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Structuring Redemptions of Partnership and LLC Interests: Issues Unique to Liquidating Distributions

IRC 754 Elections, Section 736(b) Payments, Character and Timing of Gain, Installment Sales, and More

THURSDAY, MARCH 5, 2020

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Structuring Redemptions of Partnership and LLC Interests: Issues Unique to Liquidating Distributions

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March 5, 2020

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AGENDA

1. The Basics of Sales and Redemptions
    - Liquidating distributions
    - Disguised sales
2. Redemption transactions and Section 736(a) & 736(b) payments
3. Section 754 Elections
4. Treatment of Section 751 "hot assets" in redemption transactions
5. Differences in Treatment of Sales vs. Redemptions
    - Differences in the character of gain or loss
    - Liquidating distributions of non-cash property
    - Distributions (including deemed distributions) of partnership property (including cash)
    - Hot assets
    - Installment sales
6. Stuffing allocations

Basics of Sales and Redemptions

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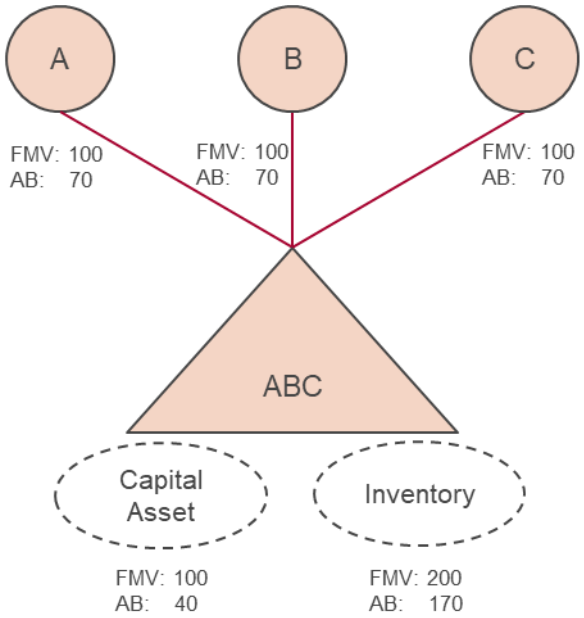
Sale Basics

- Seller's Treatment
  - gain or loss generally from the sale of a capital asset under § 741
  - § 751(a), partially recasts a transfer of a partnership interest as a transfer of a direct interest in the partnership's "§ 751 property" (i.e., inventory and unrealized receivables, which includes gain from section 1250 property).
- Purchaser's Treatment
  - § 742, is purchased or is acquired in a taxable exchange, the transferee's initial basis is the cost of the interest under § 1012.
  - § 743(a), basis of partnership assets is not adjusted unless (1) the partnership elects under § 754 to be subject to the optional basis adjustment provision of § 743(b) or (2) the partnership has a substantial built-in loss immediately after the transfer.
- Liabilities
  - Amount realized includes selling partner's share of partnership liabilities under § 752(d).
  - A purchasing partner's initial cost basis includes his share of partnership liabilities under § 752.
- Installment Sales
  - Generally can sell partnership interest under installment method, but think exceptions.
  - Inventory. Plus, § 453(i) denies installment sale treatment any ordinary income recognized under § 751 attributable to § 1245 or § 1250 recapture inherent in partnership property.

Sale Basics



- What are the consequences to Partner A if it sold its interest to a purchaser "P" for $100 cash?
- What are the consequence to P?

