

## Sale of a Partnership Interests

In general, the partnership provisions in Subchapter K of the Code adopt an "entity approach" in dealing with the tax consequences of a transfer of a partnership interest. The transferred interest is treated like corporate stock. Thus, it is primarily considered to be a separate intangible asset, rather than an undivided tenancy-in-common interest in the partnership assets as it would be treated under an "aggregate approach" to partnership taxation. See Code Sec. 741 , Reg § 1.741-1(a) and Reg § 1.741-1(b) .

However, there are several exceptions to this rule. For instance, where the partnership has Code Sec. 751 assets, a sale or exchange of a partnership interest is looked through and the gain or loss on the portion allocable to those assets is treated as ordinary income or loss. Also, where a Code Sec. 754 election is made, a sale or exchange of a partnership interest will result in a basis adjustment to the partnership property.

### 5.01. Amount and Character of Seller's Gain or Loss: General Rules

As is the case on any asset's sale, the amount of the transferor-partner's gain or loss on the transfer of a partnership interest is determined under Code Sec. 1001 . Gain or loss realized is, accordingly, the amount realized by the transferor-partner for the transfer of his partnership interest which is in excess of, or less than, his adjusted basis in his partnership interest (his "outside basis"). Code Sec. 1001(a) and Code Sec. 1001(b) ; Reg § 1.1001-1(a) . In keeping with the entity approach to the taxation of transfers of partnership interests, this gain or loss is considered to be gain or loss from the sale or exchange of a capital asset, except as otherwise provided in Code Sec. 751 (which relates to unrealized receivables and inventory). Code Sec. 741 .

**NOTE:** As a practical matter, the Code Sec. 751 exception to capital gain or loss treatment applies to most sales of partnership interests since virtually every ongoing business enterprise has some amount of unrealized receivables or inventory on hand at any point in time. Under Code Sec. 751(a) , the amount of money, or the fair market value of property, received by the seller in exchange for all or part of his interest in the partnership attributable to unrealized receivables or inventory items that have appreciated substantially in value is considered an amount realized from the sale of property other than a capital asset. Thus, the amount of the seller's gain allocable to the seller's share of the appreciation in the partnership's ordinary income assets (or in unrealized receivables) is taxed as ordinary income on the sale of the partnership interest. Only the remaining gain is capital. For a full discussion of the effect of Code Sec. 751(a) on the sale of a partnership interest.

#### **Abandonment or Worthlessness of Partnership Interest:**

Depending upon the circumstances, the abandonment or worthlessness of a partnership interest may give rise to a loss deduction under Code Sec. 165 . Whether the loss is capital or ordinary depends on whether or not the loss results from the sale or exchange of a capital asset. If there is an actual or deemed distribution from the partnership, the transaction is treated as a sale or exchange of the partnership interest and any resulting loss is capital, except as provided in Code Sec. 751(b) (relating to inventory and unrealized receivables). See Code Sec. 731(a) , Code Sec. 741 , and Rev. Rul. 93-80, 1993-2 C.B. 239 . Thus, for example, if the abandonment results in the relief of the partner's share of the partnership's liabilities, the loss will be capital even if no other consideration is received. In addition, the receipt of a de minimis amount of consideration will cause the loss to be a capital loss. However, a partner who does not receive any consideration and is not relieved of a liability may take an ordinary loss on the abandonment of a partnership interest. Citron, B. Philip, (1991) 97 TC 200 .

## (A) Amount Realized

As is the situation with most sales of property, the amount realized by the transferor-partner equals the amount of cash and the fair market value of any property received by him plus debt relief. Reg § 1.1001-1(a) and Reg § 1.1001-2(a)(1) . In the case of sales of partnership interests, debt relief includes the decrease in the partner's share of partnership liabilities. Reg § 1.1001-2(a)(4)(v) .

### **Installment Sale of Partnership Interest Under Code Sec. 453 :**

As a practical matter, both the buyer and seller of a partnership interest may find it beneficial to structure the sale and purchase transaction as an installment sale in which the selling partner, rather than a third-party creditor, holds the note. From the buyer's perspective, this allows the purchase price to be paid over time (rather than in a lump sum), perhaps with distributions of partnership profits. In addition, the buyer gets a cost basis equal to 100% of the purchase price *at the time of the purchase* (i.e., an installment sale does not delay the creation of basis until installment payments are made). From the seller's perspective, an installment sale can provide a steady income stream over a period of years and may allow the seller to defer the income tax liability resulting from the sale (other than the tax attributable to the sale of Code Sec. 751 property, see below).

Calculating the seller's gross profit, total contract price, gross profit reporting ratio, and yearly payments is based on the same principles that apply to sales of other personal property (a partnership interest is personal property). In addition, the selling partner's share of partnership liabilities is taken into account as part of the total contract price and as year-of-sale payments only to the extent they exceed the selling partner's basis in his partnership interest. Rev. Rul. 76-483, 1976-2 C.B. 131 .

**PLANNING POINTER:** A selling partner who accepts a buyer's note as part of the purchase price of a partnership's interest is assuming a risk of nonpayment that is not present when the purchase price is paid in a lump sum (e.g., with funds borrowed from a third-party financial institution). Accordingly, when representing the seller, it is prudent to negotiate a rate of interest on the note that adequately reflects the risk of nonpayment in *that particular situation*. In determining this risk, practitioners should consider the obvious factors such as the buyer's credit history, available collateral, and the probability that the partnership will be a financial success after the sale. In addition, it is often helpful to check with local financial institutions to find out whether they would be willing to finance such a transaction. The extent to which such institutions are willing to finance the transaction (and the conditions under which they are willing to do so) can be useful criteria in determining how high an interest rate the seller should accept. Finally, the installment note should clearly spell out what constitutes a default on the note, what type of notice the seller must give to the buyer if the buyer is in default, what remedies the seller has in the event of a default (e.g., repossession of the partnership interest and/or possession of the buyer's personal assets), and which party bears the costs of default proceedings. Care should also be taken to ensure that the partnership can take no action after the sale to affect the quantum of the seller's interest as a creditor of the buyer.

