



Partnership Distributions

By: Bruce J. Belman

Crowe Chizek and Company LLC

- 1) A brief history:
 - a) Most partnership distributions occur tax-free except when a cash distribution exceeds a partner's basis in his partnership interest.
 - b) Historically, distributions of property were almost universally considered per-se tax-free until the 1980s when taxpayers began to stretch the privilege's limits.
 - i) In effect, taxpayers achieved the benefits of a tax-free exchange without playing fairly by the rules of I.R.C. § 1031.
 - ii) Moreover, corporate partners were able to beat the corporate-level tax on distributions of appreciated assets following the repeal of *General Utilities*.
 - c) In response to these perceived abuses, Congress spent the 1990s creating ways to tax mixing bowl schemes resulting in a host of new and improved "anti-deferral" provisions designed to make otherwise tax-free transactions wholly or partially taxable.
 - d) Congress's laundry list of exceptions to the general rule that property distributions are tax-free now includes:
 - i) Disguised sales (I.R.C. § 707);
 - ii) Mixing bowl deals (I.R.C. §§ 704(c)(1)(B) and 737);
 - iii) Hot assets (I.R.C. § 751(b));
 - iv) Investment partnerships (I.R.C. § 721(b)); and
 - v) Marketable securities (I.R.C. § 731(c)).
 - e) The family limited partnership (FLP) also became popular in the 1990s:
 - i) Wealthy individuals transferred assets into family limited partnerships (FLPs) to take advantage of creditor protection and estate tax discounts.
 - ii) They usually had no thought of abusing the income tax system.
 - iii) They did not consider the future consequences of one or more partners withdrawing partnership assets.
 - f) Congress's new anti-abuse rules were in full play by the time many FLPs began to outlive their useful lives.
 - i) Reasons families consider unwinding their FLP.
 - (1) The founders were deceased and the siblings reverted to their former quarrelling selves;
 - (2) The stock market plus the enlarged estate tax exemption eliminated the need for a family limited partnership;
 - (3) Much like a good wine, the FLP had reached its full maturity and was ready to be consumed;
 - ii) Now families ask about the income tax consequences of:
 - (1) Taking distributions out of the partnership;
 - (2) Buying out one or more siblings; or
 - (3) Terminating the FLP altogether.

- iii) There are no longer any simple questions or answers - every transaction between a partner and a partnership must be analyzed for potential gain or loss recognition depending on a litany of factors that seem wholly unrelated to income taxation.
 - iv) Most partnership agreements provide that the general partner will determine, in keeping with the duties of care and loyalty to the partnership, the need to retain cash and other property in the partnership business:
 - (1) Cash may usually be retained for current or future operating capital needs and for current or future investment opportunities.
 - (2) Subject to the forgoing, the general partner should distribute any remaining cash.
 - (3) Failure to adopt and follow a cash distribution policy has several consequences:
 - (a) It could jeopardize the donor's annual gift tax exclusion for a gift of a present interest. *See Hackl v. Comm'r*, 118 T.C. 279 (Mar. 27, 2002); *see also*; PLR 9751003.
 - (b) It could also raise issues regarding the validity of the partnership entity. *See Reichardt v. Comm'r*, 114 T.C. 144 (2000); *Schauerhamer v. Comm'r*, 73 T.C.M. (CCH) 2855 (1997).
 - (c) The IRS could claim that the donor retained control of the partnership assets and therefore they should be included undiscounted in his taxable estate under I.R.C. § 2036(a). *See Strangi v. Comm'r*, 96 A.F.T.R.2d 2005-5230 (5th Cir. 2005); *Kimbell v. United States*, 91 A.F.T.R.2d 2003-585 (D.C. Tex. 2003).
- 2) General Concepts Applicable to Partnership Distributions:
- a) First, what is a distribution? A partnership distribution involves the unilateral transfer of cash or other property from the partnership to a partner.
 - i) The Code does not define a partnership distribution. The closest authority is Reg. § 1.731-1(a)(i)(ii), which states that "advances or drawings of money or property against a partner's distributive share of income shall be treated as current distributions."
 - ii) Thus, not all payments to partners are treated as distributions for this purpose. Distributions do not include:
 - (1) Loans to partners;
 - (2) Payments for services (except guaranteed payments); or
 - (3) Certain actual or disguised sales that are treated as occurring between a partnership and one who is not a partner. *See* Reg. §§ 1.707-1(a), 1.707-3(a), and I.R.C. § 707(b).
 - b) Generally, partnership distributions are taxed under I.R.C. §§ 731-735, 736(a) and 751(b).
 - i) I.R.C. § 731:
 - (1) General rule: Neither the partner nor the partnership recognizes gain or loss on a distribution of money or property to a partner. *See* I.R.C. § 731(a)-(b).
 - (2) Exception: When the amount of money or marketable securities treated as money distributed exceeds a partner's basis in his partnership interest. In that case, the partner recognizes a gain from the sale or exchange of his partnership interest (capital gain) to the extent of the excess. *See* I.R.C. §§ 731(a)(1), (c)(1).
 - (3) Distributions Causing a Loss.
 - (a) Generally, current distributions never result in a loss.

- (b) Liquidating distributions can, however, cause a partner to recognize a loss on the sale of a partnership interest when the distribution consists solely of:
 - (i) Money;
 - (ii) Unrealized receivables; or
 - (iii) Inventory. *See* I.R.C. § 731(a)(2).
 - (c) The relatively few situations where partnership distributions can cause a partner to recognize a loss are:
 - (i) Distributions in liquidation of a partnership interest that consist solely of money, unrealized receivables, or inventory. *See* I.R.C. § 731(a)(2).
 - (ii) Distributions to another partner of built-in loss property that a partner previously contributed. *See* I.R.C. § 704(c)(1)(B).
 - (iii) Transactions treated as a sale between a partner and one who is not a partner.
 - 1. However, these are subject to a loss disallowance when a partner owns more than a 50% interest in the partnership capital or profits. *See* Reg. 1.707-1(b).
 - 2. In most other situations, partnership distributions will have no tax effect or cause a partner to recognize a gain.
- (4) Timing of Distributions During the Year:
- (a) Advances or draws during the year are treated as made on the last day of the partnership's tax year. *See* Reg. § 1.731-1(a)(1)(ii).
 - (i) That is also when a partnership determines each partner's share of partnership profits or losses corresponding basis adjustments.
 - (b) There is generally no advantage to timing distributions to occur at any particular point during a tax year.
 - (c) Although, gain or loss may be measured using the FMV on the date of a property distribution under I.R.C. §§ 704(c)(1)(B) and 737, it is still treated as occurring on the last day of the year for all other purposes.
 - (d) Transactions treated as occurring between a partnership and one who is not a partner such as disguised sales of property under I.R.C. § 707(a) occur for tax purposes on the actual date of the transaction. *See* Reg. § 1.707-3(a)(2).
- (5) Non Pro-Rata Interim Distributions:
- (a) Current distributions need not be strictly pro-rata for income tax purposes. However, non-pro-rata distributions should be the exception and thus equalized as soon as possible before year end.
 - (b) The IRS can reallocate the partners' shares of income or loss for tax income purposes under I.R.C. § 704 to the extent distributions do not track a partner's stated interest in the partnership.
 - (c) Most family limited partnership agreements provide that distributions should be made in strict proportion to a partner's interest in the partnership.
- ii) I.R.C. § 732: Basis and Holding Period of Distributed Property.
- (1) The basis of property (other than money) received by a partner from a partnership is its adjusted basis to the partnership immediately before the distribution in the case of non-liquidating distributions. *See* Reg. § 1.732-1(a).

