Chapter 5: Partners Terminating Their Interest in a Partnership

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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.

About the Author

John W. Richmann, EA, is a Tax Materials Specialist at the University of Illinois Tax School. Prior to joining Tax School in 2021, he owned a tax practice in St. Charles, Illinois, and held positions in private industry and consulting firms. John earned a Masters Degree in Business Administration from the University of Texas and an electrical engineering degree from the Massachusetts Institute of Technology.

Other chapter contributors and reviewers are listed at the front of this book.

Partners often form a partnership venture with the goal of making a profit. However, various reasons might lead them to exit this venture and the exit process can become complicated. This chapter provides an introduction to various tax matters that arise when terminating a partnership interest. The method of termination influences the divestment of a partnership interest and is the first topic of discussion.

Building on this foundation, the chapter explores three ways that the termination of a partnership interest can result in unexpected costs that could further affect the profitability of a partnership interest: negative IRC §704(b) capital accounts; basis issues; and hot assets. Tax practitioners must then help clients navigate reporting information from their final Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*

> **Note.** This chapter uses the following terms throughout.
>
> - **Retiring partner** — a partner who leaves a partnership by ceasing to be a partner under local law, generally when the partnership redeems the retiring partner's interest.
> - **Selling partner** — a partner withdrawing from the partnership who sells their interest to another party. The buyer may have no connection to the partnership, or they may already be a partner.
> - **Withdrawing partner** — an individual leaving a partnership generally, without specifying whether they are retiring from the partnership or selling their interest.

METHODS OF TERMINATING A PARTNER'S INTEREST

A partner may relinquish their interest in a partnership in a number of ways. The most common ways follow.

- Sale
- Liquidation or proportionate sale to all other partners
- Retirement and death
- Gift
- Abandonment or forfeiture
- Worthlessness

Alternatively, the partnership itself may terminate, thereby terminating all partners' interests.[1] Although a partnership may approve a plan of liquidation, its partners continue to have an interest in the entity until their interests are completely liquidated. If the plan of liquidation calls for the partner's interest to be liquidated through a single distribution or a series of distributions, only upon the final distribution is the partner's interest terminated.

> **Note.** For more information about the termination of partnerships, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 4: Partnership Terminations.

1. IRC §708(b).

SALE

One of the more common methods of terminating a partner's interest is the partner selling their interest in the partnership. This includes sales to a third party, sales to other partners that are not proportionate, or a proportionate sale to all the other partners. The selling partner has a responsibility to advise the partnership that they have sold their interest.[2]

Sale to a Third Party

One of the ways an individual partner may sell their interest in a partnership is to an unrelated third party. The sale of their partnership interest is generally considered the sale of a capital asset, although IRC §751(a) requires that the partner characterize gain associated with certain types of assets as generating ordinary income. This recharacterization is discussed later.[3]

The original partner ends their relationship with the partnership, and the new partner figuratively steps into the shoes of the original partner, acquiring their **inside** basis in the partnership's asset, as well as other attributes of those assets. The new partner's **outside** basis in the partnership is the consideration they paid for the partnership interest plus any indebtedness they assumed in connection with the partnership.[4]

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> **Note.** For more information on the distinction between inside and outside basis, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 4: Select Topics for Partnership Operations.

Sale to Other Partners[5]

A partner may sell their interest to other partners, with tax treatment similar to the sale of a partnership interest to a third party.[6] The acquiring partners acquire a share of the selling partner's interest in the partnership.[7]

With a sale to other partners, the selling partner is required to recognize gain or loss.[8] If the partnership has only two partners, and one sells their entire interest to the other, this also terminates the partnership's status as an entity distinct from its owners.[9]

Example 1. Tom, Mike, and Nathan are equal partners in the TMN, LLC. Tom and Nathan want to buy Mike's interest in the limited liability company (LLC). The fair market value (FMV) of TMN is $270,000, and Mike's share is 1/3 or $90,000. Each partner has a basis in their partnership interest of $10,000. Tom and Nathan each pay Mike $45,000 for 1/2 of Mike's interest. Mike realizes a gain of $80,000 ($90,000 payment – $10,000 basis) on the sale of his interest. Tom and Nathan now have additional basis in their partnership interest having paid $45,000 for the additional 16.67% interest acquired from Mike. After the transaction, Tom and Nathan each own 1/2 of TMN LLC, and each has a basis of $55,000 ($45,000 from Mike's interest + $10,000 original 1/3 interest).

Example 2. Use the same facts as **Example 1,** except TMN, LLC only had two partners, Tom and Mike. Tom buys Mike's interest, making Tom the only remaining member of TMN, LLC. Because a partnership requires at least two partners, TMN, LLC is now a single-member LLC and no longer qualifies as a partnership.

2. Treas. Reg. §1.6050K-1(d)(1).
3. IRC §741; Treas. Regs. §§1.741-1(a) and (b).
4. IRC §752(a).
5. Treas. Reg. §1.736-1(b)(1) and IRC §741.
6. IRC §741; Treas. Reg. §1.741-1(b).
7. Ibid.
8. IRC §741.
9. Treas. Reg. §1.708-1(b)(1)(ii).

LIQUIDATION OR PROPORTIONATE SALE TO ALL OTHER PARTNERS

If a partner retires from the partnership or dies, that partner's interest may be proportionately sold to the remaining partners.[10] This transaction constitutes a sale, and the remaining partners may retain the same proportional interest in the entity after acquiring the retiring or deceased partner's interest.

If the partners handle the transaction as a **redemption** instead of a sale, payments to the departing partner should be made directly from the partnership rather than as proportionate payments that the remaining partners make themselves.[11] By definition, liquidations of a partnership interest can result only from distributions that terminate a partner's complete interest.[12] This is considered a redemption of their interest. Because the withdrawing partner's interest is redeemed, they have received a distribution that does not alter the organization's ownership structure. This is because the remaining partners proportionately increase their ownership of the partnership when the withdrawing partner's interest is redeemed.

When their interest is redeemed, the withdrawing partner **does not recognize capital gain,** provided their adjusted basis after the transaction is not negative.[13]

CONTRASTING SALES AND LIQUIDATIONS

As discussed previously, a partner treats the sale of a partnership interest as the sale of a capital asset.[14] This results in capital gain except to the extent the gain is recharacterized as ordinary income under §751. **Liquidation** of the interest of a **deceased or retiring partner** is treated as a distribution and is governed by IRC §736. If the partnership interest is liquidated for cash, it is generally only a matter of distinguishing between payments under §§736(a) and 736(b). The tax treatment of the two can differ significantly.

A **selling partner** is required to recharacterize gain as ordinary income to the extent of the partner's share of unrealized receivables.[15] The remaining partners receive no benefit from such recharacterization unless an IRC §754 election is in effect, and then only the purchasing partner or partners receive a benefit. In a liquidation, a partner's interest in unrealized receivables may be treated as a §736(a) payment for partnership property, thereby reducing ordinary income to the remaining partners because the payments reduce the distributive shares of the remaining partners or are deductible by the partnership as a guaranteed payment.[16]

> **Example 3.** Use the same facts as **Example 1,** except that the partners agree to terminate Mike's interest in the partnership. The three partners agree that Mike is entitled to a $90,000 distribution from the partnership in termination of his interest. After Mike's interest is liquidated, Tom and Nathan each own 50% of TMN, LLC and Mike receives the $90,000 distribution. However, Tom and Nathan do not receive any additional basis in their ownership interest because neither of them paid Mike for his interest.
>
> Mike may have ordinary income rather than capital gain income. If any of the $90,000 distribution is a guaranteed payment under §736, Tom and Nathan share in the deduction for the guaranteed payment, and Mike has ordinary income treatment.

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10. Treas. Reg. §1.741-1(b).
11. *Termination of a Partnership Interest*. Dulworth, Cynthia. Oct. 1, 2008. AICPA. [www.thetaxadviser.com/issues/2008/oct/terminationofapartnershipinterest.html] Accessed on Apr. 18, 2024.
12. Treas. Reg. §1.761-1(d).
13. IRC §733; Treas. Reg. §1.731-1(a)(1)(i).
14. IRC §741.
15. Ibid.
16. IRC §736(a).

In summary, the sale of a partnership interest typically results in capital gain income or loss. In contrast, the liquidation of a partnership leads to various types of payments: ordinary partnership income, guaranteed payments, payments for unrealized receivables, payments for goodwill, and potentially some distributions that are not taxed. Because of the differing tax consequences, it is important to distinguish a sale from a liquidation of the interest. The general rule is that the partners are free to determine the form in which to cast the transaction. Courts generally accept an unambiguous agreement characterizing the transaction. If it is not clear, the transaction is examined for its substance under a facts-and-circumstances determination.[17]

RETIREMENT AND DEATH[18]

A retired partner is no longer considered a partner under the state or local law under which the partnership was formed. Nevertheless, they are still partners for federal income tax purposes until their interest in the partnership has been liquidated. For partnership tax law, the term "retirement" does not mean that the partner has stopped working in general, only that they no longer have a relationship to a **continuing** partnership. Like the proportionate sale to all other partners, this also involves the provisions of §736.

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The payments made to a retiring partner may consist of some combination of the following.[19]

- The partner's distributive share of partnership income
- Guaranteed payments
- Payment for unrealized receivables
- Goodwill of the partnership

Guaranteed Payments (Liquidation Only) or Distributive Shares[20]

Payments under §736(a) are taxable to the withdrawing partner as a distributive share of partnership income if they are payable with regard to partnership profit. They are treated as **guaranteed payments** under IRC §707(c) if payable without regard to partnership profit. In either event, §736(a) payments are taxable income to the withdrawing partner and either reduce the distributive share of the remaining partners (if distributions) or are deductible by the partnership (if guaranteed payments).[21]

> **Note.** For more information about guaranteed payments, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 4: Select Topics for Partnership Operations.

17. See, e.g., *Foxman, et al. v. Comm'r*, 41 TC 535 (1964), *aff'd* 352 F.2d 466 (3rd Cir. 1965), *acq*. 1966-2 CB 4.
18. Treas. Reg. §1.736-1.
19. IRC §736.
20. Ibid.
21. IRC §736(a)(2).

Payment for Unrealized Receivables[22]

Liquidating distributions to a retiring partner for the partner's interest in partnership property are subject to §736(b). Although distributions are generally not taxable to the retiring partner, §736(b) payments can result in **capital gain or loss.** An exception is provided if there are unrealized receivables or inventory items. In that case, the partner is required under §751 to treat as ordinary income an amount equal to what the partner's share of gain would have been if the partnership disposed of all of its receivables and inventory in a taxable sale at FMV.[23] The partner, therefore, has ordinary income to the extent of that amount.[24] The remainder of the §736(b) liquidating distribution is governed by the provisions of IRC §731.[25] The constructive sale treatment is not required for distributions of §751 property contributed to the partnership by the distributee-partner or for distributions treated as distributive shares of partnership income or guaranteed payments under §736(a).[26]

> **Note.** Liquidating distributions result in the termination of a partner's interest in a partnership.[27] It does not matter whether the partnership continues. When receiving a **current distribution,** the partner's interest continues to exist. Even if the distribution is made subject to a plan for the distribution of all partnership assets, the distribution is still considered a current distribution.

Under §736(b), **liquidating** distributions to a partner are treated in the same manner as current distributions under §731. This means they are generally tax-free except to the extent the liquidated partner receives cash in excess of basis. Because a liquidating distribution is a termination of a partner's interest, the distributee-partner is required to substitute the distributee's outside basis in the partnership immediately before the distribution as the partner's basis in the property distributed by the partnership.[28] In contrast, a current distribution requires the distributee to take the carryover basis of the partnership.[29]

Although liquidating distributions use a **substituted** basis rather than a carryover basis, the actual basis allocation rules are the same for both liquidating and current distributions. In addition, unlike current distributions, a partner may be permitted to recognize a **loss** on a liquidating distribution if the distribution:[30]

- Consists solely of money (for this purpose, not including marketable securities), unrealized receivables, and inventory; and
- The partner's basis immediately before the distribution exceeds the money and the basis of the receivables and inventory distributed.

22. IRC §736(b).
23. Treas. Reg. §1.751-1(a)(2).
24. Treas. Reg. §1.751-1(a)(1).
25. Treas. Reg. §1.736-1(b)(1).
26. IRC §751(b)(2).
27. Treas. Reg. §1.761-1(d).
28. IRC §732(b).
29. IRC §732(a).
30. IRC §731(a)(2).

Example 4. David receives a **liquidating distribution** from a partnership when his outside basis in the partnership is $10,000. The distribution consists of $7,000 of cash and IRC §1231 property (property used in a trade or business and held for more than one year) with an adjusted basis of $5,000 and an FMV of $9,000. David recognizes no gain because the cash he received does not exceed his outside basis. His partnership basis is reduced from $10,000 to $3,000 by the distribution of $7,000 cash. The $3,000 of the remaining partnership basis is substituted as his outside basis in the §1231 property.

If David then sells the property for its $9,000 FMV, he would recognize $6,000 of gain. This is because David originally received a distribution with a total value of $16,000 ($7,000 cash distributed + $9,000 FMV of §1231 property distributed) against only $10,000 of basis but was not taxed at that time.

Unrealized receivables and partnership goodwill are specifically excluded from the scope of §736(b) unless an exception for goodwill applies (discussed later).[31] Therefore, they are treated as a distributive share of partnership income if the amount paid depends on the partnership's income. They are treated as a guaranteed payment if the amount is determined without regard to the partnership's income.[32]

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If a partner receives deferred payments taxable under both §§736(a) and (b) (discussed later), any payment must be allocated proportionately between the two as described in the regulations or in such other manner as the partnership and retired partner or successors of a deceased partner may agree in writing.[33]

Goodwill

The **sale** of a partnership interest to a third party under IRC §741 may include an amount for the selling partner's share of the partnership's goodwill. This is treated as capital gain to the selling partner.[34] If a §754 election is in place, the purchaser may be treated as having a basis in partnership goodwill amortizable under IRC §197 to the extent that basis is allocable to goodwill pursuant to that election.[35]

In a **liquidation,** a withdrawing partner generally treats goodwill as a distribution under §736(b)(1). However, such payments for goodwill must be treated as a guaranteed payment or distributive share of income[36] if **all** of the following criteria are met.[37]

1. Capital is not a material income-producing factor in the partnership
2. The withdrawing partner was a general partner
3. The partnership agreement does not provide for a payment in exchange for an interest in partnership property with respect to goodwill

31. IRC §736(b)(2).
32. IRC §736(a).
33. Treas. Reg. §1.736-1(b)(5)(iii).
34. IRC §741.
35. Treas. Reg. §1.755-1(a)(5).
36. IRC §736(b)(2)(B).
37. IRC §736(b)(3).