### **Inventory or Unrealized Receivables:**

If the partnership interest sold represents the selling partner's interest in both ordinary income and capital assets, under Code Sec. 751(a) , some of the gain will be characterized as ordinary income rather than capital gain. In the case of installment method reporting, the income attributable to a partnership's inventory is not eligible for installment sale treatment. Rev. Rul. 89-108, 1989-2 C.B. 100 . In addition, gain from the sale of the partnership interest attributable to Code Sec. 1245 recapture may not be reported under the installment method. Code Sec. 453(i)(2) .

## **(B) Adjusted Basis**

Often when a partnership interest is sold, the selling partner's basis cannot be determined. Where a partner's basis cannot otherwise be determined, the partner is allowed to treat his share of the partnership's basis in its assets as his basis in his interest. However, adjustments may be necessary to reflect discrepancies arising as a result of property contributions by the partners, transfers of partnership interests, or property distributions to the partners. Code Sec. 705(b) ; Reg § 1.705-1(b) .

**NOTE:** This alternative appears inviting at first blush when compared to accounting for yearly adjustments to basis as described above. However, as a practical matter, the necessary calculations and adjustments generally make it an unappealing choice for the typical partnership.

**EXAMPLE:** C, D, and E formed an equal partnership in 1976. C is selling his partnership interest, but does not have the necessary information to establish his tax basis. The adjusted basis of all partnership property is \$300,000. The partnership has liabilities totalling \$100,000. C is entitled to one-third of the partnership property on liquidation and therefore has a basis in his interest equal to one-third of the partnership's basis in its assets, \$100,000. The presence or absence of liabilities is, in essence, irrelevant for this purpose.

However, if land that is still owned by the partnership had been contributed by C with a value on contribution of \$30,000 and an adjusted basis of \$10,000, and D and E each contributed \$30,000 in cash, C's one-third share of the partnership's \$70,000 basis in the land (\$23,333) overstates C's actual \$10,000 basis by \$13,333. Thus, it is necessary to reduce C's one-third share of the partnership's \$70,000 basis in the land by \$13,333 and increase D and E's bases by \$6,667. C's basis will be \$ 86,667 ( $\$100,000 - \$13,333$ ) and D and E's bases will each be \$106,667 ( $\$100,000 + \$6,667$ ).

**NOTE:** When working with the concept of the equality of the total adjusted basis in partnership property and the total adjusted bases of partnership interests, the presence of liabilities generally will not be relevant because typically the debt already has been taken into account, having been included in the adjusted bases of assets created or purchased with cash from the debt. Alternatively, if cash had been dispersed for expenses, the increase in adjusted basis due to the debt would have been offset by an equal deduction for the expenditures. However, the presence of liabilities will be relevant where allocation of the the debt is different from the partners' shares of the partnership assets.

## **(C) Allocation of Partnership Income and Loss Between Buyer and Seller**

### **(1) Sale of Entire Interest**

When a partnership interest is sold, it is necessary to allocate partnership profit or loss between the transferor-partner and the transferee-partner. Generally, the taxable year of the partnership as a whole does not close on the sale or exchange of a partner's interest. Code Sec. 706(c)(1) ; Reg § 1.706-1(c)(1) . This is true even though the transfer often results in the partnership's technical dissolution under the *nontax* rules of most jurisdictions.

However, a partnership's taxable year closes with respect to a partner who sells his entire partnership interest. Code Sec. 706(c)(2)(A) ; Reg § 1.706-1(c)(2) . Accordingly, the selling partner's distributive share of the partnership's tax items for the short period, ending on the disposition date, is included in his tax return for his taxable year that includes the sale date. Reg § 1.706-1(c)(2)(i) .

**NOTE:** Thus, if the sale occurs in December of Year 2, a selling calendar year partner in a January fiscal year partnership may be required to include as many as 23 months of partnership income on his Year 2 return (his share of the partnership's income for the partnership year ending January of Year 2 and his share of the partnership's income from January of Year 2 to December of Year 2). The other partners will not be affected by the sale.

The selling partner's share of partnership tax items may be determined either by making an "interim closing" of the partnership books and determining the amount of partnership's items up to the day of the sale. However, if the partners agree, the partnership's income, gain, loss, deduction, and credit for the entire year may be allocated between the selling partner and the buyer. This can be done by estimating what the partner's share of the partnership's items would have been had he remained a partner until the end of the year and prorating these items between the selling partner and the buyer. The proration may be based on the portion of the taxable year that has elapsed before the sale, exchange, or liquidation or may be determined under any other reasonable method. Reg § 1.706-1(c)(2)(ii) .

**EXAMPLE:** On December 1, Year 4, D buys A's one-third interest in the calendar-year, accrual-basis ABC partnership. ABC incurred \$300 of expenses for the year, \$240 before December and \$60 in December, and has accrued \$288 of income equally over the year. Under the "interim closing" method of allocation, D's distributive share of the partnership's expenses is \$20 (incurred during December after D bought his partnership interest), and his share of partnership income is \$8. He accordingly incurs a \$12 loss from the partnership. Under the second method of allocation, however, his share of the partnership expenses is \$8.30 ( $1/3$  partner  $\times$   $1/12$  of the year  $\times$  \$300), and his share of partnership income is \$8 ( $1/3$  partner  $\times$   $1/12$  of the year  $\times$  \$288). This is based on his pro rata share of the partnership income and deductions for the partnership's entire taxable year. He accordingly incurs a loss from the partnership of \$0.30.