- (2) In liquidating distributions the partner's basis in his partnership interest is allocated among the properties received. *See* Reg. § 1.732-1(b) and (c).
 - (3) After reduction for money distributions, a partner's basis in his partnership interest is allocated:
 - (a) First, to inventory and unrealized receivables (i.e. ordinary income property);
 - (b) Second, among the properties received based on their relative unrealized appreciation or depreciation;
 - (4) As basis "tacks," so does the holding period of property distributed by a partnership. *See* I.R.C. § 735(b).
 - (a) Therefore, distributions of capital assets held by the partnership for more than a year may permit a partner who has held his partnership interest for less than a year to realize long-term rather than short-term capital gain.
 - (b) Conversely, if the partnership distributes property it has held for less than a year to a partner who acquired his interest from a decedent (and thus has a long-term holding period in his partnership interest) the distributee may have a short-term gain or loss if the property is sold within a year of the partnership's purchase date.
 - (5) Thus, there is generally no interruption in the holding period of partnership assets, even in the case of assets with a basis adjustment because of a partnership's I.R.C. § 754 election. *See* McKee, Nelson, & Whitmire, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS*, Third Edition (Warren, Gorham & Lamont, 1997), 15.02[3][b] fn. 66.
- iii) I.R.C. § 733: Nontaxable cash distributions reduce the recipient's outside basis dollar-for-dollar.
- (1) Property received in a non-liquidating distribution takes a basis equal to the basis it had in the partnership limited to the partner's outside basis.
 - (2) Property received in a liquidating distribution takes as its basis the partner's outside basis immediately before the distribution, less any money distributed. I.R.C. § 732(b).
- iv) I.R.C. § 751(a):
- (1) Before enactment of I.R.C. § 751, sales of partnership interests were generally sales of capital assets, regardless of the character of the assets sold in the hands of the partnership. Thus, if a partnership held appreciated inventory or unrealized receivables, a partner could convert its share of the ordinary income associated with those assets into capital gain by selling its partnership interest.
 - (2) General Overview:
 - (a) I.R.C. § 751(a) now provides that if a partner sells his or her partnership interest and any part of that interest represents the partner's share in appreciated inventory or unrealized receivables, that amount must be recognized as ordinary income or loss.
 - (b) I.R.C. § 751(a) applies to all transfers of partnership interests otherwise subject to capital gain treatment pursuant to I.R.C. § 741, even sales to existing partners.
 - (c) I.R.C. § 751(a) does not apply to a partner's transfer of his partnership interest to another partnership in exchange for an interest in the second partnership. *See* Rev. Rul. 84-115, 1984-2 C.B. 118.

- (d) Practitioners should exercise care in distinguishing between transfers of a partnership interests and liquidations of those interests. If an exchange constitutes a liquidating distribution, I.R.C. § 731, 741, and 751(b) apply.

(3) Application:

- (a) I.R.C. § 751(a) requires a partner to recognize ordinary gain or loss equal to the gain or loss the partnership would allocate to the partner if the partnership sold all of its property for cash at FMV immediately before the partner's transfer or exchange of its partnership interest. *See* Regs. §1.751-1(a)(2).
- (b) The FMV of the property must at least equal the value of any nonrecourse debt applicable to the property. *See* Reg. §1.751-1(a)(2).
- (c) The transferring partner's sales proceeds must include any remedial allocations otherwise required by Reg. § 1.704-3(d).
- (d) Use the following procedure to determine a partner's ordinary gain or loss pursuant to I.R.C. § 751(a):

Step 1: Calculate the partner's total gain or loss on the transfer. It will equal the amount received less the partner's basis in its partnership interest;

Step 2: Determine the transferring partner's share of the gain or loss associated with the hypothetical sale of the partnership's assets. The partner's share of that gain or loss is its ordinary gain or loss; and

Step 3: If the gain or loss calculated under Step 1 exceeds the gain loss determined under Step 2, then the excess is capital gain or loss to the transferring partner.

v) I.R.C. § 751(b):

(1) General Overview:

- (a) For I.R.C. § 751(b) to apply, a distribution must satisfy two requirements:
 - (i) A partnership must distribute property to a partner while owning 751(b) property (unrealized receivables or substantially appreciated inventory); and
 - (ii) The distributee partner must exchange either:
 1. Its interest in the partnership's 751(b) property for an additional interest in the partnership's property that is not 751(b) property; or
 2. Its interest in the partnership's non-751(b) property for an additional interest in the partnership's 751(b) property.

Note 1: "Substantially appreciated inventory" is inventory whose aggregate FMV exceeds 120% of the partnership's basis in the inventory.

Note 2: I.R.C. § 751(b) trumps I.R.C. § 737(a) to the extent that both statutes apply to the same distribution. *See* I.R.C. § 737(d)(2).

(2) The Distribution Requirement:

- (a) Distributions of money, property, or a combination of both are subject to I.R.C. § 751(b).
- (b) A decrease in a partner's share of partnership liabilities under I.R.C. § 752(b) also constitutes a distribution subject to I.R.C. § 751(b).
- (c) I.R.C. § 751(b) applies to liquidating and non-liquidating distributions. *See* Reg. § 1.751-1(b)(1)(i).

(3) The Exchange Requirement:

- (a) The IRS applies the exchange requirement liberally. However, a transaction will not constitute an “exchange” for purposes of I.R.C. § 751(b) to the extent a partner receives a pro-rata distribution of partnership assets. *See* Reg. § 1.751-1(b)(1)(ii).
- (b) I.R.C. § 751(b) requires an exchange of 751(b) property for non-751(b) property, or of non-751(b) property for 751(b) property. Thus, I.R.C. § 751(b) will not apply if a partner receives a distribution of the partnership’s 751(b) property in exchange for his interest in the partnership’s other 751(b) property with an equal value. As long as a partner receives its share of the aggregate value all of the partnership’s items of 751(b) property, I.R.C. § 751(b) will not apply.