Example 5. ABC is a personal service partnership in which capital is not a material income-producing factor. ABC's balance sheet follows.

	Adjusted Basis	FMV
Assets:		
Cash	$13,000	$13,000
Unrealized receivables	0	30,000
Capital assets and §1231 assets	20,000	23,000
Total	$33,000	$66,000
Capital:		
Alton	11,000	22,000
Brad	11,000	22,000
Carla	11,000	22,000
Total	$33,000	$66,000

Alton retires from the partnership and in accordance with an agreement with his partners, he receives $10,000 per year for three years, for a total of $30,000. His basis in his partnership interest is $11,000.

Under the agreement terminating Alton's interest, the value of his interest in §736(b) partnership property is $12,000 (1/3 × ($13,000 cash + $23,000 FMV of capital assets and §1231 assets)). Alton's share in unrealized receivables is not included in the interest in partnership property described in §736(b). Because the basis of Alton's interest is $11,000, he realizes a capital gain of $1,000 ($12,000 – $11,000) from the disposition of his interest in partnership property.

The remaining $18,000 ($30,000 total Alton receives – $12,000 for §736(b) property) constitutes payments under §736(a) that are taxable to Alton as guaranteed payments under §707(c) because they are fixed in amount and not dependent on partnership profit. Thus, unless the partners agree to allocate annual payments otherwise, each annual payment of $10,000 is allocated as follows.

- $6,000 (($18,000 payment under §736(a) ÷ $30,000 total payments) × $10,000) is a §736(a) ordinary income payment.
- $4,000 (($12,000 payments under §736(b) ÷ $30,000 total payments) × $10,000) is a payment for an interest in §736(b) partnership property.

The gain on the payments for partnership property is determined under §731 in the same manner as for any distribution. Therefore, Alton treats only $4,000 of each payment as a distribution in a series of liquidation of his entire interest. Under §731, Alton has a capital gain of $1,000 (($23,000 FMV of capital and §1231 assets – $20,000 adjusted basis) × 1/3) when the last payment is made. However, if Alton elects, he may treat each $4,000 payment as follows.

- $333 as capital gain (1/3 of the total capital gain of $1,000)
- $3,667 as a return of capital

Example 6. Use the same facts as **Example 5,** except the agreement between the partners provides that payments to Alton for three years are a percentage of annual income instead of a fixed amount. All payments received by Alton up to $12,000 (his share of §736(b) property) are treated under §736(b) as payments for his interest in partnership property. Alton's gain of $1,000 is taxed only after he receives his full basis under §731. Because the payments are not fixed in amount, the election to recover basis proportionately is not available. Any payments in excess of $12,000 are treated as a distributive share of partnership income to Alton under §736(a).

Example 7. Use the same facts as **Example 5,** except capital is an income-producing factor, Alton is considered a general partner, and the partnership agreement provides that the payment for his interest in partnership property includes payment for his interest in partnership goodwill.

At the time of Alton's retirement, the partners determine the value of partnership goodwill is $9,000. Therefore, the value of Alton's interest in partnership property under §736(b) is $15,000 (⅓ × ($13,000 cash + $23,000 capital assets and §1231 assets + $9,000 goodwill)). From the disposition of Alton's interest in partnership property, he realizes a capital gain of $4,000 ($15,000 value – $11,000 basis). The remaining payments of $15,000 ($30,000 total payments – $15,000 value) constitute ordinary income under §736(a), which are taxable to Alton as guaranteed payments under §707(c).

If a §754 election is in place, however, the partnership can adjust its inside bases to reflect certain tax consequences to the liquidated partner (discussed earlier). To the extent gain is recognized by that partner on partnership goodwill, the partnership may be able to allocate this to partnership goodwill as a §197 amortizable intangible. This is not the case in a partnership in which capital is not a material income-producing factor. Such partnerships are not eligible to treat goodwill as partnership property under §736(b) and must, therefore, always treat it as a §736(a) payment.

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> **Note.** For more information about §754 elections, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 4: Select Topics for Partnership Operations.

The IRS has not defined circumstances in which capital is not a material income-producing factor. However, the Conference Committee Report to the Revenue Reconciliation Act of 1993, which enacted §736(b)(3), states the following.[38]

For purposes of this provision, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice.

Special Considerations for Death

Although the death of a partner may cause the dissolution of a general partnership under state law,[39] death does not trigger a partnership's termination for federal tax purposes.[40] This is true even in the case of the death of one partner in a 2-partner partnership, as long as any successor-in-interest of the deceased partner continues to receive payments from the partnership before a complete liquidation of the decedent's interest.[41] Payments for a deceased partner's interest in the partnership are considered payments under §736 and are taxed accordingly.

A partner's death closes the partnership's tax year for the deceased partner.[42] The decedent's final return should include any distributive share of income to that point. Any distributive share after death is reported on the successor's return.[43]

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38. HR Rep. No. 103-213 at 698 (1993) (Conf. Rep.).

39. See *New York Partnership Law Section 109 — Effect of retirement, death or insanity of a general partner*. Feb. 3, 2019. Onecle Inc. [law.onecle.com.new-york/partnership/PTR0109_109.html] Accessed on Jan. 9, 2024.

40. IRC §706(c)(1).

41. Treas. Reg. §1.708-1(b)(1)(i).

42. IRC §706(c)(2)(A).

43. Treas. Regs. §§1.706-1(c)(2)(i) and (ii).

The tax year for a partner ends on the date of their death,[44] even though the partnership continues in existence.[45] Also, on that date, their outside basis in the partnership steps up to its FMV[46] unless the partner's executor elects an alternate valuation date.[47] However, the outside basis must take into account the decedent's share of the partnership's liabilities.[48]

If a partner was already receiving liquidating distributions at the time of death, these payments are generally considered income in respect of a decedent (IRD).[49] IRD is income that would have been recognized by the recipient if they had not died. This income may be included in the estate of the deceased partner, particularly if the estate assumes the partner's role in the partnership.[50] Consequently, IRD is excluded from the stepped-up outside basis in the partnership.[51]

Note. In reviewing a partner's final tax return, tax practitioners should expect to see some portion of a liquidating payment treated as an unrecognized receivable under §751(c).

Note. For more information about IRD, see the 2021 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Select Trust Topics. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

GIFT

If a partner transfers their interest through a gift, the donee uses the carryover basis from the donor. If the donor pays gift tax associated with the transfer of the partnership interest, this amount is added to the donee's basis as of the date of the gift.[52] The holding period for the donor carries over to the donee.[53] The partnership year of the donor ends on the date of the gift, while that of the donee begins on the next day.[54]

In addition, the donee may increase their basis in the partnership by any suspended **passive** losses associated with the donor's interest at the time of the transfer,[55] as they can never be deducted. However, any of the donor's losses that have been suspended because of their lack of basis or the at-risk limitations do not flow over to the recipient.[56]

44. IRC §706(c)(2)(A).
45. IRC §706(c)(1).
46. IRC §1014(a)(1).
47. IRC §2032(a).
48. Treas. Reg. §1.741-1(a).
49. IRC §691(c).
50. IRC §753.
51. Treas. Reg. §1.753-1(b).
52. IRC §1015(d)(1).
53. IRC §1223(2).
54. Treas. Reg. §1.706-1(c)(5).
55. IRC §469(j)(6)(A).
56. IRC §704(d)(1).

Practitioner Planning Tip

Tax practitioners may need to advise their clients about their outside basis in the partnership when they receive gifts of partnership interests. These recipients may not be aware that suspended losses affect their outside basis in the partnership. Additionally, practitioners should advise clients to ask the donor for a copy of Form 8582, *Passive Activity Loss Limitations*, showing any suspended losses.

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Example 8. In January 2022, Austin gifted his niece, Mallory, his entire interest in the Circle P Partnership. The entity's only asset is 640 acres of Oklahoma land. Because of cumulative losses, Austin's outside basis in the partnership is $0. He has no gift tax liability associated with this gift but has $10,000 of suspended losses related to the partnership, as he is a passive investor. Thus, Mallory's outside basis in the Circle P Partnership is $10,000 on the day she receives it.

Mallory is a passive investor in Circle P, just like her uncle. For each of 2022 and 2023, Mallory's share of the partnership's losses was $1,000. Thus, she had $2,000 of suspended losses as of December 31, 2023.

In January **2024,** Mallory sells her entire interest in Circle P to an oil company for $16,000. Her adjusted basis in the partnership is $8,000. Mallory's 2024 tax return reports a capital gain on the sale of her interest of $8,000 ($16,000 sale proceeds – $8,000 adjusted basis). Additionally, she deducts the $2,000 of suspended losses in her 2024 Schedule E, *Supplemental Income and Loss,* because she sold her entire interest

Family Gift of a Partnership Interest[57]

Family partnerships are subject to special rules to prevent income-shifting from high-income family partners to low-income family partners. The IRS may reallocate the income between the partners without regard to their respective capital interests if the partnership **does not meet certain tests.** The applicable tests depend on whether capital is a material income-producing factor in the business.

The determination that capital is the source of a material portion of the partnership's income is made based on the facts and circumstances related to the business. In general, capital is usually a **material income-producing factor** if the operation of the business requires substantial inventories or a substantial investment in land, plant, machinery, or other equipment. Farming is a business in which capital is a material income-producing factor.[58] Capital is **not** a significant factor if the income of the business consists principally of fees, commissions, or other compensation for services.

If **capital is a material income-producing factor,** the facts and circumstances must support the following.

1. The partners acquired their capital interests in a bona fide transaction (which includes gifts).
2. The partners actually own their purported interests.
3. The partners have dominion and control over their respective interests.

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57. IRC §704(e). See also Treas. Reg. §1.704-1(e).

58. *Leo A. Woodbury et al. v. Comm'r*, 49 TC 180 (1967).

Additional rules apply when the partnership interest is gifted or sold to a family partner. Under these rules, the following restrictions affect the partner's distributive share of partnership income.

- The distributable income must be reduced by reasonable compensation for services that the donor renders to the partnership.
- The distributive share of income allocated to the recipient of the gifted interest must not be proportionately greater than the donor's distributive share attributable to the donor's capital.

Note. The presence or absence of a tax-avoidance motive is one of the many factors to be considered in determining the ownership in a partnership interest acquired by gift.

If capital is not a material income-producing factor, the facts and circumstances must support the conclusion that the partners joined together in good faith to conduct a business. It is extremely important that any family partners performing significant services for the partnership receive adequate guaranteed payments in return.

ABANDONMENT OR FORFEITURE

Abandonments may result in ordinary losses in limited situations if both of the following requirements are satisfied.[59]

- The transaction is not a sale or exchange.
- The partnership has not made a distribution to the partner, either actual or deemed. Under IRC §752(b), if a partner is relieved of their share of liabilities, they are deemed to have received a distribution of money from the partnership.[60]

Although abandonment of a partnership interest can result in a loss, a higher standard exists for ordinary losses. In general, the taxpayer must be able to show the following.[61]

- They have evidence of their intent to abandon the partnership interest.
- They have "overtly act[ed] to abandon the asset."
- They have received nothing in distribution that is not classified as money, unrealized receivables, or inventory.

The requirement to establish a clear intent to abandon a partnership interest generally results in a partner providing a signed document that clearly expresses their intent to the partnership.[62] The taxpayer should furthermore undertake an act that affirms their desire to abandon their interests in the partnership.

Taxpayers handle the forfeiture of a partnership interest in the same way as an abandonment.[63]

Reporting Abandonments

In certain circumstances, an abandoning partner may conclude that their best option is to abandon their interest in a partnership. Under these circumstances, it is unlikely that the partnership has the assets to make a liquidating distribution.

At first glance, it might appear that the amount the partner realizes upon abandonment is zero because they receive no cash distributions in most cases. However, the concepts previously discussed in association with partnership termination come into play and affect this plan in two ways.

59. IRS Pub. 541, *Partnerships*.

60. See *Thomas E. and Mary Watts v. Comm'r*, TC Memo 2017-114 (Jun. 14, 2017).

61. Rev. Rul. 93-80, 1993-2 CB 239.

62. *Taxation of Worthless and Abandoned Partnership Interests*. Schnee, Edward, and Seago, W. Eugene. Feb. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/feb/taxation-of-worthless-and-abandoned-partnership-interests.html] Accessed on Mar. 19, 2024. See the appellate court's opinion regarding the 2-part test in *A. J. Industries, Inc. v. U.S.*, 503 F.2d 660 (9th Cir. 1974).

63. *Echols v. Comm'r*, 950 F.2d 209 (1991), *aff'g* 935 F.2d 703, *rev'g* 93 TC 553.

First, the abandoning partner has likely received an allocation of the partnership's liabilities, and the allocation may exceed their outside partnership basis. Their basis may have been adjusted downward because of sustained losses.[64] The resulting disposition is a deemed sale that could provide the partner with a **taxable gain or loss** to report on Schedule D (Form 1040), *Capital Gains and Losses*.[65] Any reduction of the partner's share of liabilities is considered a distribution of money.[66] However, if the partner retains the liability for the debts, the reduction in debt is not considered to be income.[67]

Second, the abandoning partner may have unexpected ordinary income arising from how the Code requires that they treat hot assets.[68] Assuming they have appropriately notified the partnership of their abandonment, Rev. Rul 93-80 may cause a reduction to any losses because of §751(b). Because it is considered a distribution of only money, the reduction of any liabilities triggers a **disproportionate distribution of hot assets,** as discussed previously. In this case, §751 attributes a portion of this money to the partner's share of the entity's hot assets. These assets are then sold for their FMV. The net result is that the partner has another potential source of ordinary income, even though they abandon their partnership interests with no compensation.

> **Example 9.** Joe has been a 1% partner in the XOP Partnership, having invested $100,000 for his interest in 2010 when the partnership was started. The partnership invests in rental real estate, which secures the mortgages used to finance it. Due to a downturn in the rental market, the properties have lost value, and the partnership has consistently reported losses over the last few years.
>
> On his 2023 Schedule K-1 (Form 1065), Joe's tax basis capital account is reported as negative $10,000, which corresponds to Joe's records, which also show Joe's outside tax basis in XOP is $10,000. Joe is concerned that there is no future for him in this investment vehicle and decides to abandon his interest. The Schedule K-1 shows that Joe has been allocated $20,000 of partnership debt. Furthermore, the partnership has maintenance equipment that it depreciates under IRC §1245. The equipment had a basis of $80,000 with accumulated depreciation of $30,000. This is an unrealized receivable under §751(b).
>
> Joe sends a letter to the general partner of XOP stating his desire to abandon his interest. Joe states that he will contribute no more funds to the partnership, and he specifically asks that no distributions, earnings, or allocations be made on his behalf, aside from those required by law. Joe includes a letter that he requests the general partner sign and return. This letter acknowledges Joe's intent to abandon his interest as of March 31, 2024, and accepts it as of that date. This letter confirms that Joe will receive no further distributions or allocations of earnings, expenses, or credits after December 31, 2023, aside from those required by law through March 31, 2024. Joe's letter further requests that he be excused from any obligation for the partnership's debt. The general partner dates the letter March 15, 2024, mails it the following day, and Joe receives it on March 20, 2024.
>
> In February 2025, Joe receives a Schedule K-1 (Form 1065) that is marked final with a final date of March 31, 2024, just as Joe expected. It shows $2,000 as Joe's allocation of rental income for the first three months of the year. It also shows ordinary income of $300 ($30,000 accumulated depreciation × 1%), which is Joe's share of the §1245 property that is subject to depreciation and an unrealized receivable.

