that the decrease exceeds their outside basis in the partnership.

Example 17. Vicky and Alvin are 50-50 partners in the Falcon Partnership. Vicky's outside basis in the partnership is $12,000, as is Alvin's. The entity owns a piece of undeveloped Alabama land clear of debt with an FMV of $14,000, as well as another parcel of land in Virginia worth $14,000. The partnership also has $4,000 cash. Falcon purchased the Alabama land in 2021 for $6,000, which is still its basis.

Vicky and Alvin terminate their partnership on June 1, 2024. Falcon distributes $2,000 cash to Alvin along with the Alabama land. Vicky also receives a $2,000 cash distribution, as well as the Virginia land. Alvin's basis in the land is limited to $10,000, which is his $12,000 outside basis reduced by the $2,000 he received as a distribution. Thus, by distributing the land to Alvin, its basis increased from $6,000 to $10,000, and his recognition of the gain for tax purposes is deferred until he sells it.

Example 18. Abby and Brandon formed the ABV partnership five years ago, each contributing $5,000 cash. The partnership agreement provides for partners to participate equally in gains, losses, and contributions. It also requires any distributions to be made proportionately to the partner's capital account, but these distributions are only permitted if their capital account is positive.

A year later, ABV purchases undeveloped land for $20,000, incurring $20,000 in nonrecourse debt secured by the land. The partnership makes no cash distributions for five years, and all revenues are exactly offset by expenses. In early January 2024, Abby and Brandon have the land appraised and learn that its FMV is $30,000.

When they originally formed ABV and made their cash contributions, both Abby and Brandon had capital accounts of $5,000. Acquiring the undeveloped land did not change Abby's or Brandon's partnership capital. The property is acquired with nonrecourse debt for which neither Abby nor Brandon is responsible or has an economic risk of loss. Thus, before the appraisal, Abby and Brandon each had a partnership capital account of $5,000.

Example 19. Use the same facts as **Example 18.** Brandon and Abby terminate the partnership. The partnership had not spent the $10,000 in total initial contributions that it had received from the partners when ABV was formed. The entity distributes the land with the debt to Abby, and Brandon receives $10,000 in cash.

Because the land is distributed in a terminating distribution, the partners' capital accounts must be adjusted to reflect the unrealized gain. Subject to the provisions of the partnership agreement that gains and losses be equally shared, Abby's partnership capital account is increased by $5,000 (($30,000 appraised value – $20,000 purchase price) × 50%) to $10,000 ($5,000 initial contribution + $5,000 increase due to appreciation of the land).

For the same reasons, Brandon's capital account has also increased to $10,000. Because the land is distributed to a partner, the asset is transferred to the partner with the same basis as its hands in the partnership.

126. Treas. Reg. §1.752-1(f).

Basis Issues: Lender Acquires Assets and Forgives Debt

When a loan goes into default, and a lender must seize the collateral, the tax consequences of this transaction depend on whether the debt is considered nonrecourse or recourse.

Nonrecourse Debt Forgiven. When a partnership's assets are acquired by a nonrecourse lender in foreclosure, the lender's acquisition of the property is considered a deemed sale by the partnership to the lender.[127] If the asset so conveyed was the principal asset of the partnership, the partnership may terminate. The amount realized in the deemed sale is the principal amount of the nonrecourse debt plus unpaid associated interest and other expenses potentially paid by the lender.[128]

The partnership likely realizes income on this transaction, as the income realized through the deemed sale may exceed the inside basis of the encumbered asset.[129] No cancelation of debt income (CODI) arises from this scenario, however.[130]

Recourse Debt Forgiven.[131] If the lender forecloses on a partnership asset securing recourse debt, at least one partner has liability for the loan, even if the lender acquires the asset. The deemed sale amount arising from the forgiveness of recourse debt is the lesser of the following two amounts.[132]

- FMV of the property foreclosed and acquired by the lender
- Amount of the secured debt

Depending on the remaining basis of the property, the terminating partnership may realize a **gain or loss** on the acquisition by the lender.[133] If the lender forgives the outstanding loan, partners for whom the debt was recourse may have CODI.[134] This occurs to the extent the outstanding balance of the forgiven loan exceeds the property's FMV.[135] However, if the lender continues to pursue repayment from a recourse partner, no cancelation of debt has occurred, although the partnership will still be treated as having a deemed sale of the property.