(4) Situations Where I.R.C. § 751(b) Does Not Apply:

- (a) A distribution of property which the distributee partner contributed to the partnership.” I.R.C. § 752(b)(2)(A).
- (b) A partnership reorganization or realignment if the transaction has a legitimate business purpose and no tax avoidance motive.
- (c) “Current drawings or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital.” Reg. § 1.751-1(b)(1)(ii).

(5) Use the following procedure to determine a partner’s ordinary gain or loss pursuant to I.R.C. § 751(b):

Step 1: Determine the partner's pre-distribution interest in the partnership’s 751(b) property and non-751(b) property;

Step 2: Determine the partner's post-distribution interest in the partnership’s 751(b) property and non-751(b) property;

Step 3: Determine whether the partner received 751(b) property in exchange for relinquishing an interest in the partnership’s non-751(b) property or received non-751(b) property in exchange for relinquishing an interest in the partnership’s 751(b) property;

Step 4: Determine the partner's adjusted basis in the properties exchanged;

Step 5: Determine the distributee partner's ordinary income or loss under I.R.C. § 751(b), equal to the difference between:

- (i) Its adjusted basis in the 751(b) property it relinquished in the exchange, and
- (ii) The FMV of the non-751(b) property the partner received in the exchange;

Step 6: Determine the partner's I.R.C. § 751(b) gain or loss, equal to the difference between:

- (iii) Its adjusted basis in the non-751(b) property relinquished in the exchange, and
- (iv) The FMV of the 751(b) property the partner received in the exchange;

Step 7: Determine the partner's I.R.C. § 731(a)(1) capital gain under or I.R.C. § 731(a)(2) capital loss;

Step 8: Determine the partnership's I.R.C. § 751(b) ordinary income or loss, equal to the difference between:

- (i) The partnership's adjusted basis in the 751(b) property exchanged, and

- (ii) The FMV of the distributee partner's interest in the non-751(b) property it relinquished; and

Step 9: Determine the partnership's I.R.C. § 751(b) gain or loss, equal to the difference between:

- (i) The adjusted basis of the non-751(b) property exchanged, and
- (ii) The FMV of the distributee partner's interest in the 751(b) property it relinquished.

(6) Character of I.R.C. § 751(b) Gain or Loss Recognized.

- (a) The character of non-751(b) property deemed sold by a partnership determines the character of the partnership's gain or loss. Reg. § 1.751-1(b)(3)(ii). Generally, partnerships recognize capital or I.R.C. § 1231 gain or loss.
- (b) The partnership must allocate the gain or loss to the non-distributee partners in proportion to their post-distribution interests in the partnership's gains and losses. Reg. § 1.751-1(b)(3)(ii).

(7) Adjusted Basis and Holding Period of Property Received by a Partner.

- (a) If a partner receives its share, or less than its share of a partnership's assets, the partner will determine its adjusted basis and holding period in distributed property in accordance with I.R.C. § 732. Reg. § 1.751-1(g).
- (b) But if a partner receives more than its proportionate share of partnership property, it is deemed to have purchased the "excess" property. Accordingly, its adjusted basis in the property will equal its adjusted basis in its proportionate share of the property received plus the "cost" of the "excess" property. Reg. § 1.751-1(g).
- (c) Further, the partner's holding period will tack to the partnership's for the partner's proportionate share of the property distributed while any "excess" property will begin a new holding period. Reg. § 1.751-1(g).

(8) I.R.C. § 751(b) and Partnership Liabilities.

(a) Decrease in Partnership Liabilities:

- (i) If a partner's share of partnership liability decreases because the partner either retires or reduces his ownership %age, I.R.C. § 752(b) and Reg. § 1.752-1(c) treat the as if it received a distribution of cash from the partnership equal to the decrease in the partner's share of the partnership's liabilities.
- (ii) If a partner receives cash and or receives a reduction in its share of partnership liabilities, I.R.C. § 751(b) will apply if the value of the distribution exceeds the partner's share of the partnership's non-751(b) assets.

(b) Increase in Partnership Liabilities.

- (i) If a partner receives a distribution of property subject to a liability or assumes a partnership liability, I.R.C. § 752(b) and Reg. § 1.752-1(b) deem the partner to have paid money to the partnership equal to the amount by which its share of partnership liabilities have increased.

(9) Example: Reg. § 1.751-1(g) provides a comprehensive example of I.R.C. § 751(b) in action:

- (a) Facts: Partnership ABC makes a distribution to partner C in liquidation of his entire one-third interest in the partnership. At the time of the distribution, the balance sheet of the partnership, which uses the accrual method of accounting, is as follows:

	<u>Assets</u>	
	<u>Adjusted</u>	
	<u>Basis Per</u>	
	<u>Books</u>	<u>Market Value</u>
Cash	\$ 15,000	\$ 15,000
Accounts Receivable	9,000	9,000
Inventory	21,000	30,000
Depreciable Property	42,000	48,000
Land	<u>9,000</u>	<u>9,000</u>
Total	<u>96,000</u>	<u>111,000</u>

	<u>Liabilities</u>	
	<u>Adjusted</u>	
	<u>Basis Per</u>	
	<u>Books</u>	<u>Market Value</u>
Current Liabilities	\$ 15,000	\$ 15,000
Mortgage Payable	21,000	21,000
Capital:		
A	20,000	25,000
B	20,000	25,000
C	<u>20,000</u>	<u>25,000</u>
Total	<u>96,000</u>	<u>111,000</u>

C receives a distribution of \$10,000 cash and depreciable property with a FMV of \$15,000 and an adjusted basis to the partnership of \$15,000.

- (b) Analysis:
- (i) Presence of section 751 property: The partnership has no unrealized receivables, but the dual test provided in I.R.C. § 751(d)(1) must be applied to determine whether the partnership's inventory items, in the aggregate, have appreciated substantially in value. The FMV of all partnership inventory items, \$39,000 (inventory \$30,000, and accounts receivable \$9,000), exceeds 120 % of the \$30,000 adjusted basis of such items to the partnership. The FMV of the inventory items, \$39,000, also exceeds 10 % of the FMV of all partnership property other than money (10% of \$96,000 or \$9,600). Therefore, the partnership inventory items have substantially appreciated in value.
 - (ii) The properties exchanged: Since C's entire partnership interest is to be liquidated, I.R.C. § 736 applies. No part of the payment, however, constitutes a distributive share or guaranteed payment under I.R.C. § 736(a) because the entire payment is made for C's interest in partnership property. Therefore, the entire payment is for an interest in partnership property under I.R.C. § 736(b), and, to the extent applicable, subject to I.R.C. § 751. C received his share of cash (\$5,000) and \$15,000 in depreciable property (\$1,000 less than his \$16,000 share). In addition, he received other partnership property (\$5,000 cash and \$12,000 liabilities assumed, treated as money distributed under I.R.C. § 752(b)) in exchange for his interest in accounts receivable (\$3,000), inventory (\$10,000), land (\$3,000), and the balance of his interest in depreciable property (\$1,000). I.R.C. § 751(b) applies only to the extent of the exchange of other property for

751 property (i.e., inventory items, which include trade accounts receivable). The 751 property exchanged has a FMV of \$13,000 (\$3,000 in accounts receivable and \$10,000 in inventory). Thus, \$13,000 of the total amount C received is considered as received for the sale of 751 property.