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64. IRC §705; Treas. Reg. §1.1001-2(a); *Gifts of Partnership Interests.* Ellentuck, Albert. Apr. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/apr/gifts-of-partnership-interests.html] Accessed on Mar. 28, 2024.

65. IRC §741.

66. Treas. Reg. §1.752-1(c).

67. IRC §752(b).

68. *Taxation of Worthless and Abandoned Partnership Interests*. Schnee, Edward and Seago, W. Eugene. Feb. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/feb/taxation-of-worthless-and-abandoned-partnership-interests.html] Accessed on Mar. 28, 2024.

The rental income in the first quarter of 2024 and the allocation of $300 ordinary income increase Joe's tax basis to $12,300 ($10,000 December 31, 2023, tax basis + $2,000 rental income + $300 of allocated income from the unrealized receivable). To his surprise, Joe has the following sources of income for 2024.

- $7,700 capital gain on the abandonment of the partnership interest ($20,000 money received from debt cancelation – $12,300 outside tax basis)
- $300 ordinary income from the equipment depreciation recapture, which is a §751(b) asset
- $2,000 rental income from rental operations January 1 – March 31, 2024

Therefore, Joe must recognize income of $8,000 on the abandonment of the partnership ($7,700 capital gain + $300 ordinary income from depreciation recapture) in addition to the first quarter's $2,000 rental income.

Practitioner Planning Tip

Tax practitioners may consider advising their clients not to disavow their share of any partnership debts. By retaining the liabilities, they may prevent §751 from converting a portion of a capital loss from the abandonment into ordinary income.

WORTHLESSNESS[69]

The IRS defines the worthlessness of a partnership interest as a consequence of "hopeless insolvency." The IRS used this term in the context of the *Echols* case,[70] in which the Echols contended that their interest in a partnership was being abandoned and was also worthless. The Tax Court found that the Echols had not properly abandoned their partnership interest, consequently sustaining the IRS's denial of an ordinary deduction. However, the appellate court found that the court should have considered the claim of worthlessness under IRC §165(a).

While abandonment of a partnership interest has objective criteria, worthlessness of a partnership interest has elements of objective and subjective judgment. Owning a 75% capital interest in the partnership, the Echols clearly indicated their perception of the worthlessness of their partnership interest at a 1976 annual partnership meeting when they conveyed their partnership interest to anyone who wanted it without compensation. Within a year, the only property the partnership owned was sold at foreclosure. The appellate court concluded that the requirements for worthlessness had been satisfied and, therefore, the Tax Court had "clearly erred," enabling it to overturn the Tax Court's findings.

As a result, the appellate court found that a taxpayer who conclusively demonstrates their perception that their partnership interest is worthless is entitled to an ordinary loss deduction under §165(a), independent of whether they had abandoned it.

Reporting Worthlessness

A partner's interest in a partnership is worthless to the extent that it has no current or potential value.[71] IRC §165(a) enables a partner to take a deduction for a loss they sustain during a year under certain circumstances, as noted in *MCM Investment Management, LLC v. Comm'r*.[72]

> *[A] loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the tax year.*

69. *Echols v. Comm'r*, 950 F.2d 209 (1991), *aff'g* 935 F.2d 703, *rev'g* 93 TC 553.

70. Ibid.

71. Rev. Rul. 77-17, 1977-1 CB 44, cited in *Gifts of Partnership Interests.* Ellentuck, Albert. Apr. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/apr/gifts-of-partnership-interests.html] Accessed on Mar. 28, 2024.

72. *MCM Investment Management, LLC v. Comm'r*, TC Memo 2019-158 (Dec. 10, 2019).

To claim a worthless partnership interest, the partner must carefully determine the year in which the partnership interest became worthless. For a partner to determine the worthlessness of their partnership interest, they generally must meet both subjective and objective criteria.

The actual belief that their partnership interest is worthless constitutes the subjective criterion. The MCM Investment Management, LLC filed its tax returns consistent with this belief. Its 2009 Form 1065, *Partner's Share of Income, Deductions, Credits, etc.,* reported a loss of over $41 million with the notation "Worthless Ptrship Interest — McMillan Companies" on its Form 4797, *Sales of Business Property*. Because this LLC had elected to be taxed as a partnership, each member received a Schedule K-1 (Form 1065) consistent with this form. This filing and the severe impact that the 2009 financial debacle had on MCM's industry persuaded the court that it had met the subjective criterion for worthlessness.

The court's decision in the *MCM Investment Management* case illustrates how a partner can satisfy the objective criterion for the worthlessness of a partnership interest.

- No current or liquidating value
- Lack of potential future value
- Identifiable events
- Hopeless insolvency

5

NEGATIVE IRC §704(b) PARTNERSHIP CAPITAL ACCOUNTS[73]

Capital accounts track a partner's equity in the partnership. They track the partner's share of capital contributions, distributions, profits, and losses. A positive capital account indicates the partner has positive equity, while a negative value indicates a deficit of equity value. A series of losses may result in a negative capital account, or the negative capital account may be the result of overgenerous distributions, including distributions that are funded by the partnership's assumption of debt.

Regardless of how a partner terminates their interest, the partner has an obligation to restore their capital account to at least zero. Before a partner can consider the impact that terminating their partnership interest has on their outside basis, they must consider the impact of a negative capital account, if they have one. A partner with a negative capital account may take one of the following actions.[74]

- Pay the deficit in the capital account to the partnership
- Undertake a deficit restoration obligation (DRO), which requires them to restore the deficit in their capital account within 90 days after the liquidation of the partnership
- Execute a promissory note or other unconditional obligation
- Report the deficit capital account as income, such as cancelation of debt income[75]

Any of these actions would affect their outside basis in the partnership.

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

73. IRC §§704(a) and (b).
74. Treas. Reg. §1.704-1(b)(2)(ii).
75. *Monahan v. Comm'r*, TC Memo 1994-201 (May 5, 1994).

Practitioner Planning Tip

It is essential for a tax practitioner to review a current version of the partnership agreement to understand their client's obligations to correct negative capital accounts. If they must correct negative capital accounts, the resulting payments or changes in the allocation of income and expenses under Treas. Reg. §1.704-1 likely affect the client's outside basis in the partnership. If the partnership agreement does not address negative capital accounts, the tax practitioner should advise their client to seek legal counsel.

BASIS CONSIDERATIONS

When a partnership distributes assets to a partner when their interest is being terminated, the tax basis of those assets influences the partner's economic outcome from the partnership. This outcome is the result of many transactions that affect the partner's outside basis during their ownership, including those that terminate their interest. When their tax return for the year is prepared, gain or loss is computed relative to their outside basis.

To help clients who are terminating their interests in partnerships, tax practitioners should help them understand the different rules for basis calculations when the partnership terminates. A current distribution from a continuing partnership reduces their capital account and outside tax basis.[76] In contrast, the termination of a partner's interest subjects the distributed assets to a different set of rules if those assets are not considered money.[77]

CASH DISTRIBUTIONS

IRC §731(a) provides that distributions of money to partners (including liability relief) are tax-free to the extent of the partner's outside basis in the partnership. For this purpose, the FMV of marketable securities distributed to the partner may be treated as money.[78] The partner's basis is reduced to the extent of the money distributed. Distributions of money in excess of basis are treated as gain from a constructive sale of the partnership interest. This results in short- or long-term capital gain, except to the extent such distributions are governed by IRC §§736, 737, and 751.

If both money and property are distributed, the partner's outside basis is always reduced first to the extent of money distributed.[79] With liquidating distributions, the partner can recognize a loss, even though a **current** distribution cannot result in recognition of a loss.[80] The partnership itself recognizes neither gain nor loss on a distribution.[81]

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76. IRC §733.
77. IRC §731(a)(2).
78. IRC §731(c)(1). Certain exceptions are provided for securities distributed to the contributing partner and for investment partnerships.
79. IRC §732(a)(2).
80. IRC §731(a)(2).
81. IRC §731(b).

When a partner's interest terminates, their gain or loss is determined by the difference between the partner's outside basis and the money received. The amount of any relieved liabilities is added to the money received to determine the amount they realize.[82] For this purpose, a partner treats the reduction of a liability as though it were the receipt of cash. The release of liabilities is treated as a distribution of money to the partner.[83] Accordingly, the tax consequences are determined under the rules applicable to the distribution.

Example 10. Travis is a general partner of Travis and Sons, LLP. He owns ³⁄₄ of the partnership interests. He made the initial capital contribution to start the partnership, but his sons perform all the work. The partnership has shown years of losses, eroding Travis's entire basis. In addition, the partnership has a $10,000 liability as a result of a bank loan.

After a competitor on the other side of town expresses interest in the business, Travis sells his interest in Travis and Sons, LLP, to that individual for $20,000, to be paid in cash. This new partner agrees to be liable for Travis's share of the bank loan, to which the bank also agrees. Therefore, Travis must report $27,500 income ($20,000 cash received + ($10,000 bank liability relieved × ³⁄₄ partnership interest)) on the sale of his partnership interest.

Travis's ³⁄₄ share of the $10,000 liability had increased his basis, which was $0 prior to the sale. Because he previously received a tax benefit from claiming the losses, he must reclaim those losses due to the relief of the liability.[84]

Example 11. Use the same facts as **Example 10,** except that Travis and Sons, LLP redeems Travis's interest with a payment of $20,000, as there is no outside investor willing to acquire Travis's interest.

Travis's sons assume responsibility for Travis's share of the bank loan, and this is acceptable to the bank. With the same calculation used in **Example 10,** Travis must still report $27,500 income on the disposition of his partnership interest. Travis may have a capital gain or loss, depending on his outside basis immediately before his interest was redeemed.

PROPERTY DISTRIBUTIONS

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 before the distribution. However, this 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.

In contrast, if the property is distributed in a **liquidating** distribution, the property distributed acquires a basis equal to the partner's outside basis minus the FMV of money received.[85] If the distributee-partner's outside basis in the partnership is less than the bases in properties distributed (after reduction for money distributed), the partner's basis is first allocated to hot assets. Any remaining basis is allocated among other distributed property in proportion to the partnership's bases in the properties. Thus, the retiring partner is then left with a zero basis in the partnership.

The point of the property distribution rules is to defer the taxation of any gain or loss on the distributed property until the distributee-partner disposes of it.[86]

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82. Treas. Reg. §1.752-1(h).

83. IRC §752(b).

84. See, e.g., *Comm'r v. Tufts*, 461 U.S. 300 (1983).

85. Treas. Reg. §1.732-1(b).

86. Treas. Reg. §1.731-1(a)(1)(i).

Example 12. Renee has an outside basis of $15,000 in the Electron Partnership and is retiring from the partnership on December 31, 2024. She receives a liquidating distribution on that date consisting of $5,000 cash and a parcel of land the partnership purchased for $14,000. Renee's basis in Electron is first reduced by the cash received, reducing it from $15,000 to $10,000 ($15,000 original outside basis – $5,000 cash distributed). Because Renee's status as a partner is ending, her remaining basis, $10,000, is assigned to the real estate distributed to her.

In contrast, if Renee had retained her partnership interest, perhaps by not receiving the cash distribution, her basis in the land distributed to her would be $14,000, as the partnership's basis would carry over to her.

Cash and Property Distributed[87]

When a partner receives cash and property in liquidation of their interest, the amount of cash is first subtracted from their outside basis. Any remaining basis is then apportioned to the property distributed. If multiple assets exist, the basis is next assigned to hot assets, valued at their adjusted basis in the partnership's hands. To the extent that any portion of the partner's outside basis remains, it is allocated among remaining assets.

Special allocation rules apply under §732(c) in situations in which the distributee-partner's partnership basis required to be allocated among the distributed assets is greater (in the case of a liquidating distribution) or less (in the case of current or liquidating distributions) than the partnership's aggregate bases in those assets.

Step 1. These rules allocate a distributee-partner's basis adjustment among distributed assets first to unrealized receivables and inventory items in an amount equal to the partnership's basis in each such property, as under the usual rules.

Step 2. To the extent of any basis not allocated in accordance with step 1, basis is allocated first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective FMVs.

Example 13. The XYZ partnership has two assets, A and B, which are both distributed in liquidation to Yolanda, whose basis in the partnership interest is $55. Neither asset consists of inventory or unrealized receivables. Asset A has a basis to the partnership of $5 and an FMV of $40. Asset B has a basis to the partnership of $10 and an FMV of $10. Yolanda's basis in the partnership is first allocated $5 to asset A and $10 to asset B (their respective adjusted bases to the partnership).

Yolanda's remaining basis in the partnership is $40 ($55 original basis − $15 partnership's total basis in distributed assets). This basis is then allocated to asset A in the amount of its unrealized appreciation of $35 ($5 partnership basis – $40 FMV). No allocation is attributable to asset B for unrealized appreciation because its FMV equals the partnership's adjusted basis in it. The remaining basis adjustment of $5 is then allocated in the ratio of the assets' FMVs. Therefore, the remaining basis is allocated $4 to asset A ($5 basis adjustment × ($40 FMV for asset A ÷ $50 FMV for both assets)) and $1 to asset B ($5 basis adjustment × ($10 FMV for asset B ÷ $50 FMV for both assets)). After these allocations, asset A has a total basis of $44 ($5 + $35 + $4), and asset B has a total basis of $11 ($10 + $1).

87. Treas. Regs. §§1.732-1(b) and (c)(1).

Step 3. Any remaining basis adjustment that is a decrease arises when the partnership's total adjusted basis in the distributed properties exceeds the amount of the partner's basis in its partnership interest, and the latter amount is the basis to be allocated among the distributed properties (nonliquidating distributions). If the partner's basis to be allocated is less than the sum of the adjusted bases of the properties in the hands of the partnership, then, to the extent a decrease is required to make the total adjusted bases of the properties equal to the basis to be allocated, the decrease is allocated in the following order.

- Among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation)
- In proportion to their respective adjusted bases (taking into account the adjustments already made)

Example 14. Andy is a partner in a partnership, and his outside basis in it is $10,000.[88] The partnership is terminating and it distributes two depreciable machines to Andy: a copier and a drill press. In the hands of the partnership, the copier's adjusted basis is $7,500, and its FMV is also $7,500. The drill press has a $2,500 FMV and an adjusted basis of $7,500.