**NOTE:** The allocation of partnership items for the year of sale normally is of more concern to the buyer than to the seller. This is because the seller's share of partnership income will increase the basis in his partnership interest, with the result that the seller has less gain on the sale. Thus, the seller will often have no increase in his income as a result of an income allocation, but his income will be ordinary income rather than capital gain. The buyer and seller may consider allocating more income to the seller, in exchange for the buyer's agreement to pay a higher price for the partnership interest.

## (2) Sale of Partial Interest

If a partner sells less than his entire interest in a partnership, the partnership year does not close with respect to the selling partner. Code Sec. 706(c)(2)(B) . The selling partner's distributive share of partnership income is includible in his taxable year within which ends the normal partnership year-end by taking into account his varying interest in the partnership during its taxable year. Reg § 1.706-1(c)(4) . However, in determining the partners' distributive shares of partnership items of income, gain, loss, deduction or credit, the partnership must take into account the varying interest of the partners in the partnership during the taxable year under any method prescribed in the regulations. Code Sec. 706(d)(1) .

**NOTE:** The legislative history suggests that a monthly or semi-monthly convention may be used in order to determine the amount allocable to the selling and buying partners.

The basis of the portion of the interest that is sold is adjusted to reflect the partnership's profit and loss attributable to both the interest that was disposed of and the interest that was retained up to the date of sale. Reg § 1.705-1(a)(1) .

When a partner sells a portion of his partnership interest, the following "allocable cash-basis items" must be prorated over the period to which they are attributable:

- interest,
- taxes,
- payment for services or for the use of property, and
- any other item of a kind specified in regulations as being an item with respect to which the application of Code Sec. 706(d)(2) is appropriate to avoid significant misstatements of the income of the partners.

Any item within these categories must be assigned to each day in the period to which it is attributable. The amounts so assigned are then apportioned among the partners in proportion to their interests in the partnership at the close of each day. Code Sec. 706(d)(2)(A) .

**NOTE:** The determination of the period to which an expense is attributable for this purpose is made according to economic accrual principles. Thus, in effect, cash-basis partnerships are placed on the accrual method of accounting for purposes of allocating income and deductions with respect to allocable cash-basis items. Nevertheless, the partnership's deduction is allowed only when the item is paid, even though the accrual system is used in determining which partners are entitled to that deduction.

All allocable cash-basis items which are attributable to periods before or after the current taxable year are allocated entirely to the first day of the year, in the case of items allocable to prior years, and entirely to the last day of the year, in the case of items allocable to future periods. Code Sec. 706(d)(2)(C) . Any portion of a *deductible* cash-basis item that is assigned in this manner to the first day of any taxable year is allocated among persons who are partners during the prior period to which the portion is attributable, in accordance with their varying interests in the partnership during such prior period, rather than in accordance with their interests on the first day of the year. Code Sec. 706(d)(2)(D)(i) . If, however, all or part of a deductible cash-basis item is allocated to persons who are no longer partners on the first day of the taxable year in which the items are taken into account, then such part of the item must be capitalized by the partnership and allocated to the basis of partnership assets under Code Sec. 755 . Code Sec. 706(d)(2)(D)(ii) .

**NOTE:** Capitalized expenditures which are allocated to basis under Code Sec. 755 will presumably be treated as Code Sec. 743(b) adjustments. As such, they will reduce the new partner's share of partnership income. The amount of the reduction will depend upon whether the regulations allocate the basis adjustments solely to the buying partners or treat them as common basis adjustments.

**NOTE:** Although a partnership may not allocate deductions that were generated before a new partner was admitted to the new partner, the partnership may allocate a disproportionate share of the deductions generated after the new partner was admitted to the new partner.

#### **Unanswered Questions With Respect to Cash-Basis Income Items:**

The application of Code Sec. 706(d)(2) to cash-method *income* items is unclear. While the focus of both the statute and the accompanying legislative history clearly is on cash-method *deduction* items, the definition of "allocable cash-method items" in Code Sec. 706(d)(2)(B) arguably includes income items. The provision at Code Sec. 706(d)(2)(B)(iv) includes any "item" specified by regulations and does not, by its terms, limit the regulations to deductible items. In addition, the general rule provided in Code Sec. 706(d)(1) refers to "items" as including both income and deduction.

If Code Sec. 706(d)(2) is applicable to income items, several questions arise. First, what is the relationship between Code Sec. 706(d)(2) and Code Sec. 751 , which provides rules for dealing with shifts in the partners' interests in unrealized receivables? Second, what is a cash-

method income item? Does it include installment receivables under Code Sec. 453 and Code Sec. 453A ? Third, what are the mechanical rules for assigning an "appropriate portion" of a cash-method income item to each day in the period to which it is attributable? Suppose, for example, that an accounting partnership accepts an engagement on January 1, receiving a retainer on that day; performs services at various times through the following December; and renders a statement for its fee (net of the retainer) on January 1 of the following year. To what days is the fee allocable? Is it necessary to account for the services rendered on a daily basis? Are the rules different if the fee eventually charged is result-oriented or is wholly contingent? Fourth, if an income item is allocated to one who is no longer a partner, what adjustment is made to the partnership assets? Would IRS be better off exempting all income items by regulation pursuant to the authority granted in Code Sec. 706(d) ?