(iii) Distributee partner's tax consequences: C's tax consequences on the distribution are as follows:

1. The I.R.C. § 751(b) sale or exchange: C's share of the inventory items is treated as if he received them in a current distribution, and his basis for such items is \$10,000 (\$7,000 for inventory and \$3,000 for accounts receivable). Then C is considered as having sold his share of inventory items to the partnership for \$13,000. Thus, on the sale of his share of inventory items, C realizes \$3,000 of ordinary income.
2. The part of the distribution not under I.R.C. § 751(b). I.R.C. § 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was \$32,000 (\$20,000 plus \$12,000, his share of partnership liabilities). This basis is reduced by \$10,000, the basis attributed to the I.R.C. § 751 property treated as distributed to C and sold by him to the partnership. Thus, C has a \$22,000 basis for his remaining partnership interest. The total distribution to C was \$37,000 (\$22,000 in cash and liabilities assumed, and \$15,000 in depreciable property). Since C received no more than his share of the depreciable property, none of the depreciable property constitutes proceeds of the sale under I.R.C. § 751(b). C received more than his share of money. Therefore, the sale proceeds, treated separately in subparagraph (b), must consist of money and therefore must be deducted from the money distribution. Consequently, in liquidation of the balance of C's interest, he receives depreciable property and \$9,000 in money (\$22,000 less \$13,000). Therefore, C recognizes no gain or loss on the distribution. Under I.R.C. § 732(b), C's basis for the depreciable property is \$13,000 (the remaining basis of his partnership interest, \$22,000, reduced by \$9,000, the money received in the distribution).

(iv) Partnership's tax consequences: The tax consequences to the partnership on the distribution are as follows:

1. The I.R.C. § 751(b) sale or exchange: The partnership consisting of the remaining members has no ordinary income on the distribution since it did not give up any 751 property in the exchange. Of the \$22,000 money distributed (in cash and the assumption of C's share of liabilities) \$13,000 was paid to acquire C's interest in inventory (\$10,000 FMV) and in accounts receivable (\$3,000). Since under I.R.C. § 751(b) the partnership is treated as buying these properties, it has a new cost basis for the inventory and accounts receivable acquired from C. Its basis for C's share of inventory and accounts receivable is \$13,000, the amount which the partnership is considered as having paid C in the exchange. Since the partnership is treated as having distributed C's share of inventory and accounts receivable to him, the partnership must decrease its basis for inventory and accounts receivable (\$30,000) by \$10,000, the basis of C's share treated as distributed to him, and then increase the basis for inventory and accounts receivable by \$13,000 to reflect the purchase prices of the items acquired. Thus, the basis of the partnership inventory is increased from \$21,000 to \$24,000 in the

transaction. (Note that the basis of property acquired in a I.R.C. § 751(b) exchange is determined under I.R.C. § 1012 without regard to any elections of the partnership. See paragraph (e) of §1.732-1.) Further, the partnership realizes no capital gain or loss on the portion of the distribution treated as a sale under I.R.C. § 751(b) since, to acquire C's interest in the inventory and accounts receivable, it gave up money and assumed C's share of liabilities.

2. The part of the distribution not under I.R.C. § 751(b): In the remainder of the distribution to C which was not in exchange for C's interest in I.R.C. § 751 property, C received only other property as follows: \$15,000 in depreciable property (with a basis to the partnership of \$15,000) and \$9,000 in money (\$22,000 less \$13,000 treated under subparagraph (1) of this paragraph of this example). Since this part of the distribution is not an exchange of I.R.C. § 751 property for other property, I.R.C. § 751(b) does not apply. Instead, the provisions which apply are I.R.C. §§ 731 through 736, relating to distributions by a partnership. No gain or loss is recognized to the partnership on the distribution. (See I.R.C. § 731(b).) Further, the partnership makes no adjustment to the basis of remaining depreciable property unless an election under I.R.C. § 754 is in effect. (See I.R.C. § 734(a).) Thus, the basis of the depreciable property before the distribution, \$42,000, is reduced by the basis of the depreciable property distributed, \$15,000, leaving a basis for the depreciable property in the partnership of \$27,000. However, if an election under I.R.C. § 754 is in effect, the partnership must make the adjustment required under I.R.C. § 734(b) as follows: Since the adjusted basis of the distributed property to the partnership had been \$15,000, and is only \$13,000 in C's hands the partnership will increase the basis of the depreciable property remaining in the partnership by \$2,000 (the excess of the adjusted basis to the partnership of the distributed depreciable property immediately before the distribution over its basis to the distributee). Whether or not an election under I.R.C. § 754 is in effect, the basis for each of the remaining partner's partnership interests will be \$38,000 (\$20,000 original contribution, plus \$12,000, each partner's original share of the liabilities, plus \$6,000, the share of C's liabilities each assumed).
3. Partnership trial balance: A trial balance of the AB partnership after the distribution in liquidation of C's entire interest would reflect the results set forth in the schedule below. Column I shows the amounts to be reflected in the records if an election is in effect under I.R.C. § 754 with respect to an optional adjustment under I.R.C. § 734(b) to the basis of undistributed partnership property. Column II shows the amounts to be reflected in the records where an election under I.R.C. § 754 is not in effect. Note that in column II, the total bases for the partnership assets do not equal the total of the bases for the partnership interests.

	I		II	
	I.R.C. § 754 Election in Effect		I.R.C. § 754 Election Not in Effect	
	Basis	FMV	Basis	FMV
Cash	\$ 5,000	\$ 5,000	\$ 5,000	\$ 5,000
Accounts Receivable	9,000	9,000	9,000	9,000
Inventory	24,000	30,000	24,000	30,000
Depreciable Property	29,000	33,000	27,000	33,000
Land	<u>9,000</u>	<u>9,000</u>	<u>9,000</u>	<u>9,000</u>
Total Assets	<u>76,000</u>	<u>86,000</u>	<u>74,000</u>	<u>86,000</u>
Current Liabilities	15,000	15,000	15,000	15,000
Mortgage	21,000	21,000	21,000	21,000
Capital:				
A	20,000	20,000	20,000	20,000
B	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>	<u>20,000</u>
Total Liabilities and Capital	<u>76,000</u>	<u>86,000</u>	<u>74,000</u>	<u>86,000</u>

3) Tricky requirements applicable to partnership distributions.

a) I.R.C. § 704(c)(1)(B) - The 7 Year Rule:

i) One of the roadblocks Congress enacted in 1989 to keep partners from avoiding their unrecognized I.R.C. § 704(c) gain or loss was to tax a contributing partner if I.R.C. § 704(c) property that he contributed is distributed to another partner within 7 years of its original contribution. I.R.C. § 704(c)(1)(B).