Because of this difference, Andy must allocate his basis in the machines in two steps. In step 1, Andy allocates a provisional basis to each machine based on its adjusted basis. Thus, the copier has a provisional basis of $7,500, and the drill press has a provisional basis of the same amount. Because the total basis of the two machines exceeds Andy's outside basis in his partnership interest by $5,000 ($7,500 copier basis + $7,500 provisional drill press basis – $10,000 outside basis), he must reduce the basis in the drill press by the lesser of its unrealized depreciation ($5,000, which is $2,500 FMV – $7,500 adjusted basis) and his outside basis in the partnership ($10,000).

Although a partner increases their basis when they accept a distribution of an asset encumbered with recourse debt they are liable to repay, the increase in basis is permitted "to the extent of the" FMV of the asset.[89] This has no effect if an asset's FMV exceeds its basis. However, the basis associated with an asset declining in value may be limited by its FMV rather than the basis itself.[90]

Example 15. Use the same facts as **Example 14,** except that the drill press is subject to recourse debt with a principal amount of $5,000, which Andy accepts with the distribution. Generally, Andy's outside basis in the partnership would increase by the amount of the liability secured by the drill press, or $5,000. However, because the drill press has an FMV less than the amount of the liability, his outside basis increases only by $2,500, the FMV of the drill press. In this instance, Andy's basis becomes $12,500 ($10,000 outside basis before distribution + $2,500 increase in outside basis limited by the FMV of the drill press).

Holding Period and Character of Distributed Assets.[91] In general, a partner's holding period for an asset distributed to them includes the period that the partnership owned the asset. However, if **inventory** has been distributed to a partner, its disposition results in ordinary gain or loss if the partner disposes of it within five years from the time it is distributed to them. If **unrecognized receivables** are distributed to a partner, they always result in ordinary income or loss, regardless of when the partner disposes of them.

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88. This example is a modified version of the example appearing on page 6 of Pub. 541, *Partnerships* (2022).

89. IRC §752(c).

90. Treas. Reg. §1.752-1(e). Although this principle is illustrated for terminating partnerships, it also applies to continuing partnerships.

91. IRC §735.

Precontribution Gain on Contributed Assets. The Code provides special rules that may alter the tax impact of distributions to partners who have contributed property to the partnership with a built-in gain or loss. This type of property is commonly referred to as §704(c) property. Under §737, if a partner who contributed property with a built-in gain receives other property in a distribution in the seven years following the contribution, then that partner will have a gain recognition event.[92] IRC §737 does not differentiate between liquidating and continuing distributions. Thus, §704(c) gain can be triggered in a liquidating distribution. The contributing partner must recognize gain equal to the lesser of the remaining unrecognized §704(c) gain or the excess of the current FMV of the distributed property over the adjusted basis of the partner's interest.

Thus, §704(c) requires recognition of precontribution gain associated with contributed property to be specially allocated to the partner who contributed it. If the contributing partner is no longer a partner when the underlying property is sold, this cannot be accomplished. However, §737 ensures that the contributing partner recognizes the gain on property that the partner has effectively converted to another form, either through cash distributions from the partnership or through receiving other property. The gain is not necessarily equal to the partner's excess distribution, which is the amount by which the distributed property's FMV exceeds the partner's adjusted basis in the partnership.[93]

The gain recognized by the partner is limited to the lesser of the following amounts.[94]

- Excess distribution
- Partner's net precontribution gain

The partner's excess distribution is the amount by which the distributed property's FMV exceeds the partner's adjusted basis in the partnership.[95] The partner's net precontribution gain is the difference between the partner's adjusted book value in the distributed property and their adjusted tax basis at the time of the distribution.[96]

The partner who contributed the property has then paid tax on the precontribution gain from the original property. IRC §737(c)(2) provides the partnership with a step-up in basis equal to the gain recognized by the departing partner.

Example 16. In December, 2022, John, George, and Ringo form Cicada, LLC as equal members. The partners contribute the following assets.

- John contributes a specialty sound recording machine with an FMV of $30,000 and an adjusted tax basis of $20,000.
- George contributes a piece of artwork with an FMV and adjusted tax basis of $30,000.
- Ringo contributes $30,000 of cash.

The sound recording machine has a remaining useful life of 10 years and is depreciated using the straight-line method. The **book** depreciation in 2023 is $3,000 ($30,000 FMV ÷ 10 years) allocated equally among the partners. The **tax** depreciation for 2023 is $2,000 ($20,000 adjusted tax basis ÷ 10 years) and this is allocated 50% each to George and Ringo.

In 2024, John decides that he no longer wants to be a partner of Cicada, LLC. His outside basis in his partnership interest remains unchanged at $20,000 because he was not allocated any tax depreciation. The book value of the sound recording machine is $27,000 ($30,000 FMV – $3,000 book depreciation), and the tax basis of the sound recording machine is $18,000 ($20,000 adjusted tax basis – $2,000 tax depreciation).

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92. IRC §737(c).

93. Treas. Reg. §1.737-1(b)(1).

94. Treas. Reg. §1.737-1(a)(1).

95. Treas. Reg. §1.737-1(b)(1).

96. Treas. Reg. §1.737-1(c).

John receives a liquidating distribution of the artwork. The book value of the artwork at the end of 2023 is $30,000. John's tax basis in his partnership interest at the time of the distribution is $20,000 because he was not allocated any tax depreciation. The excess distribution, if any, is the difference between the FMV of the artwork ($30,000) and John's basis in his partnership interest ($20,000), or $10,000. John's net precontribution gain is the difference between the book value of the sound recording machine ($27,000) and its adjusted tax basis at the time of the distribution ($18,000) or $9,000.

John must recognize gain on the distribution that is equal to the lesser of the excess distribution of $10,000 and the net precontribution gain of $9,000.

Note. IRC §737 applies only to built-in **gains.** A partner may also contribute property with a built-in loss. There are special allocations with respect to loss property only to the contributing partner.[97] For the remaining partners, the contributed property is deemed to have a basis equal to its FMV at the time of contribution. The recognition of any built-in loss triggered by a distribution of property may be limited by other provisions.[98]

5

EFFECT OF LIABILITIES

A partner's outside basis is adjusted for increases and decreases in their share of any debt owed by the partnership. Additional liabilities increase basis while reductions in liabilities reduce basis.

If the partner has sold their interest, they may be relieved of certain partnership liabilities.[99]

Relief from Liabilities

When a partner **sells** their interest to a third party, the selling partner generally transfers a share of the partnership's liabilities to the third party. The selling partner's overall share of the partnership's liabilities is zero if they have sold their entire interest. They treat the reduced amount of liabilities as consideration for their partnership interest.[100] The reduced amount of liabilities is the total of liabilities outstanding before the sale minus the total liabilities after the partner has sold their partnership interest.[101]

The amount of gain or loss a withdrawing partner realizes is equal to the difference between the amount realized and the withdrawing partner's adjusted basis in the partnership interest.[102] The amount realized on the sale or exchange of a partnership interest is calculated as follows.

	Money received
+	FMV of property received
+	Reduction in the partner's share of partnership liabilities
	Amount realized on sale or exchange

Example 17. Mona has a basis in her partnership interest of $30,000, which includes her $20,000 share of partnership liabilities. She sells her entire partnership interest to Luann, an unrelated taxpayer, for $15,000. The amount Mona realizes from the sale is calculated as follows.

Money received	$15,000
Liabilities assumed by purchaser	20,000
Amount realized from the sale	$35,000

97. IRC §704(c)(1)(C).

98. See, e.g., IRC §707(b).

99. See Treas. Reg. §1.707-6(d), example 2, for an example of a partner's receipt of a distributed asset that is encumbered with a nonrecourse liability.

100. Treas. Reg. §1.752-1(h), citing IRC §1001.

101. Ibid.

102. IRC §1001; Rev. Rul. 84-53, 1984-1 CB 159.

If a **gift** of the partnership interest releases the donor from partnership liabilities, the donor must treat the gift as a disposition.[103] The amount realized from the disposition includes the liabilities from which the donor was released.[104] If the amount realized is greater than the partner's basis, the result is a taxable gain.[105] However, the loss is not deductible if the amount realized is less than the partner's basis.[106]

If only a portion of the partnership interest is transferred by gift, the reduction in the partner's share of partnership liabilities is treated as a cash distribution rather than as an amount received from a sale.[107] Therefore, the transferred liability reduces the donor's basis immediately **before** the gift.

Gifts of partnership interests potentially have the following three implications.[108]

1. The gift's value is the FMV of the property transferred to the recipient minus liabilities transferred.[109] If any gift tax is paid, it is added to the recipient's basis in the property.[110]
2. If the donor recognizes gain because their liability relief exceeds their basis, they must treat the transfer as a deemed sale transaction under Treas. Reg. §1.1001-2(a).
3. If the general partner has unrestricted authority to make or withhold distributions, the gift is of a **future interest** and, therefore, does **not** qualify for the annual exclusion under IRC §2503(b)(1).[111]

Practitioner Planning Tip

Tax practitioners may wish to warn clients that the capital gains they realize from the redemption or sale of a partnership interest are likely going to be greater than they expect because not all of the amount realized assumes the form of cash. The relief of liabilities is treated as money when a partnership interest is redeemed, even though it never touches the retiring partner's hands.

Assumption of Liabilities

When a partner assumes the liabilities of the partnership, they, in effect, are contributing money to the partnership.[112] If the liabilities they assume are attached to property that is also distributed to the partner, they also increase their investment in the partnership, but only to the extent that the amount of debt does not exceed the FMV of the property that is encumbered to the debt. This is not an issue if the property has increased in value since the partnership acquired it. However, if the property has declined in value since the partnership acquired it, the partner's basis is increased only to the extent of the property's FMV on the day it was distributed to the partner.

103. Treas. Reg. §1.1001-2(a)(4)(iii).
104. Treas. Reg. §1.1001-2(a)(1).
105. See Treas. Reg. §1.1001-2(c), example 4.
106. Ibid.
107. Treas. Reg. §1.1001-1(c); IRC §752(b).
108. *Gifts of Partnership Interests*. Ellentuck, Albert. Apr. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/apr/gifts-of-partnership-interests.html] Accessed on Mar. 22, 2024.
109. IRC §2512.
110. IRC §1015(a).
111. TAM 9751003 (Aug. 28, 1997).
112. IRC §752(a).

In other cases, a partnership may terminate by distributing all property with debt still attached to it. In this case, the partner acquiring the property from the terminating partnership treats the debt as though it were not associated with the partnership.[113] When there are both increases and decreases associated with the partner's share of partnership liabilities, the two are netted against each other.[114]

Debt Assumed by Partners Upon Distribution of Assets. A partner in a partnership may receive an asset encumbered with debt that has been distributed by the partnership. In a current distribution of non-cash property from a partnership to a partner, the partnership's basis in the property carries over to the partner. However, if the partner's interest has terminated, the partner's basis in all assets is limited to the partner's **outside** basis in their partnership interest after reduction for any money received by the partner.[115] Their basis is also limited by the assets' FMVs and any associated debt.[116] If the amount of debt attached to an asset exceeds the FMV of the asset, the partner's increase in outside basis is limited to the FMV of the asset.[117]

- If the basis of distributed assets exceeds the partner's outside basis, the bases of any assets distributed is reduced.
- If the basis of distributed assets is less than the partner's outside basis, then their bases are adjusted **up** to the partner's outside basis.

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If distributed property is subject to any liabilities assumed by the partner, their basis in the partnership is changed in the following manner.[118]

- Increased by the liabilities assumed in connection with the distribution
- Decreased by the partner's resulting reduction in partnership liabilities
- Decreased by the basis of the distributed property[119]

Example 18. Ryan has a partnership basis of $3,000 and a capital account balance of $2,600 when he decides to retire from the partnership. He receives a liquidating distribution of property with an FMV of $12,000. The property has an adjusted basis to the partnership of $3,000 and is subject to a liability of $10,000. At the time of distribution, $6,000 of the liability was included in Ryan's $3,000 basis. Ryan's information is summarized in the following table.

FMV of property	$12,000
Basis of property	(3,000)
Net unrealized gain on property	9,000
Liability attached to property	10,000

Effective immediately before the distribution, two transactions are deemed to have occurred. First, the partnership recognizes the gain on the property it is about to distribute. For Ryan, this results in a $5,400 gain to his capital account ($9,000 net unrealized gain × 60%).

113. IRC §752(d).
114. Treas Reg. §1.752-1(f).
115. IRC §732(b).
116. Treas. Reg. §1.732-1(b).
117. Treas. Reg. §1.752-1(e).
118. IRC §752. See Treas. Regs. §§1.752-1, 1.752-2, and 1.752-3.
119. IRC §733.

Second, Ryan's capital account is increased by the incremental liability he is about to assume. In this example, he is increasing his responsibility for the liability associated with the asset by $4,000 ($10,000 total liability – $6,000 already allocated to him). With these two adjustments, Ryan's capital account increases to $12,000 immediately before the distribution of the property, as shown in the following table.

	Ryan	Other Partners	Total
Partnership ownership	60%	40%	100%
Opening capital account	$ 2,600	$1,733	$4,333
Book gain on property	5,400	3,600	9,000
Net increase in capital account from assumption of partnership liability	4,000		
Capital account prior to distribution	$12,000		
Distribution	(12,000)		
Closing capital account	$ 0		

Upon receiving the distribution, Ryan's capital account is reduced to $0 ($2,600 opening capital balance + $5,400 gain on property + $4,000 Ryan's net increase in liability – $12,000 FMV of property distributed), and he has retired from the partnership. Ryan's adjusted basis in the property distributed to him is $12,000 ($3,000 opening outisde basis + $9,000 unrealized gain).

HOT ASSETS

The general rule that a partner's sale or exchange of their partnership interest triggers capital gain does not apply to the extent the gain realized on the transaction is attributable to **hot assets.** Hot assets (as defined under §751) include the following.

- Unrealized receivables
- Inventory items of the partnership

When the withdrawing partner transfers their interest, the partnership has either not recognized income that the hot assets generate (in the case of unrealized receivables) or the value of the assets may change, even though the partnership has recognized income from them (in the case of substantially appreciated inventory). In either case, the partner would eventually recognize **ordinary** income from them. The partner must receive an allocation of ordinary income, which is taxed at ordinary income tax rates.

The partner's sale or exchange of their interest merely accelerates the recognition of the ordinary income (such as with depreciation recapture). Thus, the income on the transaction is recharacterized from capital to ordinary.[120] The rationale for the recharacterization is that, if the partnership were to sell such hot assets, ordinary income or loss would be recognized on the sale. Thus, when a partner sells or exchanges a partnership interest, the partner should recognize ordinary income on the portion of the income from the sale of the partnership interest that is attributable to the hot assets.