### **Tiered Partnerships:**

The legislative history indicates that Congress was concerned about the use of tiered partnership arrangements to make retroactive allocations. For example, multitiered partnership structures were created when a parent partnership owned an interest in a subsidiary partnership that carried on the business activity. When a new partner purchased an interest in the parent partnership, the "interim closing" method of allocation was used and it was claimed that the parent partnership only realized its share of the subsidiary's income, gain, losses, and deductions on the last day of the subsidiary's taxable year, with the result that the incoming partner was entitled to a full pro rata share of any losses incurred by the subsidiary.

Because of this, the Tax Reform Act of 1984 added Code Sec. 706(d)(3) , which provides that when a parent partnership holds an interest in a subsidiary partnership and there is a change in any partner's interest in the parent partnership during the taxable year, the parent partnership's share of any tax items of the subsidiary partnership must be apportioned over that portion of the taxable year during which the parent partnership had an interest in the subsidiary. The IRS had earlier taken the position that losses in this situation cannot be allocated to the incoming partner because the losses are treated as sustained by the parent partnership at the time they are sustained by the subsidiary partnership. See Rev. Rul. 77-311, 1977-2 C.B. 218 . The effect of this amendment is to place the parent partnership effectively on a consolidated basis of accounting vis-a-vis the subsidiary partnership.

## **(D) Special Capital Gain Rules**

When an interest in a partnership that is held for more than one year is sold, the following special rules come into play under Code Sec. 1(h) for "collectibles gain," and for " Code Sec. 1250 capital gain":

- Gain from the sale of an interest in a partnership that's attributable to unrealized appreciation in the value of collectibles is treated as gain from the sale or exchange of a collectible, applying rules similar to Code Sec. 751(a) (see ¶ 5.03 ) to determine the amount of the gain (referred to as collectibles gain, as discussed below) ( Code Sec. 1(h)(6)(B) );
- The amount of long-term capital gain (not otherwise treated as ordinary income under Code Sec. 751(a) ) that would be treated as ordinary income under that Code section if Code Sec. 1250 applied to all depreciation (referred to as Code Sec. 1250 capital gain, as discussed below) must be taken into account in computing unrecaptured Code Sec. 1250 gain when an interest in a partnership is sold. Code Sec. 1(h)(7)(A) , Code Sec. 751(a) , Code Sec. 751(c) .

**NOTE:** A collectible is generally defined for this purpose to include any work of art, any rug or antique, any metal or gem, any stamp or coin, any alcoholic beverage, or any other tangible

personal property specified by IRS for this purpose. Code Sec. 1(h)(6)(A) , Code Sec. 408(m)(2)(F) .

When a partnership interest interest that is held for more than one year is sold or exchanged, the seller may recognize—

- ordinary income (e.g. under Code Sec. 751(a) ),
- collectibles gain,
- Code Sec. 1250 gain, and
- residual long-term capital gain or loss.

The amount of the seller's gain that is collectibles gain is determined by reference to the gain that would be allocated to the selling partner if the partnership had sold all of its collectibles in a fully taxable transaction immediately before the sale of the interest in the entity. A special rule applies where the seller does not recognize his entire realized gain on the sale. In this situation, the same approach is applied to determine the seller's share of the entity's collectibles gain, except that he recognizes only a fraction of that gain. The numerator of the fraction would be the seller's recognized gain and the denominator would be his realized gain. Reg § 1.1(h)-1(b)(2)(ii) .

When a partnership interest held for more than one year is sold, the amount of Code Sec. 1250 capital gain allocable to the partner is taken into account under Code Sec. 1(h)(7)(A)(i) in determining the partner's unrecaptured Code Sec. 1250 gain. The regulations define Code Sec. 1250 capital gain as the long-term capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if Code Sec. 1250(b)(1) included all depreciation and the applicable percentage under Code Sec. 1250(a) were 100%. The amount of Code Sec. 1250 capital gain allocable to a partner is determined by reference to the gain that would be allocated to the selling partner if the partnership had sold all of its Code Sec. 1250 property in a fully taxable transaction immediately before the transfer of the partnership interest. Where the selling partner does not recognize his entire realized gain on the sale, a rule similar to the one for collectibles would apply. Reg § 1.1(h)-1(b)(3)(ii) .

**EXAMPLE:** A and B are equal partners in a personal service partnership (PRS). B transfers B's interest in PRS to T for \$15,000 when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

	ASSETS	
	Adjusted Basis	Market Value
Cash	\$ 3,000	\$ 3,000
Loans Owed to Partnership	10,000	10,000
Collectibles	1,000	3,000
Other Capital Assets	6,000	2,000
	-----	-----
Capital Assets	7,000	5,000
Unrealized Receivables	0	14,000
	-----	-----
Total	\$20,000	\$32,000
	LIABILITIES AND CAPITAL	
Liabilities	\$ 2,000	\$ 2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
	-----	-----
Total	\$20,000	\$32,000

At the time of the transfer, B has held the interest in PRS for more than one year, and B's basis for the partnership interest is \$10,000 (\$9,000 plus \$1,000, B's share of partnership liabilities). The total amount realized by B is \$16,000, consisting of the cash received, \$15,000, plus \$1,000, B's share of the partnership liabilities assumed by T. B's undivided one-half interest in PRS includes a one-half interest in the partnership's unrealized receivables and a one-half interest in the partnership's collectibles. If PRS were to sell all of its Code Sec. 751 property in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer of B's partnership interest to T, B would be allocated \$7,000 of ordinary income from the sale of PRS's unrealized receivables. Therefore, B recognizes \$7,000 of ordinary income with respect to the unrealized receivables. The difference between the amount of capital gain or loss that the partner would realize in the absence of Code Sec. 751 (\$6,000) and the amount of ordinary income or loss determined under Reg § 1.751-1(a)(2) (\$7,000) is the partner's capital gain or loss on the sale of the partnership interest under Code Sec. 741. In this example, the transferor has a \$1,000 pre-look-through long-term capital loss.