(1) For example, if built-in gain or loss property is contributed by Partner A to the AB Partnership on July 1, 2003 and distributed to Partner B on or before June 30, 2010, Partner A is taxed as if he sold the property at its FMV on the distribution date, limited to his original I.R.C. § 704(c) built-in gain on contribution.

ii) Thus, I.R.C. § 704(c)(1)(B) keeps its eye on all I.R.C. § 704(c) property for 7 years from its contribution date to its date of disposition.

(1) This can be an ongoing process if built-in gain or loss property is contributed on a regular basis.

(2) There is always a 7 year look-back rule when I.R.C. § 704(c) property is distributed.

(3) Partners are usually surprised that I.R.C. § 704(c)(1)(B) taxes the contributing partner instead of the partner who receives the distribution.

iii) Computing the Gain or Loss.

(1) If built-in gain or loss property is contributed by one partner, but distributed to another partner within 7 years of its contribution to the partnership, gain or loss is recognized by the contributing partner and the basis in his partnership interest is adjusted accordingly. I.R.C. § 704(c)(1)(B)(iii).

(a) Gain or loss is determined as if the property were sold at its FMV on the date of the distribution and is limited to the amount that would have been specially allocated to the contributing partner under I.R.C. § 704(c)(1)(A) (only the pre-contribution gain or loss portion). I.R.C. § 704(c)(1)(B)(i).

(i) Example:

1. On July 1, 2003 Partner A contributes Property X with a basis of \$10,000 and a FMV of \$20,000 to the AB Partnership for a 50% interest.
2. On July 1, 2004 Property X is distributed to B when its value is \$40,000.
3. A recognizes pre-contribution gain as if Property X were sold for \$40,000 on July 1, 2004.
4. The hypothetical gain is \$30,000 (\$40,000 FMV - \$10,000 basis) of which \$20,000 would be allocated to A (\$10,000 pre-contribution gain plus one-half the \$20,000 post contribution gain of \$20,000).
5. The gain recognized under I.R.C. § 704(c)(1)(B) is limited to A's pre-contribution gain of \$10,000.
6. If, instead, Property X had declined in value to \$15,000 on the distribution date, A would only recognize \$5,000 of his pre-contribution gain.

(2) UNANSWERED QUESTION:

- (a) For purposes of determining the amount of the gain or loss required to be reported by the contributing partner, the statute requires the gain to be calculated as if the property were sold at its FMV.
- (b) The statute, however, does not specify to whom the property is treated as sold. I.R.C. § 704(c)(1)(B)(i). Contrast this to I.R.C. § 704(c)(1)(B)(ii), which determines the character of the gain or loss as if the property had been sold to the distributee.
- (c) The difference between these two Code sections raises a question about whether a loss limitation may apply if the sale is treated as occurring between a partnership and a partner that owns more than a 50% interest which is disallowed under I.R.C. § 707(b)(1)(A).
- (d) Despite the statutory language of I.R.C. § 704(c)(1)(B)(i), the regulations take the liberty of rephrasing it to cast the transaction as a sale by the partnership to the distributee partner.
- (e) Therefore, it appears that the Service may take the position that any I.R.C. § 704(c) losses are disallowed to the contributing partner under I.R.C. § 704(c)(1)(B) in cases where the distributee is a more than 50% partner. *See* Preamble to Reg. § 1.704-4.

iv) Character of Gain or Loss.

- (1) The character of the gain or loss recognized by the contributing partner as a result of the distribution of contributed property is determined by the character of the gain or loss that would have resulted if the partnership had sold the property to the distributee. *See* 704(c)(1)(B)(ii).
- (2) This can be dangerous.
 - (a) For example, assume A contributes real estate to the AB Partnership and the real estate is a capital asset in the hands of AB Partnership.
 - (b) If AB distributes the real estate to Partner B, who uses the property in his trade or business and holds more than a 50% interest in the partnership, the gain would be ordinary income under I.R.C. § 707(b)(2).
 - (c) Therefore, the character of the gain to Partner A would be ordinary income. Reg. § 1.704-4(b)(2)(iii).

v) The Transferee Steps into the Transferor's Shoes:

- (1) I.R.C. § 704(c)(1)(B) also applies to the transferee of a partnership interest just as it would to the transferor partner with a I.R.C. § 704(c) gain or loss. *See* Reg. § 1.704-4(d)(2).
 - (2) If a partner that contributes I.R.C. § 704(c) property transfers (sells, exchanges, or gifts) his partnership interest and the partnership distributes the I.R.C. § 704(c) property he contributed within 7 years to a partner other than the partner to whom he transferred his interest, the transferee is taxed as the contributor of the transferor's I.R.C. § 704(c) property.
 - (3) The transferee "steps into both the shoes" of the transferor – the shoe that transfers the I.R.C. § 704(c) account to him and the shoe that treats him as the contributing partner for purposes of gain or loss recognition under I.R.C. § 704(c)(1)(B).
 - (4) Compare this to the rule with marketable securities where it appears that a transferee partner does not step into the transferor's shoes in determining whether he previously contributed the property.
- vi) New Rules Regarding Contributions of Loss Property.
- (1) I.R.C. § 704(c)(1)(B): Added to the Code by the American Jobs Creation Act of 2004, the new provision requires partnerships to account for built-in loss property only when allocating items to the contributing partner. For all other partners, the partnership will treat the loss property as having a basis equal to its FMV on the date of its contribution. Thus, if a partner who contributes built-in loss property leaves the partnership, the partnership must adjust the asset's basis.
 - (2) The new provision applies on a property-by-property basis to distributions made October 22, 2004. Most commentators believe it will override traditional ceiling-rule notions of entity-level computation of gain and loss.
- vii) Effective March 22, 2005, the Service amended Reg. § 1.704-3 to address partnership distributions considered an installment sale under I.R.C. § 453(b). The new provision requires taxpayers to treat the installment obligation received by the partnership as I.R.C. § 704(c) property with the same amount of built-in gain as the property disposed of by the partnership.
- b) I.R.C. § 737 - Property Distributions Triggering Gain, But Not Loss.
- i) In General: I.R.C. § 737(a) was enacted in 1992 as another method to prevent partners from avoiding recognition of I.R.C. § 704(c) gain.
 - (1) Congress felt that the rules under I.R.C. § 704(c)(1)(B) did not go quite far enough to tax partners who contributed appreciated property to a partnership.
 - (a) For example, partners could avoid the application of I.R.C. § 704(c)(1)(B) altogether by cashing out their interest in the partnership with other property while the partnership continued to own the I.R.C. § 704(c) property. *See* H. Rep't No. 102-1018, 102d Cong, 2d Sess., 1992 U.S.C.C.&A.N. 2472, 2519-2520 (10/5/92).
 - (2) Therefore I.R.C. § 737 taxes a partner who receives a distribution of any partnership property within 7 years (5 for property contributed on or before June 8, 1997) of when he contributed any other appreciated property to the partnership. Therefore I.R.C. § 737 taxes a partner who receives a distribution of any partnership property within 7 years (5 for property contributed on or before June 8, 1997) of when he contributed any other appreciated property to the partnership.