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127. *Comm'r v. Tufts*, 461 US 300 (1983).

128. *Allan v. Comm'r*, 856 F.2d 1169 (8th Cir. 1988).

129. *Commercial real estate: Debt restructuring and planning*. Broze, Ryan. Aug. 1, 2021. The Tax Adviser. [www.thetaxadviser.com/issues/2021/aug/commercial-real-estate-debt-restructuring-planning.html] Accessed on Dec. 8, 2023.

130. IRC §108(i)(6). Nonrecourse debt would not decrease a partner's share of liabilities.

131. *Commercial real estate: Debt restructuring and planning*. Broze, Ryan. Aug. 1, 2021. The Tax Adviser. [www.thetaxadviser.com/issues/2021/aug/commercial-real-estate-debt-restructuring-planning.html] Accessed on Dec. 8, 2023.

132. Treas. Reg. §1.1001-2(a).

133. These provisions are not specific to terminating partnerships, but the loss of a key asset to foreclosure likely results in a partnership termination.

134. IRC §108(d)(6).

135. See Treas. Reg. §1.1001-2(c), example 8.

Partnership Debt Paid by Partner

It is not uncommon for lenders to request personal guarantees from the principals of a business. A guarantee may eventually become a personal liability of a partner if the partnership is unable to satisfy the liability. In this circumstance, the partner may be required to make good on a guarantee. Generally, the partner increases their basis to the extent that they personally cover the liabilities of the partnership they actually pay. The contingent obligation associated with the guarantee by itself has no effect on the partner's basis or their capital account.[136]

Observation. Partnerships treat CODI differently from S corporations. Partnerships report CODI on partners' Schedules K-1 (Form 1065), passing the income to them as a separately stated item.[137] However, S corporations apply certain exclusions at the entity level, specifically the following.[138]

- Any cancelation of debt excluded from income under IRC §108(a)
- Any reduction of tax attributes under §108(b)
- Any qualified real property business indebtedness under §108(c)
- Any discharge of qualified farm indebtedness under §108(g)

Other CODI is passed to the S corporation's shareholders.[139]

4

Debt Paid by Partner to Former Creditor. Occasionally, a partner may voluntarily settle a debt of a terminating partnership in return for an increased interest in the partnership. Thus, the former creditor is paid by a partner, not the partnership that was obligated to repay the debt. With a partnership in financial distress, a partner's payment of third-party debt is likely to be considered a capital contribution. Although it may be more advantageous for the partner to extend a personal loan that replaces the third-party loan, the financial distress makes the repayment of the loan questionable. If the debt payment is treated as a capital contribution, the partner's interest is increased by the amount of the payment made to the creditor.[140] The partnership does not recognize gain or loss in this event.[141]

If the partnership does not provide the partner who pays the debt with an increased partnership interest, the partner may be able to treat the payment of principal or interest as a worthless debt, although the questions about the nature of the partner's advance, capital or debt, may arise.[142] The loan documents should identify the partner as the loan's guarantor, endorser, or indemnitor. In addition, the taxpayer must have received some form of "reasonable consideration" for having undertaken the guarantee.[143]

136. IRC §752(a), which restricts a partner's increase in basis to their "share of the liabilities of a partnership" or the assumption by the partner of the entity's liabilities.

137. IRC §108(d)(6).

138. IRC §108(d)(7)(A).

139. Ibid.; See *Debt Discharge Under Sec. 108: Partnerships vs. S Corps.* Boos, Robert, Nov. 30, 2012. The Tax Adviser. [www.thetaxadviser.com/issues/2012/dec/clinic-story-05.html] Accessed on Feb. 8, 2024.

140. IRS Pub. 541, *Partnerships*, p. 10 (2022).

141. Ibid., p. 8 (2022).

142. Treas. Reg. §1.166-9(a).

143. Treas. Reg. §1.166-9(e)(1).

Debt Assumed by Purchaser that Acquires Assets

If a terminating partnership sells property subject to indebtedness, the treatment depends on whether the indebtedness was recourse or nonrecourse. If the debt is nonrecourse, the partnership must treat the assumption of the debt by the property's purchaser as an increase in the amount realized for the sale of the property.[144] In contrast, the sale of property securing a recourse liability generates CODI unless another taxpayer agrees to pay the debt.