> **Observation.** If this recharacterization rule did not apply, a partner would be able to transform what would have been ordinary income into capital gain by selling or exchanging their partnership interest.
>
> However, a **proportionate** distribution of hot assets does not trigger the provisions of §751.[121] For example, if a 20% partner withdraws from a partnership and receives a 20% distribution of the entity's hot assets, §751 does not require the partner to recognize ordinary income. However, if a partner receives a disproportionate distribution, the provisions are triggered.

120. IRC §751(a).

121. IRC §751(b)(1).

When a partnership distributes property to a partner in exchange for the partner's interest in the hot assets of the partnership, the transaction may be treated as a sale or exchange of the hot assets between the partner and the partnership, generating ordinary income.

As defined by §751, a liquidating distribution of cash may require the former partner to recognize ordinary gain on the distribution of hot assets. The withdrawing partner's outside basis in the partnership is allocated among distributed items in the following sequence.

1. Money, including cash, marketable securities, and any net decrease in the partner's share of partnership liabilities[122]
2. Hot assets, valued at the partnership's inside basis in them[123]
3. Other assets[124]

In the following circumstances, the rules for hot assets do not apply.[125]

- A withdrawing partner receives a distribution of property they previously contributed to the partnership.
- The property received by the retiring partner is their distributive share of the partnership's income or a guaranteed payment.

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TYPES OF §751 HOT ASSETS

IRC §751 defines two broad classes of assets for which a partner must recognize ordinary income upon receiving a distribution of them: unrealized receivables and substantially appreciated inventory.

Unrealized Receivables

According to §751(c) and Treas. Regs. §§1.751-1(c)(4)(iii) and (v), there are three categories of unrealized receivables.

1. Goods
2. Services
3. Recapture items

The term unrealized receivables includes money owed to a taxpayer using the **cash receipts and disbursements method** for work already performed or goods already provided.[126] However, the accounts receivable of an **accrual method** taxpayer are considered inventory items, not unrealized receivables,[127] as the income for an accrual basis taxpayer would have been realized. The scope of unrealized receivables reaches far beyond trade receivables. Anything receivable that could generate ordinary income upon receipt of payment is also treated as an unrealized receivable for purposes of §751(c), including the following.[128]

- Property subject to recapture of depreciation under IRC §§1245 and 1250
- Market discount bonds and short-term obligations
- Stock of certain controlled foreign corporations
- Oil, gas, or geothermal property for which intangible drilling costs were deducted

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122. IRC §§732(b), 731(c), and 752(b).

123. Treas. Reg. §1.732-1(c)(1)(i).

124. Treas. Reg. §1.732-1(c)(1)(ii).

125. IRC §751(b)(2); IRS Pub. 541, *Partnerships*.

126. IRC §446(c)(1); Treas. Reg. §1.751-1(c).

127. IRC §446(c)(2); Treas. Reg. §1.751-1(d)(2)(ii).

128. IRS Pub. 541, *Partnerships*, p. 12 (2022).

- Franchises, trademarks, or trade names
- Certain farmland for which expenses for soil and water conservation or land clearing were deducted
- Stock in a domestic international sales corporation (DISC)
- Mining property for which exploration expenses were deducted

If a partner's interest in a partnership is being sold on an installment basis under IRC §453, they must recognize §1245 recapture as ordinary income in the year of the sale, thus making the recapture ineligible for installment sale treatment.[129] The recapture may take one of the following two forms.

- §1245 recapture income to the extent that it is included in unrealized receivables under §751
- §1250 **recapture** income to the extent that it is included in unrealized receivables

In both cases, the recapture income is limited to the amount that would be considered an unrealized receivable under §751.[130] Because §1250 recapture income is associated with a tax provision that ended with the Tax Reform Act of 1986, this type of income is rarely seen.

Note. Although part of a liquidating distribution is associated with §751 assets and results in ordinary income, this does **not** also convert it to self-employment (SE) income to the selling partner. For example, the sale of inventory by a partnership may result in SE income for certain partners of a continuing partnership. However, Treas. Reg. §1.1402(a)-6(a) expressly prevents the ordinary income from depreciation recapture under §1231 being considered SE income.

Example 19. The Callisto Partnership is terminating on December 31, 2024, making its two partners, Ned and Lydia, retiring partners. The partnership has $10,000 cash and two identical pieces of machinery, each having an original cost of $4,000, an FMV of $3,000, and a remaining basis of $2,500. The machinery qualifies as §1245 property, and each unit potentially has $1,500 of depreciation recapture ($4,000 original cost – $2,500 remaining basis).

That morning, Lydia and Ned receive checks for $5,000, which they promptly deposit at their respective banks. One piece of machinery is distributed to Lydia and the other to Ned. Because the distribution of the machinery is proportionate, Lydia and Ned do not need to recognize $1,500 of ordinary income when they receive the distribution of the machinery. They can defer recognizing this income because each receives a proportionate distribution of the machinery. The depreciation associated with each piece of machinery would be an unrealized receivable, but the proportionate distribution of the partnership's assets does not fall under §751.

Even if a portion of the income associated with terminating their interests is ordinary income, Lydia and Ned do not need to report any SE income on their tax returns associated with it.

129. IRC §453(i).

130. IRC §453(i)(2).

Substantially Appreciated Inventory

Inventory is also included among hot assets. This is always the case when partnership interests are sold or exchanged, as provided by §751(a), but only to the extent that it is considered to have appreciated substantially when §751(b) requires that a distribution be treated as a sale or exchange. This threshold of substantial appreciation is met if the inventory's FMV exceeds 120% of the partnership's adjusted basis in the property. The definition of inventory is broadened to include the following.[131]

- Property that the partnership would properly include in inventory if on hand at the end of the tax year or that the entity offers for sale to customers in the normal course of business.
- Property that, if the partnership sold or exchanged it, would not be a capital asset or §1231 property (real or depreciable business property held for more than one year). For example, accounts receivable acquired for services or from the sale of inventory and unrealized receivables are inventory items.
- Property held by the partnership that would be considered inventory if held by the partner selling their interest or receiving the distribution.

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An accrual method taxpayer establishes basis in its trade accounts receivable when it recognizes revenue.[132] Because customers of a taxpayer are typically unwilling to pay more for services or goods than have been contracted for and have already been invoiced, the FMV of an accrual basis taxpayer accounts receivable generally do not increase.

Example 20. Isaac and Owen formed the Io Partnership many years ago and have always used accrual method accounting. They terminate Io on December 31, 2024, when its only two assets are $10,000 cash and accounts receivable of $10,000. Because the accounts receivable has already been recognized as income, it is considered inventory for purposes of §751. However, its FMV has not changed since the sale was finalized, and the revenue was recognized on December 10. Because it uses the accrual method of accounting, Io established its $10,000 basis in the accounts receivable on that day. The value of accounts receivable does not generally increase if the receivables are collectible. Io's accounts receivable would have had to increase to $12,000 ($10,000 basis × 120%) by December 31, 2024, to have substantially appreciated, which they did not. Because they have not substantially appreciated, Io's accounts receivable are not considered a hot asset when the partnership terminates at the end of December.

EFFECT ON DISTRIBUTIONS

Hot assets complicate the withdrawing partner's tax return. Even if the sales agreement states that only the partnership interest is being sold, §751 pulls the sale of hot assets onto the partner's tax return. The simplest scenario is discussed first and occurs when the agreement clearly communicates that a **proportionate transfer** of all partnership assets is being sold. The transfer may be accomplished by sale, redemption, gift, or bequest.

Another scenario involves the **disproportionate transfer** of assets, either by sale or liquidating distribution. This can happen when the partner sells their partnership interest for cash, omitting explicit mention of the hot assets in the sales agreement. A variation involves the sale of some hot assets disproportionately to the partner's interest.

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131. IRS Pub. 541, *Partnerships*, p. 12 (2022).

132. Treas. Reg. §1.451-1(a), which provides for income to be included in gross income when all events have occurred that fix the right to receive the income, thereby establishing basis in the accounts receivable.

Proportionate Distributions of Hot Assets

If a withdrawing partner receives a proportionate distribution of the partnership's hot assets, they do not need to make any special adjustments. With a proportionate distribution, the partner recognizes their proportion of the income that the asset eventually generates. When the asset is §1245 property, its eventual sale generates ordinary income, for example.[133]

Gain or Loss Recognized by the Withdrawing Partner. As long as the withdrawing partner does not receive more or less than their proportionate share of the partnership's hot assets, they recognize gain only if the FMV of money received and relief of liabilities exceeds their outside basis in the partnership prior to the distribution.[134]

The withdrawing partner can recognize a loss if their distribution consists of nothing other than cash, marketable securities, and hot assets. If they receive a capital asset as part of a liquidating distribution, they do not recognize a loss.[135] A capital loss can only be recognized if the retiring partner has outside basis remaining after a reduction for money received, hot assets received, and relief of liabilities and no other property is distributed. Otherwise, this remaining basis would be assigned to any capital asset distributed to the retiring partner.

Disproportionate Transfers of Hot Assets

If a partnership has hot assets and a partner withdraws from it, §751 requires the partner to recognize a distribution of hot assets. For example, if the withdrawing partner receives only cash, they have received a disproportionate distribution of hot assets, regardless of their intent.

Gain or Loss Recognized by the Withdrawing Partner. The withdrawing partner must use a series of three transactions to reflect the disproportionate distribution of hot assets. Collectively, these transactions have no cash effect but apply §751 requirements to the disproportionate transfer of hot assets.

For the **first transaction,** the partner who has received a cash or disproportionate distribution associated with their withdrawal from the partnership is deemed to have received their share of the partnership's hot assets as a distribution. Their proportionate share is based on their interest in partnership capital, not their profits interest, at the time of redemption.[136]

The **second transaction** that is deemed to occur is the sale of the same hot assets. If the partner is selling their interest, they transfer the hot assets to the buyer for a portion of the price. If the partner is liquidating their interest, they are selling their interest back to the partnership. In either case, the amount realized for this portion of the disposition is their proportionate share of the FMV of the hot assets. The withdrawing partner recognizes gain on the sale of the hot assets based on their bases.

The **third transaction** is the conveyance of the actual partnership interest. The partnership interest is transferred to its buyer in a sales transaction. Alternatively, it is surrendered to the partnership if the partner is retiring and the partnership is redeeming the partner's interest.

With this series of deemed transactions, the withdrawing partner has reconstituted their transaction so that the partnership has distributed a proportionate share of hot assets to the withdrawing partner. The rules for recognition of gain or loss and basis in assets for proportionate distributions apply, as stated previously.

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133. Treas. Reg. §1.751-1(c)(4)(iii).

134. IRC §751(a); Treas. Reg. §1.751-1(b)(1)(ii).

135. Ibid.

136. Treas. Reg. §1.751-1(g), examples 1–6 each contain references to determining proportionate interest in the partnership's assets based on their proportionate share of partnership capital, as cited in *Determining a Partner's Share of Unrealized Receivables At the Liquidation of the Partner's Interest*. Utz, Stephen. Oct. 2000. Taxes: The Tax Magazine. [papers.ssrn.com/sol3/papers.cfm?abstract_id=248150] Accessed on Feb. 26, 2024. The required use of the partner's interest in the partnership's capital is inferred from these examples, rather than by its explicit reference in the regulations they exemplify.

Example 21. Use the same facts as **Example 19,** except that Lydia and Ned receive disproportionate distributions of cash and the machinery. Lydia receives $8,000 cash, and Ned receives $2,000 cash and both machines.

The termination of their partnership interests starts with the first transaction. For Lydia, she is deemed to have received a distribution of a ½ interest in both pieces of machinery. For her second transaction, she is deemed to have sold her interest in the two machines to the partnership, recognizing ordinary income of $500 ($3,000 FMV – $2,500 adjusted basis). For the final transaction, she receives a distribution of cash for her partnership interest.

Ned is deemed to have a $3,000 gain ($6,000 FMV for both machines – ($8,000 total cash provided to Lydia – $5,000 her 50% share of partnership cash)). Of this amount, $1,500 is ordinary income and $1,500 is capital gain income ($3,000 gain – $1,500 ordinary gain).

Example 22. Aaron and Becca are equal partners in the Neptune partnership.[137] On March 1, 2024, Becca sells her interest in Neptune to Tim, for which he pays her $30,000. Neptune's February 29, 2024, balance sheet follows, showing both adjusted basis and FMV. Becca's outside basis is $18,000, the same as her inside basis.

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	Adjusted Basis per Books	FMV
Assets		
Cash	$ 6,000	$ 6,000
Loans receivable	20,000	20,000
Land	14,000	10,000
Unrealized receivables	0	28,000
Total assets	$40,000	$64,000
Liabilities and Capital		
Liabilities	$ 4,000	$ 4,000
Capital		
Aaron	18,000	30,000
Becca	18,000	30,000
Total liabilities and capital	$40,000	$64,000

Becca realizes $32,000 on the sale of her interest to Tim ($30,000 cash + $2,000 assumption of Neptune's liabilities ($4,000 × ½)). If it were not for §751, Becca would recognize a capital gain on her interest in the Neptune partnership of $12,000 ($32,000 realized on sale – $20,000 basis).

However, Neptune has unrealized receivables and §751 applies. Becca is deemed to have received her share of them as a distribution, which she passes to Tim. She recognizes **ordinary** income on the sale of the unrealized receivables in the amount of $14,000 (½ × ($28,000 FMV of unrealized receivables – $0 basis)). This amount is subtracted from the total gain she would otherwise receive of $12,000.

Consequently, Becca recognizes ordinary income of $14,000 and a capital loss of $2,000 ($12,000 total gain – $14,000 considered ordinary gain). In this case, Becca has a less favorable result as a consequence of the §751 regulations, as they convert capital gain income into ordinary income.

137. Based on Treas. Reg. §1.751-1(g), example 1.

Basis Adjustments Due to a Terminating Interest.[138] **Example 22** assumes that the partner's outside basis equals their inside basis and that the hot assets have no basis. When these assumptions are removed, the calculations change. If a partnership has hot assets with bases greater than $0, the assets' bases may be reduced by the basis limit imposed by a terminating distribution. Because the partner receiving a liquidating distribution must have zero basis after receiving the liquidating distribution, the hot assets' bases may be reduced if the partner's outside basis in the partnership is less than their inside basis.

Example 23. Use the same facts as **Example 22,** except that Becca's **outside** basis in the Neptune partnership is $10,000, including her share of its liabilities, and the basis of the unrealized receivables is $10,000. Neptune's February 29, 2024, balance sheet follows.