- (3) I.R.C. § 737 taxes the partner who receives a distribution, unlike I.R.C. § 704(c)(1)(B) which taxes the partner who contributes the I.R.C. 704(c) property.
 - (4) Another key difference between I.R.C. §§ 704(c)(1)(B) and 737 is that gain under I.R.C. § 737 is limited to the excess of the property's FMV over the partner's basis.
 - (5) Contrast this to I.R.C. § 704(c)(1)(B) which calculates the contributing partner's gain as if the property were sold on the distribution date and ignores the contributing partner's basis in his partnership interest.
- ii) Computing the Gain or Loss.
- (1) Under I.R.C. § 737, the distributee partner recognizes gain (but not loss) equal to the lesser of:
 - (a) The excess (if any) of the FMV of property (other than money) received over the adjusted basis of the partner's interest in the partnership immediately before the distribution; or
 - (b) the partner's "net pre-contribution gain."
 - (2) Note the consideration of the distributee's basis in his partnership interest as an additional limitation on the amount of gain recognized.
 - (3) Any gain recognized under I.R.C. § 737 is added to the partner's basis in his partnership interest immediately before the distribution of the property to him. *See* I.R.C. § 737(c)(1).
 - (4) The basis of the distributee's I.R.C. § 704(c) property remaining in the partnership is also increased. *See* I.R.C. § 731(c)(2).
 - (a) But the increase only applies to the distributee partner's built-in gain (not loss) property of the same character if sold by the partnership as the character of the gain recognized by the distributee in the I.R.C. § 737 distribution.
 - (5) The property distributed to the partner takes a carryover basis determined under the normal basis rules in I.R.C. § 732.
 - (6) As noted, there are two limitations on the amount of gain recognized under I.R.C. § 737:
 - (a) The excess of the value of property distributed -
 - (b) Over a partner's basis in his partnership interest and a partner's net pre-contribution gain.
 - (7) Net pre-contribution gain is:
 - (a) the gain that would be allocated to the distributee partner under I.R.C. § 704(c)(1)(B) if all the property that had been contributed to the partnership immediately before the distribution were distributed to another partner. *See* Reg. § 1.737-1(c)(1). Thus, I.R.C. § 737 keeps track of each partner's I.R.C. § 704(c)(1)(B) built-in gain or loss.
 - (8) Example:
 - (a) Same facts as the previous example where Partner A contributes Property X with a basis of \$10,000 and a FMV of \$20,000 to the AB Partnership for a 50% interest.
 - (b) Partner B also contributes Property Y with a basis of \$20,000 and a FMV of \$20,000.
 - (c) Within seven years of A's contribution, Property Y is distributed to A when its value is \$40,000. A recognizes pre-contribution gain of \$10,000 which is the lesser of his I.R.C. § 704(c) gain of \$10,000, or the excess of \$40,000 over his partnership basis of \$10,000 (or \$30,000).

- (d) If, instead, Property X had declined in value to \$15,000 on the distribution date, A would only recognize \$5,000 of his pre-contribution gain which is the lesser of his \$10,000 I.R.C. § 704(c) gain, or the excess of the property's \$15,000 FMV over A's \$10,000 basis in his partnership interest.
- (9) I.R.C. § 737 does not apply to distributions of property that a partner previously contributed to the partnership. *See* I.R.C. § 737(d)(1).
- (a) Thus, in the above example, if Property X (instead of Y) had been distributed to Partner A, I.R.C. § 737 would not have applied.
- (b) Similarly, if only half of Property X (worth \$20,000) and half of Property Y (worth \$10,000) had been distributed, I.R.C. § 737 would ignore the half of Property X distributed and apply only to distribution of Property Y. We would treat the portion of Property X as if it had been distributed to Partner A in a separate and independent distribution prior to the distribution of Property Y. *See* Reg. § 1.737-3(b)(2).
- (c) Thus, the FMV, basis, and pre-contribution gain attributable to half of Property X are simply omitted from the I.R.C. § 737 calculation and gain on the distribution is only \$5,000 as follows:

	Distribution of ½ X and Y to Partner A	Less prev. contributed Property X	Remaining subject to I.R.C. § 737
FMV of distribution	\$30,000	20,000	10,000
Basis in p'ship interest	\$10,000	5,000	5,000
Net pre-contrib gain	\$10,000	5,000	5,000

iii) Character of Gain.

- (1) The character of gain recognized under I.R.C. § 737 is determined at the partnership level as if the partnership sold all of the partner's I.R.C. § 704(c) property to an unrelated third party at the time of the distribution. *See* Reg. § 1.737-1(d).
- (2) All gains and losses are netted according to their character which would be required to be separately stated under I.R.C. § 702(a). For example, all long term capital gains and losses are netted as a single group and all short term capital gains and losses are netted as a single group.
- (3) Similarly, U.S. and foreign source items must be separately stated. Any character group with a net negative amount is ignored and the partner recognizes gain in proportion to the characters of the remaining net positive amounts.
- (4) For example, if a partner's I.R.C. § 737 gain required to be recognized is \$3,000 made up of \$14,000 long term capital gains and \$11,000 short term capital losses, all of his I.R.C. § 704(c) gain is considered long term capital gain because we ignore the short term capital loss group. This has the effect of eliminating the character groups with net positive I.R.C. § 704(c) balances faster than if the groups with net negative amounts were taken into consideration.

iv) Transferee Partner Steps into the Shoes of the Transferor.

- (1) A transferee of a partnership interest should "step into the transferor's shoes" for purposes of Sec. 737. *See* Reg. § 1.737-1(c)(2)(iii). Some commentators feel this "step into the shoes" rule applies only to the 704(c) capital account and not for determining whether a transferee partner will be treated as the contributing partner with respect to property distributions under Sec. 737(d)(1).