If PRS were to sell all of its collectibles in a fully taxable transaction for cash equal to the fair market value of the assets immediately before the transfer of B's partnership interest to T, B would be allocated \$1,000 of gain from the sale of the collectibles. Therefore, B recognizes \$1,000 of collectibles gain on account of the collectibles held by PRS.

The difference between the transferor's pre-look-through long-term capital gain or loss (-\$1,000) and the look-through capital gain determined under this section (\$1,000) is the transferor's residual long-term capital gain or loss on the sale of the partnership interest. In this example, B will recognize a \$2,000 residual long-term capital loss on account of the sale or exchange of the interest in PRS. Reg § 1.1(h)-1(f), Example 1.

A taxpayer's unrecaptured Code Sec. 1250 gain cannot exceed his net Code Sec. 1231 gain. Code Sec. 1(h)(7)(B). For purposes of applying this rule, the regulations provide that gain from the sale of a partnership interest that would result in Code Sec. 1250 capital gain is not treated as Code Sec. 1231 gain even if Code Sec. 1231 could apply to the disposition of the underlying partnership property. Reg § 1.1(h)-1(b)(3)(iii).

The amount of residual long-term capital gain or loss recognized by a partner is equal to the amount of long-term capital gain or loss that the partner recognizes under Code Sec. 741, minus (1) the collectible gain allocable to the sold interest, and (2) for partners, the Code Sec. 1250 gain allocable to the sold interest. Reg § 1.1(h)-1(d). The regulations also impose reporting requirements on the various parties. Reg § 1.1(h)-1(e).

The holding period of a partnership interest is divided if a partner acquired portions of an interest at different times or if an interest was acquired in a single transaction giving rise to different holding periods. Reg § 1.1223-3(a). The holding period of a portion of a partnership interest is determined based on a fraction equal to the fair market value of the portion of the partnership interest to which the holding period related (determined immediately after the acquisition) over the fair market value of the entire partnership interest. Reg § 1.1223-3(b)(1).

**EXAMPLE:** A contributes \$50,000 of cash and a nondepreciable capital asset A has held for two years to a partnership (PRS) for a 50% interest in PRS. A's basis in the capital asset is \$50,000, and the fair market value of the asset is \$100,000. After the exchange, A's basis in A's interest in PRS is \$100,000, and the fair market value of the interest is \$150,000. A received one-third of the interest in PRS for a cash payment of \$50,000 (\$50,000/\$150,000). Therefore, A's holding period in one-third of the interest received (attributable to the contribution of money to the partnership) begins on the day after the contribution. A received two-thirds of the interest in PRS in exchange for the capital asset (\$100,000/\$150,000). Accordingly, A has a two-year holding period in two-thirds of the interest received in PRS. Six months later, when A's basis in PRS is \$120,000 (due to a \$20,000 allocation of partnership



income to A), A sells the interest in PRS for \$170,000. Assuming PRS holds no inventory or unrealized receivables (as defined under Code Sec. 751(c) ) and no collectibles or Code Sec. 1250 property, A will realize \$50,000 of capital gain. As determined above, one-third of A's interest in PRS has a holding period of one year or less, and two-thirds of A's interest in PRS has a holding period equal to two years and six months. Therefore, one-third of the capital gain is short-term capital gain, and two-thirds of the capital gain is long-term capital gain. Reg § 1.1223-3(f) , Example 1.

The regulations provide an exception to this rule under which contributions of cash to a partnership will not create a new holding period in a partnership interest. Where a partner makes cash contributions and receives cash distributions from a partnership during the one-year period before sale of all or a portion of the interest in the partnership, it is appropriate that the net cash contribution to the partnership determine the portion of the interest that is held for one year or less. Preamble to TD 8902, 9/20/2000 . Therefore, if a partner makes one or more cash contributions and receives one or more cash distributions with respect to the partnership during the one-year period ending on the date of the sale or exchange of all or a portion of the partner's interest in the partnership, in applying the rules for determining the partner's holding period in its partnership interest with respect to cash contributions, the partner may reduce the cash contributions made during the year by cash distributions received on a last-in-first-out basis, treating all cash distributions as if they were received by the partner immediately before the sale or exchange. This rule also applies in determining the holding period of a partnership interest where gain or loss is recognized under Code Sec. 731(a) on a distribution by the partnership. Reg § 1.1223-3(b)(2) .