Forfeiture or Abandonment

At some time in the life of a partnership, one or more partners may want to leave the partnership. In some cases, the partner is willing to abandon their partnership interest just for the purpose of getting away from the potential liabilities.

If the abandonment of a partnership interest results in a loss, an **identifiable event** must occur to claim the deduction.[145] Typically, a letter to the creditors indicates that the partner is no longer liable for debts. While the lender might not release the partner from existing debts, the exiting partner is not liable for any future loans. This letter and a letter to the remaining partners are enough to demonstrate that an identifiable event occurred.

If the abandonment of a partnership interest results in the partner being relieved of debt, the debt relief is treated as a deemed sale.[146] If the partner does not have basis in excess of the deemed sale, they must recognize a gain. This gain is reported on the partner's Form 1040, Schedule D, *Capital Gains and Losses*, as a capital gain. It is reported as a long-term gain if the partnership interest has been held for more than one year. The gain is also reported on Form 8949, *Sales and Other Dispositions of Capital Assets.*

Note. For more information on forfeiture or abandonment of partnership interest, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 5: Partners Terminating Their Interest in a Partnership.

PREPARING THE FINAL PARTNERSHIP TAX RETURN

Many issues confront the managers of a terminating partnership as they approach the preparation of its final tax return. Unlike corporations, which must file Form 966, *Corporate Dissolution or Liquidation*, when they terminate, partnerships do not have a special IRS form to file when they decide to dissolve the entity or liquidate partnership interests.

The partnership is required to file a final income tax return by the 15th day of the third month following the termination,[147] although this can be extended by six months.[148] Because a partnership's tax year ends on the date the partnership terminates, it must file a short-period return unless the termination date occurs in the last month of its tax year.[149] Details on preparing the final return are covered at the end of this chapter.

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144. Treas. Reg. §1.1001-2(a)(4)(i).
145. Treas. Reg. §1.165-1(b).
146. Rev. Rul. 93-80, 1993-2 CB 239.
147. IRC §6072(b).
148. IRC §6081(a).
149. IRC §6072(b).

Example 20. Dirk, Edna, and Fran formed a service business, DEF, LLP, in 2017.[150] On April 30, 2024, they all vote to end the partnership. They stop providing services to their customers on July 31, 2024. After that date, the only partnership assets are $3,000 in cash. On September 30, 2024, each of the three partners receives their share of the partnership's assets, and they close the partnership's bank account.

DEF, LLP, continues its financial operations until September 30, 2024, which marks the termination of the partnership. DEF's final Form 1065 is due December 16, 2024, although it can file an extension that would make the return due June 16, 2025. Because DEF was a calendar-year partnership, the Form 1065 is a short-period return.

4

REPORTING THE PARTNERSHIP TERMINATION

In the absence of a special form, the partnership's final Form 1065 return should be marked as final, as should any associated Schedules K-1 or K-3, *Partner's Share of Income, Deductions, Credits, etc. — International*. The 2023 Schedule K-2, *Partners' Distributive Share Items — International*, does not contain a checkbox to indicate that the schedule is the last one the partnership will generate.

Because a partnership's **final return triggers special processing** at the IRS,[151] it is important for tax practitioners to establish the proper termination date. A partnership terminates when neither the entity nor any of its partners engages in any business, financial operation, or venture of the partnership, as discussed previously. The breadth of this requirement may make it difficult for tax practitioners to determine this date. However, the Internal Revenue Manual states this simply in the following manner.[152]

A "Final" Short Period return ends on the date the partnership went out of business.