	Adjusted Basis per Books	FMV
Assets		
Cash	$ 6,000	$ 6,000
Loans receivable	20,000	20,000
Land	14,000	10,000
Unrealized receivables	10,000	28,000
Total assets	$50,000	$64,000
Liabilities and Capital		
Liabilities	$ 4,000	$ 4,000
Capital		
Aaron	23,000	30,000
Becca	23,000	30,000
Total liabilities and capital	$50,000	$64,000

Becca still realizes $32,000 on the sale of her interest to Tim because she receives $30,000 and is still relieved of $2,000 of partnership liabilities. However, her total gain, is now increased to $22,000 ($32,000 consideration received – $10,000 outside basis).

Caution. Many factors complicate the determination of whether a particular distribution is disproportionate. For more information on this topic, see the 2006 *University of Illinois Federal Tax Workbook*, Chapter 5: Partnerships. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

In addition, §732 may require the adjustment of the withdrawing partner's basis in §751(b) property. For more information, see §732(c) and Treas. Reg. §1.732-1(c).

The situation in **Example 23** does not materially change once the partnership terminates. The regulations do not establish separate rules to govern the deemed sales of hot assets by terminating partnerships. However, it is more likely that the partnership will have liquidated all §751 assets prior to making final liquidating distributions to its partners, thus removing the need for allocating some portion of any capital gain to the hot assets' ordinary income. It is possible, however, for a terminating partnership to distribute §751 assets to its partners, who may subsequently sell them or otherwise recognize ordinary income.[139]

138. Treas. Reg. §1.732-1(b).

139. Treas. Reg. §1.751-1.

QBID[140]

Qualified business income (QBI) includes the net amount of qualified items of income, gain, deduction, and loss for any qualified trade or business conducted within the United States. Ordinary income generated by hot assets is taken into consideration when computing QBI.

If available, the qualified business income deduction (QBID) is generally 20% of the taxpayer's QBI, less its net capital gain. Thus, any hot asset transaction potentially generates QBI, and possibly provides an exiting partner with QBID.

> **Note.** For more information about QBID, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues and the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update. These can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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Depreciation Recapture[141]

The potential recapture of accumulated depreciation of §1245 property is considered an unrealized receivable or a hot asset. The calculation of ordinary income from accumulated depreciation considers the proceeds generated by the potential sale of §1245 assets for their FMV. Because the depreciation recapture generated by §1245 property is a hot asset, the recapture can generate QBI.

Example 24. On January 5, 2022, Peter, Pat, Penny, and Patsy formed the Pluto partnership as equal partners. Pluto manufactures gyroscopes and is not a specified service trade or business. Pluto operates entirely within the United States. Each partner purchased their interest with a $100,000 cash capital contribution, used to purchase manufacturing assets for the business.

On October 31, 2024, Penny announces she wishes to leave Pluto. Because the seasonal demand for gyroscopes is depressed, Pluto has no inventory or accounts receivable. The assets that Pluto purchased with its starting capital have been 50% depreciated. The FMV of the assets has declined to $360,000. Thus, Pluto has unrealized receivables of $160,000 ($360,000 FMV – ($400,000 original basis of equipment purchased × 50% depreciation)) associated with the depreciation that Pluto would recapture if it sold the equipment. Pluto determines this value on December 31, 2024, Penny's last day as a partner. Thus, Pluto reports $40,000 of unrealized receivables to Penny ($160,000 unrealized receivables × Penny's 1/4 partnership interest). This amount represents her share of Pluto's unrealized receivables that she must treat as ordinary income on her tax return.

Penny can include this income with her other sources of QBI. Her QBID from unrealized receivables can be up to $8,000 ($40,000 QBI × 20% deduction).

> **Note.** For more information about the implications of QBID for partnerships, 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].

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140. Treas. Reg. §1.199A-3(b); and IRC §199A.

141. Treas. Reg. §1.751-1(c).

REPORTING THE TERMINATION OF A PARTNER'S INTEREST

A partner terminating their interest in a partnership should receive a Schedule K-1 (Form 1065) marked as final. The information on the Schedule K-1, in conjunction with the partner's basis, determines any gain or loss the partner must report on their personal income tax return.

A tax return for a partner ending their partnership interest may report the entity's activities similarly to the way they have reported the same activities in prior years.[142] Although Schedule K-1 (Form 1065) contains a checkbox marked "Final K-1," the instructions make no reference to it.[143] Designating a Schedule K-1 as final may allow a partner to recognize suspended losses,[144] providing the partner has sufficient outside basis to take them.[145] Several questions can arise when completing a final tax return.

DETERMINING THE YEAR OF THE FINAL RETURN

If a partnership files its tax returns on a calendar year basis, the date on the Schedule K-1 (Form 1065) showing the partnership's final date may not correspond to the entity's prior calendar year closing. For example, if a partnership has used a calendar year basis, but its operations end in February one year, the entity must file its Form 1065 with a mid-May filing deadline.[146] Thus, the partner in a partnership that terminates early in the year may have two Schedules K-1 (Form 1065) to address, both of which show the same year. However, its individual partners must report the income from one of those Schedules K-1 on the next calendar year's Form 1040.[147]

Practitioner Planning Tip

The taxpayer has most of the year to misplace the Schedule K-1 that is prepared for a partnership that terminates early in a calendar year. This timing may result in unreported income or suspended tax benefits that are lost. A tax practitioner may suspect that a final Schedule K-1 (Form 1065) is missing if the client brought in a Schedule K-1 (Form 1065) from an entity in the prior year but does not have one for the tax year being prepared. The partnership may have sent one outside of tax season that the client discarded, not realizing it contained important tax information to be included on their tax return.

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142. 2023 Partner's Instructions for Schedule K-1 (Form 1065).

143. Ibid. The instructions for this Schedule contains no special instructions for the final Schedule K-1 that is sent to a partner.

144. IRC §469(g)(1)(A).

145. IRC §165(b), referring to IRC §1011.

146. IRC §6072(b).

147. Treas. Reg. §1.6031(a)-1(a)(1).

PARTNER REPORTING TO THE PARTNERSHIP[148]

The partner must notify the partnership that they have sold their interest, assuming that the partnership is not redeeming their interest and is already aware of the transfer. Therefore, when a partner sells or exchanges their interest in the partnership, they must notify the partnership. If they fail to notify the partnership, the partner is subject to the penalties under IRC §6722(b). The selling partner must provide the following information.

- Their name, address, and social security number (SSN) or employer identification number (EIN)
- The buyer's name, address, and SSN or EIN
- The date on which the sale or exchange occurred

The partner's provision of this information to the partnership enables it to prepare Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests,* and Schedule K-1 (Form 1065). The partner's deadline for reporting this information to the partnership is the earliest of the following.

- 30 days after the sale or exchange of their partnership interest
- January 15 of the succeeding year

The reporting requirement applies to exchanges defined in §751(a). Consequently, the donor of a gifted interest in a partnership does not have an obligation to report this information to the partnership.[149]

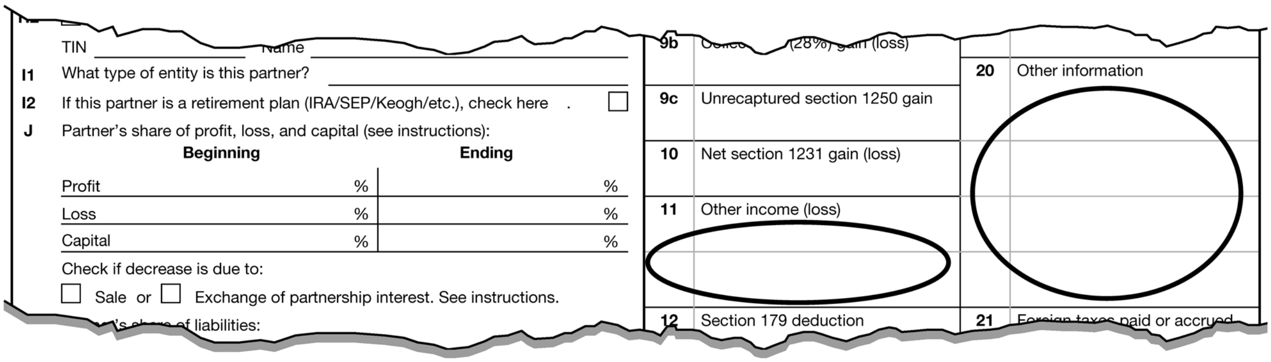
IRC §6045 contains an exception for transactions that are reported by a broker, thus relieving partners in many publicly traded partnerships from this reporting responsibility. However, the Code has no de minimis exception for small partnerships, leaving their partners and their tax practitioners with a critical responsibility.

If a partner fails to report the information associated with their sale or exchange of a partnership interest, they are subject to a $50 fine.[150]

PARTNER RECEIPT OF SCHEDULE K-1 (FORM 1065)

The partnership is responsible to report the sale of hot assets to the partner on their Schedule K-1 (Form 1065). The partner should receive a Schedule K-1 (Form 1065) that reports this information in multiple places.[151]

- Box 11, code L reports their share of the partnership's income, gain, or loss from a distribution under §751(b)
- Box 20, code AB reports the §751 gain or loss that is taxed at ordinary income rates
- Box 20, code AC reports the portion of the §751 gain or loss that is taxed at the rate for collectible assets under IRC §1(h)(5)
- Box 20, code AD reports the portion of the §751 gain that is taxed as §1250 unrecaptured gain


TIN Name
I1 What type of entity is this partner?
I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here
J Partner's share of profit, loss, and capital (see instructions):
Beginning Ending
Profit % %
Loss % %
Capital % %
Check if decrease is due to:
Sale or Exchange of partnership interest. See instructions.
9b (28%) gain (loss)
9c Unrecaptured section 1250 gain
10 Net section 1231 gain (loss)
11 Other income (loss)
12 Section 179 deduction
20 Other information

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148. IRC §6050K(c); Treas. Reg. §1.6050K-1(d), which provides requirements for information that the partner must provide.

149. Instructions for Form 8308.

150. IRC §6723.

151. 2023 Partner's Instructions for Schedule K-1 (Form 1065).

The withdrawing partner should also receive a copy of Form 8308 that the partnership files with the IRS, showing that the partner has transferred their interest in the partnership. This form has been expanded for the reporting of partnership interests beginning with those occurring on January 1, 2023.[152]

REPORTING GAIN AND LOSSES

The final Schedule K-1 (Form 1065) a partner receives **likely** reports a variety of income, gains, losses, deductions, and possibly credits. Some of these items, particularly the capital gain or unrecaptured §1250 gains, appear in the boxes for:

- Net short-term capital gain or loss,
- Net long-term capital gain or loss, and
- Unrecaptured §1250 gain.

Capital Gains on Disposition of Partnership Interests

If a partner **exchanges their interest** in the partnership to a successor, any amount they receive may be a capital gain or loss, depending on their outside basis, their allocation of hot assets, and the consideration received.[153] Capital gains from the **sale of assets** appear on the partner's Schedule K-1 (Form 1065) if they had been held longer than a year. Thus, the partner may have two sources of capital gains to report.

Generally, individual partners report gains and losses from their interests in partnerships on Form 8949, *Sales and Other Dispositions of Capital Assets,* which flows to Schedule D (Form 1040), part II, where long-term capital gains and losses are reported.

> **Note.** Nonresident aliens who sell an interest in a partnership doing business in the United States report the sale of their partnership interest on Form 8949. Additionally, nonresident aliens must attach a completed Schedule P (Form 1040-NR), *Foreign Partner's Interests in Certain Partnerships Transferred During Tax Year,* to their tax returns if they sold an interest in a partnership that conducted a U.S. trade or business.[154]

Example 25. Melody has been a $^1/_5$ partner of the TR partnership since January 1, 2020. On November 1, 2023, she received notification that Howard, another partner owning 50% of TR's capital, wished to purchase the interest of all other partners, paying $1,000 for each percentage interest held. Thus, Melody would receive $20,000 ($^1/_5$ × $100,000) on December 31, 2023, if she accepts the offer. The partnership would terminate on that date because Howard would be the last remaining individual with an equity interest. TR has no hot assets in December due to a seasonal lull in business and it owns no depreciable assets.

Melody accepts the offer, as do all the other partners. Because of large losses in 2020 and 2021 and distributions in 2022 and 2023, Melody has zero outside basis in the partnership. Thus, the $20,000 she received on December 31, 2023, represents a $20,000 capital gain ($20,000 received – $0 basis) because she has held the interest in TR for longer than one year. Melody reports the gain on Form 8949.

During 2023, TR also sold a small, undeveloped parcel of land for $50,000, having purchased it for $40,000. The land's sale in July created a $10,000 gain ($50,000 sales price – $40,000 cost) that must be allocated among the partners based on their ownership in July, following the provisions of the partnership agreement.

Because this land is a capital asset, Melody's Schedule K-1 (Form 1065) reports it as a $2,000 (($50,000 amount realized – $40,000 basis) × $^1/_5$ interest in the partnership) long-term capital gain on this form, which is marked final. The $2,000 long-term capital gain appears on her Schedule D (Form 1040), line 12.

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152. *A look at revised Form 8308*. Kim, Grace and Graves, Emilie. Feb. 1, 2024. AICPA. [www.thetaxadviser.com/issues/2024/feb/a-look-at-revised-form-8308.html] Accessed on Mar. 27, 2024.

153. IRC §§741, 751, 1001, and 1011.

154. 2023 Instructions for Form 8949.

Reporting the Disposition of Hot Assets

As mentioned previously, when a partner sells their interest in a **continuing partnership,** some portion of the gain or loss associated with the exchange of their interest in the partnership is actually attributed to hot assets. Under §751, a partner must report the sale of their proportionate share of hot assets separately from capital gain items because the sale of hot assets generates ordinary income. Similarly, when a partner reports income from their final Schedule K-1 (Form 1065) received from a **terminating partnership,** they may need to report a portion of their gain as ordinary income from the exchange of hot assets.

Partner Tax Return Reporting of Hot Asset Sales and Distributions. The partner's share of ordinary income from the exchange of hot assets appears in box 11 of their Schedule K-1 (Form 1065). Code L is associated with this ordinary income. This income passes to Form 4797, where it is reported with other ordinary gains in part II, line 10. Assuming a partner is a natural person, this income subsequently passes to Schedule 1 (Form 1040), *Additional Income and Adjustments to Income,* line 4, *Other gains or (losses),* where it is combined with other additions to income.

5

If some portion of the amount reported as ordinary income from hot assets arises from collectibles or §1250 unrecaptured income, this is reported on Schedule K-1 (Form 1065) in box 20 with code AC or code AD, respectively. Box 20 also reports gain from the exchange of hot assets. This amount is associated with code AB and may equal the amount reported in box 11 if the partnership had no collectibles or depreciable property among its assets.