- (2) *See* Robinson, “Don't Nothing Last Forever - Unwinding the FLP to the Haunting Melodies of Subchapter K,” *ACTEC Journal*, Spring 2003, p. 302; Harrison and Blum, “Another View: A Response to Richard Robinson's Don't Nothing Last Forever - Unwinding the FLP to the Haunting Melodies of Subchapter K,” *ACTEC Journal*, Spring 2003, p. 313; and Robinson’s “Comments on Blum and Harrison's Another View,” *ACTEC Journal*, Spring 2003, p. 318.
 - (3) As the regulations under I.R.C. §§ 704(c)(1)(B) and 737 were written at the same time, by the same people, as part of the same regulation project, it is this author’s opinion that they were designed to work in harmony with each other and coordinate the two statutes. Thus, it is logical to conclude that a transferee partner will be treated as the contributing partner when analyzing the tax consequences under both I.R.C. §§ 704(c)(1)(B) and 737.
- v) Effective March 22, 2005, the Service amended Reg. § 1.737-2 to address partnership distributions considered an installment sale under I.R.C. § 453(b). The new provision requires taxpayers to treat the installment obligation received by the partnership as contributed property with regard to the contributing partner for purposes of I.R.C. § 737 to the extent that the installment obligation received is treated as I.R.C. § 704(c) property under Reg. § 1.704-3(a)(8).
- c) When Marketable Securities are Treated Like Money under I.R.C. § 731(c).
- i) General Rule - Recognizing that marketable securities are the virtual equivalent of cash, one of the last attacks against abusive partnerships that Congress enacted in 1994 was to treat distributions of more than a partner’s fair share of marketable securities as money.
 - (1) I.R.C. § 731(c) provides that for distributions after December 8, 1994, all or some part of marketable securities may be treated the same as a money distribution. This can occur under two circumstances:
 - (a) The first circumstance is for purposes of determining whether a partner recognizes any gain under I.R.C. § 731(a) to the extent that the amount treated as money exceeds the basis in his partnership interest.
 - (b) The second circumstance occurs where the distribution of marketable securities also results in the application of I.R.C. § 737.
 - (c) This occurs if the marketable securities are distributed to a partner with pre-contribution gain within 7 years of his contribution of I.R.C. § 704(c) property.
 - (d) In that case, I.R.C. § 731(c) applies before I.R.C. § 737 and any portion of marketable securities that is treated like money under I.R.C. § 731(c) is ignored in applying I.R.C. § 737. *See* Reg. § 1.731-2(g).
 - (2) Only the portion of marketable securities not treated as money is taken into consideration under I.R.C. § 737. *See* I.R.C. § 737(e); Reg. § 1.731-2(g)(1)(iii).
 - (a) The extent to which marketable securities are treated as money under I.R.C. § 731(c) has a positive result under I.R.C. § 737 by reducing the property portion, and thus the I.R.C. § 737 gain potential.
 - (b) This is a particularly good result if the portion treated like cash does not exceed the partner’s basis in his partnership interest and therefore does not result in the recognition of any gain under I.R.C. § 731(a).
 - (c) A distribution of marketable securities to a partner who contributed appreciated property to the partnership can trigger gain under both I.R.C. §§ 731(c) and 737(a).

- (d) If any gain is recognized on the distribution of marketable securities, the basis in the distributed securities is the partnership's basis plus any gain recognized by the distributee partner by reason of I.R.C. § 731(c). Reg. § 1.731-2(f)(1).

ii) Marketable Securities Defined.

(1) Marketable securities include:

- (a) Stocks and other equity interests;
- (b) Common trust funds;
- (c) Regulated investment companies;
- (d) Evidences of indebtedness;
- (e) Options;
- (f) Forward or futures contracts;
- (g) Notional principal contracts;
- (h) Derivatives;
- (i) Foreign currencies;
- (j) Precious metals; and
- (k) Interests in entities containing such property *See* I.R.C. § 731(c)(2).

- (2) The list reads very much like, but is not identical to, the list of stocks and securities under I.R.C. § 351(e) which determines whether property is contributed to an investment company and therefore taxed under I.R.C. § 721(b).

- (3) The primary difference is that I.R.C. § 731(c) focuses on liquid marketable securities actively traded on an exchange, whereas I.R.C. § 351(e) targets all stocks and securities.

- (a) For example, stock in a closely held business is included as a security under I.R.C. § 351(e), but not I.R.C. § 731(c).
- (b) Similarly, transferable compensatory stock options are securities for purposes of I.R.C. § 351(e), but not I.R.C. § 731(c). These differences should be kept in mind.

iii) Reduction in the Amount Treated Like Money.

- (1) If the FMV of a distributed marketable security exceeds the partner's basis in his partnership interest, the Code allows the portion treated like money to be reduced by the partner's own share of unrealized gain in those securities. *See* I.R.C. § 731(c)(3)(B); Preamble to Prop. Regs., 61 Fed. Reg. 28 (1/2/96).

- (a) The distributee partner's share of unrealized gain in the securities is measured both before and after the distribution.
- (b) While the Code requires aggregation of securities of the same class and issuer, the regulations state that all the partnership's marketable securities are treated as being of the same class and issuer. *See* I.R.C. § 731(c)(B)(i); Reg. 1.731-2(b)(1).
- (c) To the extent of the difference between the partner's unrealized gain in marketable securities before and after the distribution, the value of the distributed securities treated like cash is reduced. The statute is not easy reading, but thankfully the regulations provide a clear example. *See* Reg. § 1.731-2(j).

- (i) Example: Able and Baker form a partnership AB as equal partners. AB holds securities X, Y, and Z worth \$100 each. The basis of these securities is \$70, 80,

and \$110 respectively. In order to avoid recognizing a \$30 gain on the sale of X, the partnership distributes it to Able. Able's share of the gain before the distribution is \$20 and his share of the gain after the distribution is \$5. Thus, Able may reduce the portion of Security X that is treated like cash by the \$15 difference. So, only \$85 of Security X is treated like cash. The balance is treated like property.

WITH X:

<u>Security</u>	<u>Value</u>	<u>Basis</u>	<u>Gain/ Loss</u>	<u>Able's 50% Share</u>
X	100	70	30	
Y	100	80	20	
Z	<u>100</u>	<u>110</u>	<u>-10</u>	
	300	260	40	\$20

WITHOUT X

Y	100	80	20	
Z	<u>100</u>	<u>110</u>	<u>0</u>	
	200	190	10	<u>5</u>
Difference				\$15

- (d) Notice that all we have done up to this point is figure the amount of the distribution that is treated like cash to Able.
- (i) To the extent that the \$85 distribution does not exceed the basis in his partnership interest, Able will not report any gain in connection with the distribution.
 - (ii) Able's basis in his partnership interest is not reduced by the cash component and he simply takes a carryover basis in the distributed securities under the normal rules of I.R.C. § 732.
- (e) Also note the opportunity to select specific securities in such a combination that the portion treated like cash will either be minimized or maximized, depending on the goal.
- (i) If the partner's partnership basis is large enough to absorb any amount of a cash distribution without recognizing gain and if a property distribution would have negative consequences for him under I.R.C. § 737, then it may be advantageous to maximize the portion of the distribution treated like cash.
 1. In the above example, if Y had been distributed instead of X, the value treated like cash would have been \$90 (\$100 reduced by (Able's % share of the gain of \$20). Likewise, if Z had been distributed, the entire \$100 would be treated like cash because there is no gain in Security Z.
- (f) Exceptions:
- (i) There are three outright exceptions to the rule that marketable securities are treated like money. I.R.C. § 731(c)(3)(A).
 1. Marketable securities are not treated as money when distributed to the partner who contributed the security because Congress did not intend to tax a partner who merely got his own property back. Instead the statute seeks to tax a partner who exchanges other property for an interest in cash-like marketable securities which it considers essentially equivalent to a sale.