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Distribution Basics

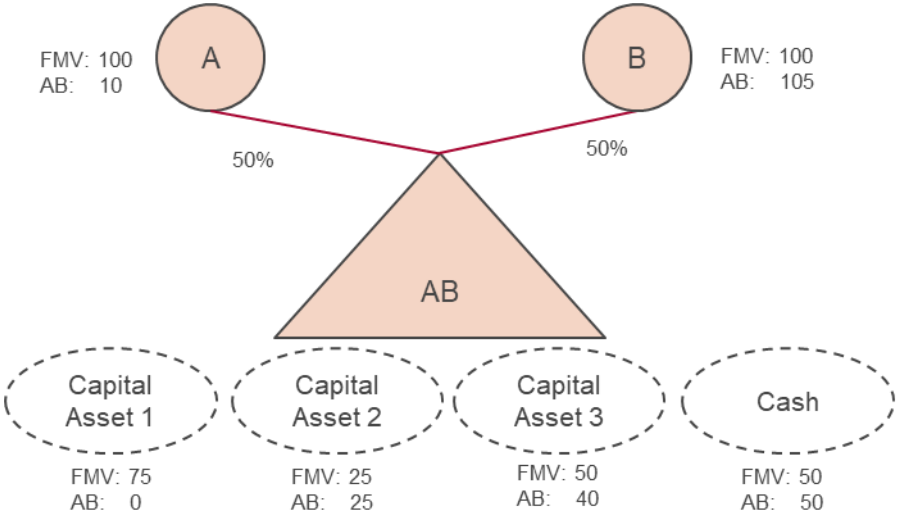
- Cash Distributions
  - recover basis first, then capital gain (subject to Sections 751(b) and 736(a)).
  - deemed cash distributions from reduction in partner's share of debt under Section
  - § 731(c), "marketable Securities" are treated as cash
- Property Distributions – in most cases nonrecognition with carryover (non-liq) or substituted (liquidating) basis.
  1. Nonliquidating Distribution – partner takes distributed asset with a basis equal to lesser of distribute partner's outside basis or partnership's inside basis in the asset and reduces outside basis by basis taken in the asset. Ability to give carry over is limited by OB.
  2. Liquidating Distribution – partner takes distributed asset(s) with basis equal to partner's outside basis.

Additional Distribution Rules to Keep in Mind

These additional rules apply as a backdrop to the general distribution rules adding another layer of complexity.

- "Mixing Bowl" - §§ 704(c)(1)(B) and 737
- "Disguised Sale" - § 707(a)(2)(B)
- "Marketable Securities" - § 731(c).
- "Hot Assets" - § 751.
- General Anti-Abuse Rules

Distribution Examples - § 732(a)



- Assumption: None of the provisions from the prior slide apply.
- Consequences if, alternatively, Capital Asset 1, Capital Asset 2 or $50 cash is distributed to Partner A in a non-liquidating distribution?
- Consequences if, alternatively, Capital Asset 1, Capital Asset 2 or $50 cash is distributed to Partner B in a non-liquidating distribution?

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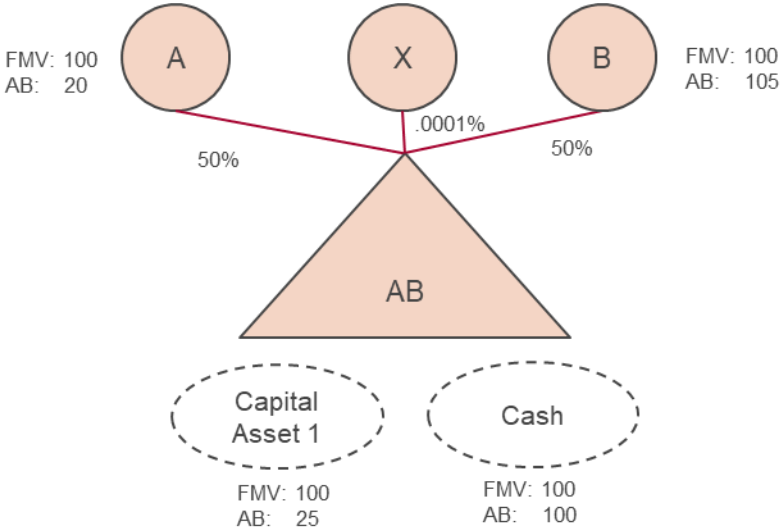
Distribution Examples - § 732(b)



- Assumption: None of the provisions from the prior slide apply.
- Consequences if, alternatively, Capital Asset 1, Capital Asset 2 or $100 cash is distributed to Partner A in a **liquidating** distribution?
- Consequences if, alternatively, Capital Asset 1 or $100 cash is distributed to Partner B in a **liquidating** distribution?
- What if $98 cash and an asset with a $2 FMV and $2 basis are distributed to Partner B a liquidating distribution?

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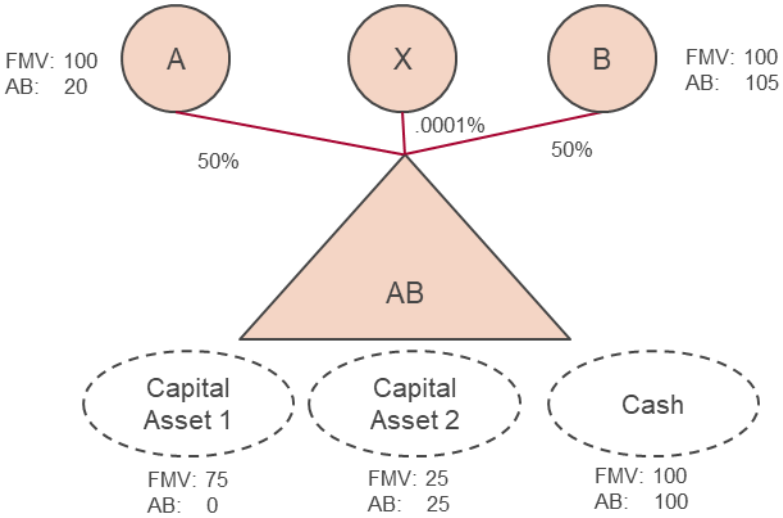
Distribution Examples - § 732(c)