The Internal Revenue Manual provides for the IRS to indicate other means of indicating a partnership return is final.[153] If the return is a final short-period return, it may also use the following words written on it to indicate it is final: "FINAL," "OUT OF BUSINESS," or "NO LONGER LIABLE."[154] A partnership may also signal that it plans to file no further Form 1065 with one of the following notations.[155]

- Deceased
- Liquidation
- Exempt under IRC §501(c)(3)
- Dissolved
- Filed in accordance with Rev. Proc. 2003-84
- Return is a "nominee" return
- IRC §"761(a) election" notated and is accepted by examination

150. Treas. Reg. §1.708-1(b)(1).

151. IRM 3.11.15.12 (2020), 3.11.15.15.4 (2022), 3.11.15.16 (2023), 3.11.15.26 (2024), 3.11.15.50.2 (2017).

152. IRC 3.11.15.8.4 (2020).

153. Ibid.

154. Ibid.

155. IRM 3.11.15.15.4 (2022).

REPORTING POINTS

Although it is always important to ensure the underlying bookkeeping is correct before undertaking a business tax return, it is especially important with a partnership termination. **Both the §704(b) book and tax basis capital accounts are critical.** For example, if §704(b) book capital accounts are incorrect, partners may receive incorrect distributions of assets. If the tax basis capital account should be reported as negative, but is not, a partner may incorrectly conclude that a distribution is not taxable, when to the contrary, it would be subject to tax. Other reports of partners' economic interests may also be distorted.

Reporting Sales of Partnership Property

Taxpayers use Form 4797 to report sales of business property. If a partnership sells property in the process of winding down, it may have to report the sale of these assets on this form. However, if the assets are distributed to partners, they are reported instead on Schedule K-1 (Form 1065), box 19, *Distributions*, either with code B if they consist of property contributed by another partner within the previous seven years or code C if the distributed assets were so contributed.[156]

Reporting Sales or Distributions of Partnership Goodwill[157]

If a terminating partnership sold assets that constitute a trade or business while winding down, it may be required to file Form 8594, *Asset Acquisition Statement Under Section 1060*. In general, the requirement to file is imposed if the assets constitute a trade or a business and goodwill is attached to the disposition. The requirement to file is also imposed if the person taking possession of the assets uses the price they paid to determine their basis in the assets.

Practitioner Planning Tip

Because both the seller of a business and the purchaser must file Form 8594, it is wise for the two to exchange copies of this form.[158]

Form 8594 may also be used to report the distribution of a partnership interest and the basis of the interest.[159] The associated regulations require both the recipient and the transferor to report the transfer of the partnership interest. Such a transaction is outside the scope of this discussion. Partnerships file Form 8594 with their Forms 1065 for the year that includes the sales of business assets. If the allocation to a specific asset changes in a subsequent year, parts I, *General Information*, and III, *Supplemental Statement*, must be filed in another Form 8594.

> **Note.** For more information on Form 8594 and the sale of a business, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Terminating a Business Interest. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

156. Partner's Instructions for Schedule K-1 (Form 1065).

157. Instructions for Form 8594.

158. Treas. Reg. §301.6721-1(h)(3)(xvii).

159. Treas. Regs. §§1.743-1(k)(1) and (2).

Reporting the Sale or Exchange of Partnership Interests[160]

If a partner sells their interest in a partnership and a part of the sale is attributable to §751(a) assets, such as accounts receivable or inventory, the partnership must report the transaction on Form 8308. This form reports the two parties in the sale, the sale date, the type of partnership interest transferred, and the partner's share of gain or loss. Generally, the partnership must include one Form 8308 for each partnership interest sold or exchanged.

Example 21. Isaac, Julie, and Kevin have been the only members of the IJK, LLC, since they formed it in 2009. IJK is a calendar-year entity taxed as a partnership that has sold lamps from a retail store throughout its existence. IJK was successful because it built a steady repeat business with interior decorators who consistently referred business to it. Although the partners worked in the business, each received guaranteed payments for their services, which were consistently reported on their Schedules K-1 (Form 1065).

In early 2024, the three partners voted to sell the business by selling its goodwill and going concern value, store fixtures, receivables, and inventory to another store, Lamps and Lights (L&L). IJK also owns a fully depreciated delivery truck that it purchased in 2013. IJK is distributing this truck to Isaac, who plans to use it in an unrelated business.

Julie, the partnership representative, discussed this plan with IJK's tax practitioner, Sam, in March 2024. Sam advises her that they should plan on filing Form 4797 to report the sale of store fixtures and Form 8594 to report the sale of inventory and goodwill to L&L. Because IJK is selling assets covered by §751(a) to L&L, Sam tells Julie that their Form 1065 must also include the following Form 8308 to report the sale of her interest to L&L. The LLC must file similar Forms 8308 to report Isaac's and Kevin's sales of their interests.

160. Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests.*

For Example 21

Form **8308** (Rev. October 2023)
Department of the Treasury
Internal Revenue Service

Report of a Sale or Exchange of Certain Partnership Interests

Go to *www.irs.gov/Form8308* for the latest information.

OMB No. 1545-0123

Name of partnership	Phone number	**Employer identification number**
IJK, LLC	**217-555-6666**	**27-1234567**

Number, street, and room or suite no. If a P.O. box, see instructions.
123 Main St

City or town, state or province, country, and ZIP or foreign postal code
Northwoods, IL 60185

Part I Transferor Information
Record holder of the partnership interest immediately before transferring that interest:

Name	**Identifying number**
Julie Smith	*****-**-6789**

Number and street (including apt. no.)
123 Red St

City or town, state or province, country, and ZIP or foreign postal code
Elgin, IL 60123

Check if the transferor is foreign: ☐

Beneficial owner of the partnership interest immediately before transferring that interest:

Name	**Identifying number**
Julie Smith	*****-**-6789**

Number and street (including apt. no.)
123 Red St

City or town, state or province, country, and ZIP or foreign postal code
Elgin, IL 60123

Notice to Transferors: The information on this form has been supplied to the IRS. The transferor in a section 751(a) exchange is required to treat a portion of the gain realized from the exchange as ordinary income. For more details, see Pub. 541, Partnerships.

Statement by Transferor: The transferor in a section 751(a) exchange is required under Regulations section 1.751-1(a)(3) to attach a statement relating to the sale or exchange to their return. See *Instructions to Transferors* on page 3 for more details.

Part II Transferee Information
Record holder of the partnership interest immediately after the transfer of that interest:

Name	**Identifying number**
Lamps and Lights	**27-8912345**

Number and street (including apt. no.)
123 Brown St

City or town, state or province, country, and ZIP or foreign postal code
Geneva, IL 60134

Beneficial owner of the partnership interest immediately after the transfer of that interest:

Name	**Identifying number**
Lamps and Lights	**27-8912345**

Number and street (including apt. no.)
123 Brown St

City or town, state or province, country, and ZIP or foreign postal code
Geneva, IL 60134

Part III Transfer of Partnership Interest

1 Date of sale or exchange of partnership interest: **09 / 04 / 2024**

2 Type of partnership interest transferred:

A Capital ☒

B Preferred ☐

C Profits ☐

D Other ☐

For Paperwork Reduction Act Notice, see instructions. Cat. No. 62503I Form **8308** (Rev. 10-2023)

For Example 21

Form 8308 (Rev. 10-2023) Page **2**

Part IV **Partner's Share of Gain (Loss) Required by Sections 751(a) and 1(h)(5) and (6)**
The amounts in column (c) should be reported to the selling partner on their Schedule K-1 in box 20 using the relevant code.

		(a) Partnership-level deemed sale gain (loss)	**(b1)** Percentage interest in the partnership transferred	**(b2)** Number of units in the partnership transferred	**(c)** Partner-level deemed sale gain (loss)	K-1 box 20 code
1	Section 751(a) gain (loss) . . .	12,000	33.3333		4,000	AB
2	Section 1(h)(5) gain					AC
3	Deemed section 1250 unrecaptured gain					AD

Sign here only if you are filing this form by itself and not with Form 1065.

Under penalties of perjury, I declare that I have examined this return, including accompanying attachments, and to the best of my knowledge and belief, it is true, correct, and complete.

Julie Smith — Signature of partnership representative or partner or limited liability company member

11 / 15 / 2024 — Date

Short-Period Tax Return Considerations

Unless a partnership terminates during the last month of its tax year, it must file a short period return by the 15th day of the third month following the partnership's termination.[161] The short-period return reports the partnership's income and expenses during the portion of its final year before it terminates. In most cases, the partnership return can be filed up to six months later under the automatic extension rules.[162]

Practitioner Planning Tip

Unless the termination occurs so late in the year that the appropriately dated tax returns become available, the return may need to be filed using the previous year's tax software. Regardless, dates indicating the beginning and the end of the partnership's final tax year should be entered at the top of Form 1065. The Internal Revenue Manual requires both dates to be maintained in the IRS's systems, identifying the return as a "Final Short Period" return.[163]

Example 22. Use the same facts as in **Example 21.** On August 21, 2024, Julie calls Sam to inform him the partnership is closing on September 4, just two weeks later. He informs her that their short-period Form 1065 is due December 16, 2024, although its filing can be extended.