- a. UNANSWERED QUESTION: Curiously, under this rule, there is no provision to treat the transferee of a partnership interest as the contributor of the transferor's property.
 - i. For example, if Partner A contributes marketable securities to a partnership and later takes a distribution of the same securities, he does not treat any part of them like money.
 - ii. However, if Partner A sells or gives his partnership interest to Partner B who takes a distribution of the securities, Partner B is not treated as the contributing partner for this purpose.
 - iii. Thus, Partner B treats the securities as money subject to the rule that allows him to reduce the money portion by his share of the appreciation.
 - iv. Neither the courts nor the Service have addressed whether they would apply I.R.C. § 731(c)(3)(A)(i) to avoid gain recognition if a partnership distributed new marketable securities it obtained to replace old marketable securities contributed by the distributee partners.
- b. The lack of any apparent “step in the shoes” rule under I.R.C. § 731(c) stands in sharp contrast to the treatment of a transferee partner under I.R.C. §§ 704(c)(1)(B) and 737 which treat a transferee partner as the contributor of the transferor partner's property.
- c. While none of the three statutes address the treatment of transferee partners, the regulations under I.R.C. § 704(c)(1)(B) and 737 fill in the gaps for transferees, but not the regulations under I.R.C. § 731(c).
- d. The I.R.C. § 731 regulations are silent on the treatment of transferees. Was this simply an oversight, or was it intentional based on the differences in the two sets of statutes?
- e. While the legislative history and purposes of I.R.C. §§ 704(c)(1)(B) and 737 on the one hand and I.R.C. § 731(c) on the other hand are similar, they are different enough to cast doubt on whether transferee partners should be treated the same under all three statutes.
- f. I.R.C. § 731 treats marketable securities as cash because they are cash equivalents, not because partners are using them to avoid I.R.C. § 704(c) gain recognition, which is the focus of I.R.C. § 704(c)(1)(B) and I.R.C. § 737.
- g. However, in footnote 8 of the 1994 House Committee Report under I.R.C. § 731(c), Congress curiously refers to a “similar rule under I.R.C. §§ 704(c)(1)(B) and 737” when stressing that marketable securities are not treated like cash when distributed to the partner who contributed them.
- h. I.R.C. § 731(c), which is required to be applied first, does not treat the transferee as the contributing partner.
- i. Therefore, the marketable securities must be separated between the money and the property portion and only the property portion enters into the I.R.C. § 737 computation.

- j. I.R.C. § 737 does treat the transferee as the contributing partner.
 - i. How do we determine what part of it to exclude as “previously contributed” property under I.R.C. § 737? Presumably all of it, dollar for dollar, up to its pre-separation components.
 - k. There are no examples of this situation in any of the regulations. Perhaps this is because neither Congress nor the IRS envisioned that the statutes, working in harmony, would treat transferees differently.
 - 2. Marketable securities are not treated like money if the property was not a marketable security when acquired by the partnership.
 - 3. Marketable securities are not treated like money when distributed by an “investment partnership” to an “eligible partner.” Reg. § 1.731-2(d).
 - a. An investment partnership is a partnership which has never been engaged in a trade or business (other than investing) and substantially all of the assets of which (by value) have always consisted of investment type assets listed under I.R.C. § 731(c)(3)(C)(ii).
 - b. An eligible partner is one who has never contributed any non-investment type assets to the partnership. For this purpose, “substantially all” means consisting of 90% or more marketable securities or money. *See* Reg. 1.731-2(c)(3).
 - 4. Note that partnerships that relied upon the “less than 80% stocks and securities” test to avoid gain recognition on formation under I.R.C. § 721(b) and 351(e) will not meet this 90% test under I.R.C. § 731(c).
 - 5. Thus, marketable securities will be treated like money distributions. However, it is not uncommon for a family partnership’s assets to have always consisted of 90% marketable securities.
 - 6. It may have either recognized gain on formation, or relied on another exception to the investment company rules to avoid gain.
 - 7. In either case, if a partnership meets the “always more than 90%” test, distributions of marketable securities will not be treated like cash.
- 4) Approaches for Avoiding Unexpected Problems:
- a) In summary, property distributions can create needless tax and accounting headaches for family partnerships.
 - i) These problems, which usually only involve timing rather than permanent differences, can be avoided with a little forethought.
 - ii) Absent other non-tax considerations, partnerships attempting to minimize or avoid adverse tax consequences on distribution of partnership assets should do the following:
 - (1) Distribute only cash up to the amount of a partner’s basis.
 - (2) Distribute only property that the partnership has purchased if within 7 years of a contribution of appreciated property.
 - (3) Distribute undivided interests in property in proportion to each partner’s interest in the partnership if the distribution occurs within 7 years of a contribution of built-in gain or loss property by one of the distributees.

- (4) Avoid distributing previously contributed built-in gain or loss property to partners other than the partner (or transferee partner) who contributed the property within 7 years of the contribution.
- (5) Avoid distributing property to a partner who has previously contributed other built-in gain property or is a transferee of one who has contributed other built-in gain property.
- (6) Distribute cash or marketable securities in a tax year that precedes one in which property is distributed. Property generally takes a substituted basis (no matter how small) while cash and the value of marketable securities in excess of basis can cause gain to be recognized.
- (7) Upon the death of a partner with I.R.C. § 704(c) gains or losses, a step-up in basis of a partnership interest reduces the gain potential under I.R.C. § 737. However, potential gain or loss under I.R.C. § 704(c)(1)(B) still exists because the partnership basis does not enter into the calculation. Therefore, the partnership should still carefully evaluate whether to make a I.R.C. § 754 election. If partnership discounts prevent the partnership's property from achieving a full step-up to FMV, some gain potential still exists under I.R.C. §§ 704(c)(1)(B) and 737 when property is distributed after a partner dies.
- (8) On the other hand, partnerships may be happy to know that they can create gain or loss by making property distributions rather than cash. Either way, the practitioner with a good working knowledge of these obscure traps and opportunities is a rare and invaluable resource to their clients (and their E & O carrier!).