Note. Treas. Reg. §1.751-1(b)(5) imposes the following notification requirements on partners **with their tax returns** when a distribution of hot assets takes place under other situations, including sales of partnership interests, their liquidation, or possibly even their abandonment if it involves hot assets.[155]

- Computation of any income, gain, or loss
- The gain or loss attributed to §751 property
- Any capital gain or loss on the sale of a partnership interest
- Date on which hot assets were distributed

Example 26. Sam is a 60% partner in P.E. On June 30, 2023, Sam sells his interest in P.E. to Dude. As compensation for his partnership interest, Sam receives $78,000 in cash. This represents the FMV of Sam's share of underlying partnership assets. The partnership assets consist of depreciable equipment (hot assets). Sam receives the following Schedule K-1 (Form 1065) from P.E. that allocates him 60% of the partnership's earnings for the first six months of the year.

[155] Treas. Reg. §1.751-1(a)(3), as referenced by Treas. Reg. §1.751-1(b)(5).

For Example 26

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

Schedule K-1 (Form 1065) **2023**

Department of the Treasury
Internal Revenue Service

For calendar year 2023, or tax year

beginning / / 2023 ending / /

Partner's Share of Income, Deductions, Credits, etc.

See separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
12-1212121

B Partnership's name, address, city, state, and ZIP code
P.E.
1 Main, Anytown IL 61801

C IRS center where partnership filed return: **e-file**

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)
*****-**-1111**

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.
Sam Partner
100 Ave, Anytown, IL 61801

G ☒ General partner or LLC member-manager ☐ Limited partner or other LLC member

H1 ☒ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:
TIN ______ Name ______

I1 What type of entity is this partner? **Individual**

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	60 %	%
Loss	60 %	%
Capital	60 %	%

Check if decrease is due to:
☒ Sale or ☐ Exchange of partnership interest. See instructions.

K1 Partner's share of liabilities:

	Beginning	Ending
Nonrecourse	$	$
Qualified nonrecourse financing	$	$
Recourse	$ 120,000	$

K2 Check this box if item K1 includes liability amounts from lower-tier partnerships ☐

K3 Check if any of the above liability is subject to guarantees or other payment obligations by the partner. See instructions ☐

L **Partner's Capital Account Analysis**

Beginning capital account	$ 0
Capital contributed during the year	$
Current year net income (loss)	$ 29,753
Other increase (decrease) (attach explanation)	$ (29,753)
Withdrawals and distributions	$ ( )
Ending capital account	$ 0

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 $

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

1	Ordinary business income (loss)	29,753	14	Self-employment earnings (loss)	A	29,753
2	Net rental real estate income (loss)					
3	Other net rental income (loss)		15	Credits		
4a	Guaranteed payments for services					
4b	Guaranteed payments for capital		16	Schedule K-3 is attached if checked ☐		
4c	Total guaranteed payments		17	Alternative minimum tax (AMT) items		
5	Interest income					
6a	Ordinary dividends					
6b	Qualified dividends		18	Tax-exempt income and nondeductible expenses		
6c	Dividend equivalents					
7	Royalties					
8	Net short-term capital gain (loss)		19	Distributions		
9a	Net long-term capital gain (loss)					
9b	Collectibles (28%) gain (loss)		20	Other information		
9c	Unrecaptured section 1250 gain				AB	78,000
10	Net section 1231 gain (loss)					
11	Other income (loss)					
12	Section 179 deduction		21	Foreign taxes paid or accrued		
13	Other deductions					

22 ☐ More than one activity for at-risk purposes*
23 ☐ More than one activity for passive activity purposes*

*See attached statement for additional information.

For IRS Use Only

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

P.E. provides Sam with the following Form 8308 to report the sale of Sam's interest in the partnership to Dude.

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
P.E.	**217-217-2170**	**12-1212121**

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

City or town, state or province, country, and ZIP or foreign postal code
Anytown, IL 61801

Part I Transferor Information

Record holder of the partnership interest immediately before transferring that interest:

Name	Identifying number
Sam Partner	*****-**-1111**

Number and street (including apt. no.)
100 Ave

City or town, state or province, country, and ZIP or foreign postal code
Anytown, IL 61801

Check if the transferor is foreign: ☐

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

Name	Identifying number
Sam Partner	*****-**-1111**

Number and street (including apt. no.)
100 Ave

City or town, state or province, country, and ZIP or foreign postal code
Anytown, IL 61801

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
Dude	*****-**-4444**

Number and street (including apt. no.)
18 Omaha

City or town, state or province, country, and ZIP or foreign postal code
Town, IL 61801

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

Name	Identifying number
Dude	*****-**-4444**

Number and street (including apt. no.)
18 Omaha

City or town, state or province, country, and ZIP or foreign postal code
Town, IL 61801

Part III Transfer of Partnership Interest

1 Date of sale or exchange of partnership interest: **06 / 30 / 23**

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 26

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) . . .	**130,000**	**60**		**78,000**	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. Signature of partnership representative or partner or limited liability company member / Date / /

Sam and his wife, Sarah, file the following Form 1040 and associated schedules to report his allocated income from P.E. and the sale of his interest.

For Example 26

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2023** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2023, or other tax year beginning ______, 2023, ending ______, 20 ____ See separate instructions.

Your first name and middle initial	Last name	Your social security number
Sam	Partner	*** ** 1111
If joint return, spouse's first name and middle initial	Last name	Spouse's social security number
Sarah	Partner	*** ** 3333

Home address (number and street). If you have a P.O. box, see instructions.		Apt. no.
1 Lane		
City, town, or post office. If you have a foreign address, also complete spaces below.	State	ZIP code
Anytown	IL	62338
Foreign country name	Foreign province/state/county	Foreign postal code

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Filing Status Check only one box.
☐ Single
☒ Married filing jointly (even if only one had income)
☐ Married filing separately (MFS)
☐ Head of household (HOH)
☐ Qualifying surviving spouse (QSS)
If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QSS box, enter the child's name if the qualifying person is a child but not your dependent: ________

Digital Assets At any time during 2023, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) ☐ **Yes** ☒ **No**

Standard Deduction **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness **You:** ☐ Were born before January 2, 1959 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1959 ☐ Is blind

Dependents (see instructions): If more than four dependents, see instructions and check here ☐

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) Child tax credit	(4) Credit for other dependents
				☐	☐
				☐	☐
				☐	☐
				☐	☐

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld. If you did not get a Form W-2, see instructions.

1a	Total amount from Form(s) W-2, box 1 (see instructions)	1a	60,000
b	Household employee wages not reported on Form(s) W-2	1b	
c	Tip income not reported on line 1a (see instructions)	1c	
d	Medicaid waiver payments not reported on Form(s) W-2 (see instructions)	1d	
e	Taxable dependent care benefits from Form 2441, line 26	1e	
f	Employer-provided adoption benefits from Form 8839, line 29	1f	
g	Wages from Form 8919, line 6	1g	
h	Other earned income (see instructions)	1h	
i	Nontaxable combat pay election (see instructions) 1i		
z	Add lines 1a through 1h	1z	60,000

Attach Sch. B if required.

2a	Tax-exempt interest	2a		b	Taxable interest	2b	
3a	Qualified dividends	3a		b	Ordinary dividends	3b	
4a	IRA distributions	4a		b	Taxable amount	4b	
5a	Pensions and annuities	5a		b	Taxable amount	5b	
6a	Social security benefits	6a		b	Taxable amount	6b	

Standard Deduction for—
- Single or Married filing separately, $13,850
- Married filing jointly or Qualifying surviving spouse, $27,700
- Head of household, $20,800
- If you checked any box under *Standard Deduction*, see instructions.

c	If you elect to use the lump-sum election method, check here (see instructions) ☐		
7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐	7	(3,000)
8	Additional income from Schedule 1, line 10	8	107,753
9	Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income**	9	164,753
10	Adjustments to income from Schedule 1, line 26	10	2,102
11	Subtract line 10 from line 9. This is your **adjusted gross income**	11	162,651
12	**Standard deduction or itemized deductions** (from Schedule A)	12	27,700
13	Qualified business income deduction from Form 8995 or Form 8995-A	13	21,130
14	Add lines 12 and 13	14	48,830
15	Subtract line 14 from line 11. If zero or less, enter -0-. This is your **taxable income**	15	113,821

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2023)

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For Example 26

Tax and Credits	16	**Tax** (see instructions). Check if any from Form(s): 1 ☐ 8814 2 ☐ 4972 3 ☐		16	15,656
	17	Amount from Schedule 2, line 3		17	
	18	Add lines 16 and 17		18	15,656
	19	Child tax credit or credit for other dependents from Schedule 8812		19	
	20	Amount from Schedule 3, line 8		20	
	21	Add lines 19 and 20		21	0
	22	Subtract line 21 from line 18. If zero or less, enter -0-		22	15,656
	23	Other taxes, including self-employment tax, from Schedule 2, line 21		23	4,204
	24	Add lines 22 and 23. This is your **total tax**		24	19,860
Payments	25	Federal income tax withheld from:			
	a	Form(s) W-2	25a 8,000		
	b	Form(s) 1099	25b		
	c	Other forms (see instructions)	25c		
	d	Add lines 25a through 25c		25d	8,000
If you have a qualifying child, attach Sch. EIC.	26	2023 estimated tax payments and amount applied from 2022 return		26	
	27	Earned income credit (EIC)	27		
	28	Additional child tax credit from Schedule 8812	28		
	29	American opportunity credit from Form 8863, line 8	29		
	30	Reserved for future use	30		
	31	Amount from Schedule 3, line 15	31		
	32	Add lines 27, 28, 29, and 31. These are your **total other payments and refundable credits**		32	
	33	Add lines 25d, 26, and 32. These are your **total payments**		33	8,000
Refund	34	If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you **overpaid**		34	
	35a	Amount of line 34 you want **refunded to you**. If Form 8888 is attached, check here ☐		35a	
Direct deposit? See instructions.	b	Routing number	c Type: ☐ Checking ☐ Savings		
	d	Account number			
	36	Amount of line 34 you want **applied to your 2024 estimated tax**	36		
Amount You Owe	37	Subtract line 33 from line 24. This is the **amount you owe**. For details on how to pay, go to *www.irs.gov/Payments* or see instructions		37	11,860
	38	Estimated tax penalty (see instructions)	38		

Do you want to allow another person to discuss this return with the IRS? See

Year Ending: December 31, 2023 ***-**-1111

Sam and Sarah Partner

Statement of Sale or Exchange of Interest in Partnership That Has Code Sec. 751 Property

Taxpayer submits the following information in accordance with Reg 1.751-1(a)(3) for the sale or exchange of an interest in (EIN 12-1212121) that had Code Sec. 751 property at the time of sale or exchange:

Date of sale or exchange:	6/30/23
Gain or (loss) attributable to Code Sec. 751 property:	$78,000
Gain or (loss) attributable to capital gain or loss on the sale of the partnership interest:	($29,753)

For Example 26

SCHEDULE 1 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2023
Attachment Sequence No. **01**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR: **Sam and Sarah Partner**
Your social security number: ***-**-1111

Part I Additional Income

1	Taxable refunds, credits, or offsets of state and local income taxes			**1**	
2a	Alimony received			**2a**	
b	Date of original divorce or separation agreement (see instructions):				
3	Business income or (loss). Attach Schedule C			**3**	
4	Other gains or (losses). Attach Form 4797			**4**	78,000
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			**5**	29,753
6	Farm income or (loss). Attach Schedule F			**6**	
7	Unemployment compensation			**7**	
8	Other income:				
a	Net operating loss	**8a**	( )		
b	Gambling	**8b**			
c	Cancellation of debt	**8c**			
d	Foreign earned income exclusion from Form 2555	**8d**	( )		
e	Income from Form 8853	**8e**			
f	Income from Form 8889	**8f**			
g	Alaska Permanent Fund dividends	**8g**			
h	Jury duty pay	**8h**			
i	Prizes and awards	**8i**			
j	Activity not engaged in for profit income	**8j**			
k	Stock options	**8k**			
l	Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property	**8l**			
m	Olympic and Paralympic medals and USOC prize money (see instructions)	**8m**			
n	Section 951(a) inclusion (see instructions)	**8n**			
o	Section 951A(a) inclusion (see instructions)	**8o**			
p	Section 461(l) excess business loss adjustment	**8p**			
q	Taxable distributions from an ABLE account (see instructions)	**8q**			
r	Scholarship and fellowship grants not reported on Form W-2	**8r**			
s	Nontaxable amount of Medicaid waiver payments included on Form 1040, line 1a or 1d	**8s**	( )		
t	Pension or annuity from a nonqualifed deferred compensation plan or a nongovernmental section 457 plan	**8t**			
u	Wages earned while incarcerated	**8u**			
z	Other income. List type and amount:	**8z**			
9	Total other income. Add lines 8a through 8z			**9**	
10	Combine lines 1 through 7 and 9. This is your **additional income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8			**10**	107,753

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2023**

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For Example 26

Part II Adjustments to Income

11	Educator expenses			11	
12	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106			12	
13	Health savings account deduction. Attach Form 8889			13	
14	Moving expenses for members of the Armed Forces. Attach Form 3903			14	
15	Deductible part of self-employment tax. Attach Schedule SE			15	2,102
16	Self-employed SEP, SIMPLE, and qualified plans			16	
17	Self-employed health insurance deduction			17	
18	Penalty on early withdrawal of savings			18	
19a	Alimony paid			19a	
b	Recipient's SSN				
c	Date of original divorce or separation agreement (see instructions):				
20	IRA deduction			20	
21	Student loan interest deduction			21	
22	Reserved for future use			22	
23	Archer MSA deduction			23	
24	Other adjustments:				
a	Jury duty pay (see instructions)	24a			
b	Deductible expenses related to income reported on line 8l from the rental of personal property engaged in for profit	24b			
c	Nontaxable amount of the value of Olympic and Paralympic medals and USOC prize money reported on line 8m	24c			
d	Reforestation amortization and expenses	24d			
e	Repayment of supplemental unemployment benefits under the Trade Act of 1974	24e			
f	Contributions to section 501(c)(18)(D) pension plans	24f			
g	Contributions by certain chaplains to section 403(b) plans	24g			
h	Attorney fees and court costs for actions involving certain unlawful discrimination claims (see instructions)	24h			
i	Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations	24i			
j	Housing deduction from Form 2555	24j			
k	Excess deductions of section 67(e) expenses from Schedule K-1 (Form 1041)	24k			
z	Other adjustments. List type and amount:	24z			
25	Total other adjustments. Add lines 24a through 24z			25	
26	Add lines 11 through 23 and 25. These are your **adjustments to income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 10			26	2,102

Schedule 1 (Form 1040) 2023

For Example 26

SCHEDULE 2 (Form 1040) Department of the Treasury Internal Revenue Service	**Additional Taxes** Attach to Form 1040, 1040-SR, or 1040-NR. Go to *www.irs.gov/Form1040* for instructions and the latest information.	OMB No. 1545-0074 2023 Attachment Sequence No. 02

Name(s) shown on Form 1040, 1040-SR, or 1040-NR	Your social security number
Sam and Sarah Partner	***-**-1111

Part I Tax

1	Alternative minimum tax. Attach Form 6251		1	0
2	Excess advance premium tax credit repayment. Attach Form 8962		2	
3	Add lines 1 and 2. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 17		3	0

Part II Other Taxes

4	Self-employment tax. Attach Schedule SE		4	4,204
5	Social security and Medicare tax on unreported tip income. Attach Form 4137	5		
6	Uncollected social security and Medicare tax on wages. Attach Form 8919	6		
7	Total additional social security and Medicare tax. Add lines 5 and 6		7	
8	Additional tax on IRAs or other tax-favored accounts. Attach Form 5329 if required. If not required, check here ☐		8	
9	Household employment taxes. Attach Schedule H		9	
10	Repayment of first-time homebuyer credit. Attach Form 5405 if required		10	
11	Additional Medicare Tax. Attach Form 8959		11	
12	Net investment income tax. Attach Form 8960		12	
13	Uncollected social security and Medicare or RRTA tax on tips or group-term life insurance from Form W-2, box 12		13	
14	Interest on tax due on installment income from the sale of certain residential lots and timeshares		14	
15	Interest on the deferred tax on gain from certain installment sales with a sales price over $150,000		15	
16	Recapture of low-income housing credit. Attach Form 8611		16	

(continued on page 2)

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71478U **Schedule 2 (Form 1040) 2023**

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For Example 26

SCHEDULE D (Form 1040)

Department of the Treasury Internal Revenue Service

Capital Gains and Losses

Attach to Form 1040, 1040-SR, or 1040-NR.
Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.
Go to *www.irs.gov/ScheduleD* for instructions and the latest information.