When a partnership terminates prior to its normal year end, the short year is identified at the top of Form 1065 with the appropriate date of the year end.

Form **1065** — Department of the Treasury, Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2023, or tax year beginning ____________, 2023, ending ____________, 20___.

Go to *www.irs.gov/Form1065* for instructions and the latest information.

OMB No. 1545-0123 — **2023**

Name of partnership

161. IRC §6072(b).

162. IRC §6081(a).

163. IRM 3.11.15.8.1 (2020); IRM 3.11.15.8.4 (2020).

Other Matters

A miscellany of other issues can warrant a tax practitioner's attention as a partnership terminates.

Reporting Rental Income and Expenses. A partnership normally reports all real estate rental activity on Form 8825, *Rental Real Estate Income and Expenses of a Partnership or an S Corporation*. This information should coincide with the information on the partnership's Form 1065, Schedule K, line 2.

> **Note.** Form 8825 is not required when a partnership files a final tax return.[164] However, if a terminating partnership has any rental or royalty activity, completing this form may assist the tax practitioner in ensuring that the tax basis capital accounts are properly reported.

Employment Tax Returns.[165] If the partnership had employees, it should file final payroll tax returns when it terminates.[166] This return should be marked "Final," and it should also provide a statement with the form indicating the address where the partnership plans to maintain its payroll records. This statement is required with both Forms 941, *Employer's QUARTERLY Federal Tax Return,* and 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*.

Additionally, Forms W-2, *Wage and Tax Statement*, and Forms 1099 must be sent to employees and recipients. Filing these forms can be easily overlooked among the myriad of tasks surrounding the termination of a partnership.

Record Retention. A terminating partnership may have many years of records to maintain. The partnership must maintain records for at least several more years to be able to answer an IRS inquiry.[167] Treas. Reg. §1.6001-1(e) states that taxpayers, and potentially their agents, should maintain them "at all times available for inspection" by authorized IRS personnel. This regulation requires their retention "so long as the contents thereof may become material" for the enforcement of tax law.

However, this requirement does not just apply to partnerships. A reasonable reading suggests that the partnership maintain records as long as they may be useful to any partner's tax matter. Under some circumstances, the partners may need the records longer than the partnership.

Unamortized Expenses.[168] If a partnership has not fully amortized any deferred expenses when it terminates, the unamortized balance can be deducted on the entity's final return. IRC §709 specifically permits deductions for organization and syndication fees. For example, if a partnership incurred start-up or organizational expenses when it started,[169] but they have not been fully amortized, they can be deducted on the final return. They are subject to the requirement that they must be deductible under IRC §165, which pertains to losses. As a consequence, goodwill acquired through an acquisition can be deducted because it is a business expense deductible under IRC §197(c)(1). However, the self-created goodwill of a terminating partnership cannot be deducted because the Code does not permit taxpayers to amortize intangibles they have created.[170]

Winding Up Expenses. There may be expenses associated with the ending of the partnership that are paid or incurred after the final tax return has been prepared. For example, if the tax preparer fails to bill and collect the final return preparation fee, that expense will be incurred after the final return has been filed. Additionally, the final return may reflect a refund of state income taxes that may be received after all accounts have been closed. As discussed previously, the IRS may claim that the partnership has not terminated until after all of these winding-up activities have been completed.

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164. IRM 3.11.15.25.1 (2021).

165. Treas. Regs. §§31.6011(a)-1(a)(1) and 31.6011(a)-6.

166. Treas. Reg. §31.6011(a)-1(a)(1).

167. IRC §6001.

168. IRC §195(b)(2); IRS Pub. 535, *Business Expenses*, p. 30 (2022).

169. IRC §195(b)(1).

170. IRC §197(c)(2).