**EXAMPLE:** On January 1, of tax year 1, A contributes property with a basis of \$1,000 and a fair market value of \$10,000 in exchange for an interest in a partnership (ABC). On September 30, of tax year 4, when A's interest in ABC is worth \$12,000 (and the basis of A's partnership interest is still \$1,000), A contributes \$12,000 cash in exchange for an additional interest in ABC. A is allocated a loss equal to \$10,000 by ABC for the taxable year ending December 31, of tax year 4, thereby reducing the basis of A's partnership interest to \$3,000. On February 1, of tax year 5, ABC makes a cash distribution to A of \$10,000. ABC holds no inventory or unrealized receivables. A is allocated no gain or loss for the taxable year ending December 31, of tax year 5, so that the basis of A's partnership interest does not increase or decrease as a result of such allocations. The netting rule contained in Reg § 1.1223-3(b)(2) provides that, in determining the holding period of A's interest in ABC, the cash contribution made on September 30, of tax year 4, must be reduced by the distribution made on February 1, tax year 5. Accordingly, for purposes of determining the holding period of A's interest in ABC, A is treated as having made a cash contribution of \$2,000 (\$12,000 - \$10,000) to ABC on September 30, tax year 4. A's holding period in one-seventh of A's interest in ABC (\$2,000 cash contributed over the \$14,000 value of the entire interest (determined as if only \$2,000 were contributed rather than \$12,000)) begins on the day after the cash contribution. After the distribution, A's basis in the interest in PRS is \$0, and the holding period for the interest in PRS continues to be divided in the same proportions as before the distribution. Reg § 1.1223-3(f) , Example 8.

A selling partner may be able to use the actual holding period of the portion of a partnership interest sold if the partnership was a publicly traded partnership, the partnership interest was divided into identifiable units with ascertainable holding periods, and the selling partner could identify the portion of the interest transferred. Reg § 1.1223-3(c)(2) . Otherwise, the holding period(s) of the transferred interest is divided in the same ratio as the holding period(s) of the partner's entire partnership interest. Reg § 1.1223-3(c)(1) .

**EFFECTIVE DATE:** The regulations under TD 8902 apply to transfers of interests in partnerships, S corporations, and trusts, as well as to distributions of property from a partnership, which occur after September 20, 2000. Reg § 1.1(h)-1(g) ; Reg § 1.1223-3(g) .

### 5.03. Sales of Partnership Interest When the Partnership Holds Ordinary Income Property

Although the general rule under Code Sec. 741 is that gain or loss from the sale of a partnership interest is treated as capital gain or loss, Code Sec. 751 provides that any amount realized on the sale of a partnership interest which is attributable to unrealized receivables or inventory ("hot assets") is treated as an amount realized from the sale of a noncapital asset.

**NOTE:** The purpose of the Code Sec. 751 hot asset provisions is to prevent partners from converting unrealized ordinary income of the partnership into long-term capital gain by selling their partnership interests. The Code Sec. 732(c) rule preventing a partner who receives hot assets from stepping up the basis of the hot assets also prevents partners from avoiding the recognition of ordinary income on hot assets.

The rules of Code Sec. 751(a) basically apply only to sales or exchanges of a partnership interest. The section itself does not expressly create a sale or exchange limitation, but the legislative history indicates that it is intended to have coverage identical to Code Sec. 741 . Furthermore, Code Sec. 751(a) is not applicable to amounts received as distributions from the partnership, since they are taxed under Code Sec. 751(b) . Code Sec. 751(a) applies regardless of whether the transfer is of all or part, of an interest or is to another partner or to an outsider.

The collapsible partnership rules in Code Sec. 751 are extremely complex and are frequently overlooked (or ignored) by both practitioners and revenue agents. However, these rules are extremely broad and are potentially applicable to a wide variety of common situations. In part, the wide applicability of these rules is a direct consequence of the definition of "unrealized receivables." Thus, for instance, any partner who transfers his partnership interest is likely to be subject to Code Sec. 751(a) if the partnership owns depreciable personal property or real property that has been depreciated using an accelerated method.

#### (A) Mechanics of Code Sec. 751(a)

Under Code Sec. 751 , the amount realized by a selling partner in exchange for all or part of his interest in the partnership attributable to "unrealized receivables" or to inventory items is treated as an amount realized from the sale or exchange of property that is not a capital asset. Code Sec. 751(a) ; Reg § 1.751-1(a)(1) .

For sales, exchanges, and distributions before August 6, 1997, ordinary income or loss was realized only to the extent of the consideration for the partnership's unrealized receivables and *substantially appreciated inventory*. Code Sec. 751(a) before AMEND by Sec. 1062(a), PL 105-34, 8/5/1997 . The pre-August 6, 1997 rules apply for sales and exchanges under a written binding contract in effect on June 8, 1997, and at all times before the sale or exchange. Sec. 1062(c), PL 105-34, 8/5/97 .

Any gain or loss attributable to Code Sec. 751 property is ordinary gain or loss. The difference between the remainder, if any, of the partner's adjusted basis for his partnership interest and the balance, if any, of the amount realized is the selling partner's capital gain or loss. Reg § 1.751-1(a)(2) .

**Analysis of How Code Sec. 751(a) Operates:**

The following steps must be taken to determine the consequences under Code Sec. 751(a) :

- (1) Determine the selling partner's share of the gain (or loss) that the partnership would recognize on its Code Sec. 751 property if it sold all its properties in a fully taxable transaction for cash equal to their fair market values (taking into account the Code Sec. 7701(g) rule that the fair market value cannot be less than the amount of the nonrecourse debt to which the property is subject) immediately before the partner's transfer of the interest in the partnership;
- (2) Take the ordinary income (or loss) and subtract the ordinary income (or loss) from the amount of capital gain (or loss) the partner would have realized in the absence of Code Sec. 751 . The difference is the amount of capital gain or (or loss) recognized by the partner.