OMB No. 1545-0074

2023

Attachment Sequence No. **12**

Name(s) shown on return: **Sam and Sarah Partner**

Your social security number: ***-**-1111

Did you dispose of any investment(s) in a qualified opportunity fund during the tax year? ☐ **Yes** ☒ **No**
If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.

Part I **Short-Term Capital Gains and Losses—Generally Assets Held One Year or Less** (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	**(d)** Proceeds (sales price)	**(e)** Cost (or other basis)	**(g)** Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	**(h) Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b .				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 . .	4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions	6	( )
7 **Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back	7	

Part II **Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year** (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	**(d)** Proceeds (sales price)	**(e)** Cost (or other basis)	**(g)** Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	**(h) Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b .				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked.	**78,000**	**107,753**	**0**	**(29,753)**

11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13 Capital gain distributions. See the instructions	13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	14	( )
15 **Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). Then, go to Part III on the back	15	**(29,753)**

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H **Schedule D (Form 1040) 2023**

For Example 26

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side	Social security number or taxpayer identification number
Sam and Sarah Partnership	***-**-1111

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part II **Long-Term.** Transactions involving capital assets you held more than 1 year are generally long-term (see instructions). For short-term transactions, see page 1.

Note: You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 8a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box D, E, *or* F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☐ **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
☐ **(E)** Long-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
☒ **(F)** Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis See the **Note** below and see *Column (e)* in the separate instructions.	Adjustment, if any, to gain or loss If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g).
Sale of Partnership Interest	6/30/19	6/30/23	78,000	107,753			(29,753)
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 8b** (if **Box D** above is checked), **line 9** (if **Box E** above is checked), or **line 10** (if **Box F** above is checked) . .			78,000	107,753		0	(29,753)

Note: If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8949** (2023)

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For Example 26

Name(s) shown on return. Do not enter name and social security number if shown on other side.	**Your social security number**
Sam and Sarah Partnership	*****-**-1111**

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note: If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column (**e**) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column (**f**) on line 28 and attach **Form 6198**. See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section . . . ☐ **Yes** ☒ **No**

28	**(a)** Name	**(b)** Enter **P** for partnership; **S** for S corporation	**(c)** Check if foreign partnership	**(d)** Employer identification number	**(e)** Check if basis computation is required	**(f)** Check if any amount is not at risk
A	**P.E.**	**P**	☐	**12-1212121**	☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

	Passive Income and Loss		**Nonpassive Income and Loss**		
	(g) Passive loss allowed (attach **Form 8582** if required)	**(h)** Passive income from **Schedule K-1**	**(i)** Nonpassive loss allowed (see **Schedule K-1**)	**(j)** Section 179 expense deduction from **Form 4562**	**(k)** Nonpassive income from **Schedule K-1**
A					**29,753**
B					
C					
D					
29a Totals					**29,753**
b Totals					

30	Add columns (h) and (k) of line 29a	30	**29,753**
31	Add columns (g), (i), and (j) of line 29b	31	( )
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31	32	**29,753**

Part III Income or Loss From Estates and Trusts

33	**(a)** Name	**(b)** Employer identification number
A		
B		

	Passive Income and Loss		**Nonpassive Income and Loss**	
	(c) Passive deduction or loss allowed (attach **Form 8582** if required)	**(d)** Passive income from **Schedule K-1**	**(e)** Deduction or loss from **Schedule K-1**	**(f)** Other income from **Schedule K-1**
A				
B				
34a Totals				
b Totals				

35	Add columns (d) and (f) of line 34a	35	
36	Add columns (c) and (e) of line 34b	36	( )
37	**Total estate and trust income or (loss).** Combine lines 35 and 36	37	

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

38	**(a)** Name	**(b)** Employer identification number	**(c)** Excess inclusion from **Schedules Q**, line 2c (see instructions)	**(d)** Taxable income (net loss) from **Schedules Q**, line 1b	**(e)** Income from **Schedules Q**, line 3b

39	Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below	39	

Part V Summary

40	Net farm rental income or (loss) from **Form 4835**. Also, complete line 42 below	40	
41	**Total income or (loss).** Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Schedule 1 (Form 1040), line 5	41	**29,753**
42	**Reconciliation of farming and fishing income.** Enter your **gross** farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120-S), box 17, code AN; and Schedule K-1 (Form 1041), box 14, code F. See instructions	42	
43	**Reconciliation for real estate professionals.** If you were a real estate professional (see instructions), enter the net income or (loss) you reported anywhere on Form 1040, Form 1040-SR, or Form 1040-NR from all rental real estate activities in which you materially participated under the passive activity loss rules	43	

Schedule E (Form 1040) 2023

For Example 26

SCHEDULE SE (Form 1040) Department of the Treasury Internal Revenue Service	**Self-Employment Tax** Attach to Form 1040, 1040-SR, 1040-SS, or 1040-NR. Go to *www.irs.gov/ScheduleSE* for instructions and the latest information.	OMB No. 1545-0074 **2023** Attachment Sequence No. **17**
Name of person with self-employment income (as shown on Form 1040, 1040-SR, 1040-SS, or 1040-NR) **Sam Partner**	Social security number of person with **self-employment** income	***-**-1111

Part I Self-Employment Tax

Note: If your only income subject to self-employment tax is **church employee income**, see instructions for how to report your income and the definition of church employee income.

A If you are a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361, but you had $400 or more of **other** net earnings from self-employment, check here and continue with Part I ☐

Skip lines 1a and 1b if you use the farm optional method in Part II. See instructions.

1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A			1a	
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AQ			1b	( )
	Skip line 2 if you use the nonfarm optional method in Part II. See instructions.				
2	Net profit or (loss) from Schedule C, line 31; and Schedule K-1 (Form 1065), box 14, code A (other than farming). See instructions for other income to report or if you are a minister or member of a religious order			2	29,753
3	Combine lines 1a, 1b, and 2			3	29,753
4a	If line 3 is more than zero, multiply line 3 by 92.35% (0.9235). Otherwise, enter amount from line 3			4a	27,477
	Note: If line 4a is less than $400 due to Conservation Reserve Program payments on line 1b, see instructions.				
b	If you elect one or both of the optional methods, enter the total of lines 15 and 17 here			4b	0
c	Combine lines 4a and 4b. If less than $400, **stop**; you don't owe self-employment tax. **Exception:** If less than $400 and you had **church employee income**, enter -0- and continue			4c	27,477
5a	Enter your **church employee income** from Form W-2. See instructions for definition of church employee income	5a			
b	Multiply line 5a by 92.35% (0.9235). If less than $100, enter -0-			5b	0
6	Add lines 4c and 5b			6	27,477
7	Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2023			7	160,200
8a	Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If $160,200 or more, skip lines 8b through 10, and go to line 11	8a	60,000		
b	Unreported tips subject to social security tax from Form 4137, line 10	8b			
c	Wages subject to social security tax from Form 8919, line 10	8c			
d	Add lines 8a, 8b, and 8c			8d	60,000
9	Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11			9	100,200
10	Multiply the **smaller** of line 6 or line 9 by 12.4% (0.124)			10	3,407
11	Multiply line 6 by 2.9% (0.029)			11	797
12	**Self-employment tax.** Add lines 10 and 11. Enter here and on **Schedule 2 (Form 1040), line 4**, or **Form 1040-SS, Part I, line 3**			12	4,204
13	**Deduction for one-half of self-employment tax.** Multiply line 12 by 50% (0.50). Enter here and on **Schedule 1 (Form 1040), line 15**	13	2,102		

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2023**

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For Example 26

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

Attach to your tax return.
Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184

2023

Attachment Sequence No. **27**

Name(s) shown on return	Identifying number
Sam and Sarah Partner	***-**-1111

1a	Enter the gross proceeds from sales or exchanges reported to you for 2023 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1a	
b	Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets	1b	
c	Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets	1c	

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below. **Individuals, partners, S corporation shareholders, and all others.** If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

(a)	(b)	(c)	(d)	(e)	(f)	(g)
From K-1						78,000

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	78,000
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	78,000

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2023)

For Example 26

Form **8995**

Department of the Treasury
Internal Revenue Service

Qualified Business Income Deduction Simplified Computation

Attach to your tax return.

Go to *www.irs.gov/Form8995* for instructions and the latest information.

OMB No. 1545-2294

2023

Attachment Sequence No. **55**

Name(s) shown on return	Your taxpayer identification number
Sam and Sarah Partner	***-**-1111

Note. *You can claim the qualified business income deduction **only** if you have qualified business income from a qualified trade or business, real estate investment trust dividends, publicly traded partnership income, or a domestic production activities deduction passed through from an agricultural or horticultural cooperative. See instructions.*

Use this form if your taxable income, before your qualified business income deduction, is at or below $182,100 ($364,200 if married filing jointly), and you aren't a patron of an agricultural or horticultural cooperative.

1	**(a)** Trade, business, or aggregation name	**(b)** Taxpayer identification number	**(c)** Qualified business income or (loss)
i	P.E.	12-1212121	105,651
ii			
iii			
iv			
v			

2	Total qualified business income or (loss). Combine lines 1i through 1v, column (c)	2	105,651		
3	Qualified business net (loss) carryforward from the prior year	3	(0)		
4	Total qualified business income. Combine lines 2 and 3. If zero or less, enter -0-	4	105,651		
5	Qualified business income component. Multiply line 4 by 20% (0.20)			5	21,130
6	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss) (see instructions)	6			
7	Qualified REIT dividends and qualified PTP (loss) carryforward from the prior year	7	( )		
8	Total qualified REIT dividends and PTP income. Combine lines 6 and 7. If zero or less, enter -0-	8			
9	REIT and PTP component. Multiply line 8 by 20% (0.20)			9	
10	Qualified business income deduction before the income limitation. Add lines 5 and 9			10	21,130
11	Taxable income before qualified business income deduction (see instructions)	11	134,951		
12	Enter your net capital gain, if any, increased by any qualified dividends (see instructions)	12	0		
13	Subtract line 12 from line 11. If zero or less, enter -0-	13	134,951		
14	Income limitation. Multiply line 13 by 20% (0.20)			14	26,990
15	Qualified business income deduction. Enter the smaller of line 10 or line 14. Also enter this amount on the applicable line of your return (see instructions)			15	21,130
16	Total qualified business (loss) carryforward. Combine lines 2 and 3. If greater than zero, enter -0-			16	( )
17	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 6 and 7. If greater than zero, enter -0-			17	( )

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 37806C Form **8995** (2023)

No Like-Kind Exchanges for Partnership Interests

The exchange of a partnership interest for another one does not satisfy the requirements for like-kind exchanges under IRC §1031, even if the partnership owns real estate. Thus, a partner in a terminating partnership cannot defer any gain in that partnership by exchanging it with another taxpayer.

TRANSFERS OF PARTNERSHIP INTERESTS AND FORM 8594 REQUIREMENTS

In some cases, the transfer or exchange of a partnership interest requires filing Form 8594, *Asset Acquisition Statement under Section 1060*. IRC §1060 requires the transfers of property associated with a **trade or business and subject to IRC §755** to be reported. Transactions need not be reported if the assets do not constitute a trade or business to either the former owner or the new owner.[156] A secondary exception exists for gifted or inherited property because the basis of that property is not "determined wholly by reference to the consideration paid for such assets."[157] Generally, the basis of gifted property is the donor's basis, and because the recipient did not pay for the gifted assets, they usually are not subject to the requirement to file Form 8594.[158] Because the basis of an inherited partnership interest is generally its FMV on the date of the decedent's passing, the transfer of a partnership interest by bequest also generally avoids the requirement to file Form 8594.[159]

Caution. Tax practitioners should consider whether the deemed sale provisions of Treas. Reg. §1.1001-2(a) may bring certain gifts under the jurisdiction of §1060.[160] A deemed sale occurs when a donor is relieved of debt greater than their basis in the property. The donor of the partnership interest recognizes gain to the extent that they are relieved of debt that exceeds their tax basis. The recipient accepts the gift with a basis equal to the donor's debt relief or the donor's adjusted outside basis, whichever is greater.[161] The recipient's basis is further increased for any gift tax paid by the donor.[162] Because it may have been adjusted for the partnership's losses, the donor's adjusted outside basis in the partnership could be very small.[163] In such circumstances, the deemed sale provisions may indirectly impose the requirement to file Form 8594 on the gift of a partnership interest.

156. Treas. Reg. §1.1060-1(b)(1).

157. Treas. Reg. §1.1060-1(c)(2).

158. IRC §§1015(a), 1060(c)(2), and 1060(d)(2).

159. IRC §1014(a)(1).

160. *Gifts of Partnership Interests.* Ellentuck, Albert. Apr. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/apr/gifts-of-partnership-interests.html] Accessed on Mar. 28, 2024.

161. Treas. Reg. §1.1015-4(a).

162. Treas. Reg. §1.1015-5(a).

163. IRC §705.