A partner may recognize ordinary income in excess of the gain on the overall sale, with the result that the partner will have a capital loss equal to the excess. Reg § 1.751-1(g) , Ex (1). This is illustrated by the following example:

**EXAMPLE 1:** Assume that C buys B's interest in a personal service partnership, AB, when the balance sheet of the firm is as follows:

	Assets	
	Adjusted basis	Market value
Cash.....	\$ 3,000	\$ 3,000
Loans receivable.....	10,000	10,000
Capital assets.....	7,000	5,000
Accounts receivable.....	0	14,000
	\$20,000	\$32,000
	=====	=====

	Liabilities and Capital	
	Adjusted basis	Market value
Liabilities:		
Note payable.....	\$ 2,000	\$ 2,000
Capital:		
A.....	9,000	15,000
B.....	9,000	15,000
	\$20,000	\$32,000
	=====	=====

If AB sold all of its Code Sec. 751 property before the transfer of the partnership interest, B would have been allocated \$7,000 of ordinary income from the sale of the unrealized receivables. Therefore, B recognizes \$7,000 of ordinary income with respect to the unrealized receivable. The difference between the \$6,000 of capital gain or loss that the partner would

realize in the absence of Code Sec. 751 (\$16,000 (\$15,000 cash plus \$1,000 assumption of liability) minus \$10,000 basis) and the \$7,000 in ordinary income (\$1,000) is a capital loss. Reg § 1.751-1(g) , Ex. (1).

For transfers of partnership interests before December 15, 1999, the ordinary income or loss was the difference between the amount realized for the partnership interest allocated to unrealized receivables and inventory and the portion of the selling partner's basis for his partnership interest attributable to these receivables and inventory items and the difference between the remainder, if any, of the partner's adjusted basis for his partnership interest and the balance, if any, of the amount realized was capital gain or loss on the sale of the partnership interest. Reg. § 1.751-1(a)(2) before amended by TD 8847, 12/14/99 .

The portion of the partner's adjusted basis for his partnership interest allocated to Code Sec. 751 property was equal to the basis such property would have had under Code Sec. 732 if the selling partner had received his share of such properties in a current distribution made immediately before the sale. Generally, this was equal to the partnership's adjusted basis in the asset immediately before the deemed distribution. However, where the partnership's adjusted basis in the property deemed distributed exceeded the partner's adjusted basis in his partnership interest, the entire adjusted basis (limited to the partner's basis in his partnership interest) was allocated to the Code Sec. 751 assets. The adjusted basis reflected the Code Sec. 704(c) rules. Reg. § 1.751-1(a)(2) before amended by TD 8847, 12/14/99 .

**NOTE:** The amount allocated to Code Sec. 751 assets normally will be the fair market value of those assets. The reason why an arm's-length allocation between buyer and seller is respected is that the parties have opposing interests. The seller wants to allocate as little as possible to Code Sec. 751 assets in order to minimize his ordinary income. The buyer will have an interest in allocating as much as possible to Code Sec. 751 assets only if there is a Code Sec. 754 election in effect or if the buyer can use Code Sec. 732(d) to provide him with a stepped-up basis.

Although the IRS normally will respect arm's length agreements, it is not bound by the agreements. In contrast, the parties are normally bound by their agreements. See e.g., *Com. v. Danielson, Carl*, (1967, CA3) 19 AFTR 2d 1356 , 378 F2d 771 , 67-1 USTC ¶9423 , cert den(1967, S Ct) 389 US 858 , 19 L Ed 2d 123 , on remand(1968) 50 TC 782 (party must show mistake, undue influence, fraud, or duress in connection with the agreement). See also *Schatten, Joan v. U.S.*, (1984, CA6) 55 AFTR 2d 85-1417 , 746 F2d 319 , 84-2 USTC ¶9965 ; *Spector, Bernard v. Com.*, (1981, CA5) 47 AFTR 2d 81-1248 , 641 F2d 376 , 81-1 USTC ¶9308 , cert den(1981, S Ct) 454 US 868 , 70 L Ed 2d 171 . Compare Code Sec. 1060(a) .

**NOTE:** In practice, taxpayers often approximate the Code Sec. 751 gain on the sale of a partnership interest by calculating how much ordinary income would have been realized if they had remained in the partnership (here ordinary gain potential of  $\$30 \div 4 = \$7.50$ ). This comports with the underlying rationale of Code Sec. 751 . It will not produce the same result, however, as a mechanical application of the regulations in all cases. However, the regulations contain no guidance for partnerships with capital account shares at variance with income and loss shares. Where the partner's basis for his partnership interest is less than the *distributed* Code Sec. 751 assets' bases to the partnership, Code Sec. 732(a)(2) limits the basis allocated to the Code Sec. 751 assets to the lower basis of the partnership interest. In this case, the Code Sec. 751(a) gain may exceed that which would have been realized by continuing in the partnership.

Although there appears to be an item-by-item requirement, an allocation agreement between the buyer and the seller can allocate the purchase price to specific partnership assets in addition to making overall allocations between categories of assets. A specific amount can then be allocated to the fair market value of unrealized receivables for goods and/or services ( Reg § 1.751-1(c)(3) ) and to depreciated recapture property. Reg § 1.751-1(c)(4)(iii) .

## **(B) Code Sec. 751 Assets Defined**

### **(1) Definition of Unrealized Receivables**

The term "unrealized receivables" includes any rights (contractual or otherwise) to payment for (1) goods, to the extent the proceeds are treated as received from the sale of property other than a capital asset, or (2) services. Code Sec. 751(c) ; Reg § 1.751-1(c) .

**NOTE:** The term "rights ... to payment for" is construed liberally, including a noncontractual or equitable right (*quantum meruit*) to payment, whether it is partially or fully earned, and when there is a noncancelable future contract to perform services or deliver goods. However, if the agreement is cancelable at will by the buyer-customer, it is not an unrealized receivable to the seller. Thus, general expectations of profit are likened to goodwill, which is not a Code Sec. 751 asset. Even though goodwill represents future profits on which the purchaser has put economic value, the seller will have capital gain on its disposition.

**NOTE:** Unrealized receivables include the right to receive payments for goods delivered or to be delivered. Reg § 1.751-1(c)(1)(i) . However, to the extent these constitute accounts receivable for financial accounting purposes, they most likely will have been recognized by the partnership because taxpayers selling inventoried goods generally must use the accrual method of accounting for sale of goods. Accrual method partnerships will often have a right to be paid for goods that have been ordered but not yet delivered.

Except for purposes of payments to retiring or deceased partners, the unrealized receivables also include:

- Depreciation recapture under Code Sec. 1245 ;
- Excess depreciation under Code Sec. 1250 ;
- Oil, gas, or geothermal property under Code Sec. 1254 to the extent of mining exploration expenses recapture under Code Sec. 617(d)(1) ;
- Stock in a DISC or certain foreign corporations defined in Code Sec. 1248 ;
- Franchises, trademarks, etc.;
- Excess farm loss recapture under Code Sec. 1252 ; and
- Market discount bonds and short-term obligations.

Of course, the recapture items above are different from the right to receive payments for goods or services in that they do not involve any type of contractual right to receive payments. They are, in effect, the current unrealized potential ordinary income inherent in the property if it were sold at its current fair market value. This unrealized receivable is an amount determined by referring to the fair market value of the asset, its adjusted basis, and the type of gain, ordinary or capital, which would be reported if it were sold. An arm's-length agreement between the buyer and seller may be used in certain circumstances to establish a fair market value.

**NOTE:** Since Code Sec. 751 assets include only assets that represent potential ordinary income, assets with short-term capital gain potential are not Code Sec. 751 assets, and gain from the sale of the partnership interest attributable to such items may receive long-term capital gain treatment.

**NOTE:** Although Code Sec. 751(c) does not purport to provide an exhaustive list of unrealized receivables, but merely indicates that the term "includes" the items listed, the IRS has not argued for any other inclusions.

Generally, Code Sec. 751(c) defines unrealized receivables for all purposes of partnership taxation. References to "unrealized receivables" may be found in the following sections in Subchapter K:

- Code Sec. 731(a)(2) , which provides for the recognition of loss upon certain distributions in liquidation of a partner's partnership interest;
- Code Sec. 732(c) , which provides for an allocation of adjusted basis to distributed property to be made first to Code Sec. 751 assets; and
- Code Sec. 735(a) , which provides that the character of gain or loss realized on a subsequent sale of unrealized receivables received in a distribution is ordinary income.

## **(2) Definition of Substantially Appreciated Inventory Items**

Substantially appreciated inventory items only apply to sales of partnership interests before August 6, 1997 and to ANY distribution of those assets.

## **(3) Tiered Partnerships**

In determining whether partnership property is an unrealized receivable or an inventory item, a partnership will be treated as owning its proportionate share of the property held by any other partnership in which it is a partner. Code Sec. 751(f) .

**NOTE:** The purpose of this provision is to ensure that the collapsible partnership rules will be applied evenly without regard to whether property is held directly by a partnership or indirectly through another partnership.

The application of Code Sec. 751(f) when a parent partnership's only significant asset is its interest in a subsidiary partnership should not pose any significant difficulties. This is true despite some potential flaws and ambiguities in the statutory language which are not cured by the legislative history. In this context, the subsidiary partnership's activities, trade or business, intent, and so forth, presumably should be attributed directly to the parent partnership, along with the ownership of the parent's share of the subsidiary partnership's assets. However, where the parent partnership is engaged in a separate trade or business, it is unclear whether the character of the subsidiary partnership's assets is determined in its hands or in the hands of the parent partnership. It is also unclear whether the "substantial appreciation" test for inventory items is applied on a partnership-by-partnership basis or on a pooled basis in which the assets of the parent partnership and its share of the assets of each subsidiary partnership are combined. Although it would appear that the legislative purpose would be best served by completely ignoring the separate existence

## **(C) Enforcement**

A transferor-partner selling an interest in a partnership that has Code Sec. 751 assets must file a statement with his tax return for the year of sale. The statement is to provide the following information:

- The date of the transfer;
- The amount of gain or loss attributable to the Code Sec. 751 assets;
- The amount of gain or loss attributable to capital gain or loss on the sale of the partnership interest.

For the information that had to be in the statement for transfers before December 15, 1999, See, Reg. § 1.751-1(a)(2) before amended by T.D. 8847, 12/14/99.

In addition, Code Sec. 6050K requires that a partnership generally is required to file information returns ( Form 8308 ) with its Form 1065 for any transfers described in Code Sec. 751(a) for the tax year in which the calendar year of the exchange takes place. These returns must identify the transferor and transferee involved in the exchange and provide such other information as the regulations require. Code Sec. 6050K(a) . The information in the return must also be disclosed to the transferor and transferee before January 31 following the calendar year for which the return was made. Code Sec. 6050K(b) .

**NOTE:** Even though the legislative intent of Code Sec. 6050K is to force compliance with Code Sec. 751(a) , the Form does not include the instructions necessary for the partner to determine the portion of his gain or loss that is ordinary income under Code Sec. 751(a) .

Any transferor of a partnership interest must give prompt notice of the transfer to the partnership, and the partnership's required filing date is delayed until after it is notified of the exchange. Code Sec. 6050K(c) . Thus, the burden of triggering the entire reporting process falls on the transferor, who may not be in a position to determine whether reporting is required unless he happens to be intimately familiar with the partnership's operations.