- Assumption: None of the provisions from the prior slide apply.
- Consequences if Capital Asset 1 and Capital Asset 2 are distributed to Partner A in complete redemption of A's interest?
- Consequences if Asset 1 and Asset 2 are distributed to Partner B in complete redemption of B's interest?

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Disguised Sale Basics

- Under § 707(a)(2)(B), a contribution of property by a partner to a partnership may be recharacterized as a sale (generally for all tax purposes) where the contributing partner receives distributions of cash or other property that are, in substance, consideration for the contribution.
- An odd timing rule in the regulations is that the deemed a sale occurs when the partnership becomes the owner of the contributed property, rather than upon the occurrence of a subsequent distribution to the contributing partner.
- Generally, property contributions followed by distributions are treated as sales only if, based on all the facts and circumstances, (1) a distribution of money or other consideration from the partnership to the partner would not have been made but for the contribution of the property to the partnership and (2) a distribution of money or other consideration either is made simultaneously with the property contribution or is not dependent on the entrepreneurial risks of partnership operations.
- With respect to nonsimultaneous transfers, the Regulations create the following rebuttable presumptions
    - if the transfers occur within a two-year period, then, regardless of the order, they are presumed to constitute a sale unless the facts and circumstances clearly establish that no sale occurred and
    - if the transactions are more than two years apart, they are presumed not to constitute a sale unless the facts and circumstances clearly establish to the contrary.
- Regs list a number of factors to be considered in evaluating these points.

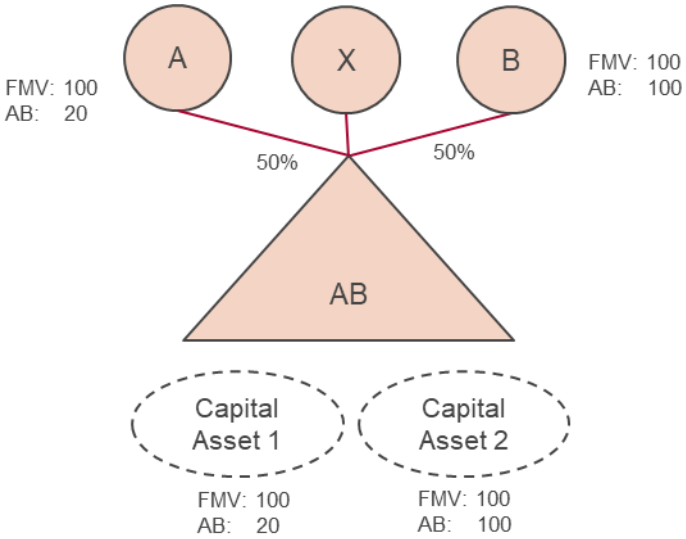
Disguised Sale Basics

- Exceptions to Disguised sale rules. :
    - Guaranteed payments
    - Reasonable preferred returns
    - Operating Cash Flow
    - Leveraged Distributions

Mixing Bowl Basics

- § 704(c)(1)(B)
  - Generally, if a partner contributed 704(c) gain/loss property and the partnership and that property is distributed to another partner (not contributor) within 7 years of the contribution the contributing partner recognizes the built-in gain or loss on the contributed property.
  - Purpose: prevent partners from circumventing the rule of § 704(c)(1)(A), which requires that gain or loss on § 704(c) property be allocated to the contributing partner.
- § 737
  - Generally, if a partner that contributed 704(c) gain property and receives a distribution of property within seven years thereafter is required to recognize gain (but not loss) in an amount equal to the lesser of:
    - The excess (if any) of the fair market value of property (other than money) received in the distribution over the adjusted basis of the distributee-partner's interest immediately before the distribution (reduced, but not below zero), by the amount of any money received in the distribution (the "excess distribution") or
    - the "net precontribution gain" of the distributee-partner.

Disguised Sales & Mixing Bowl



- Partner A contributes Capital Asset 1 and Partner B contributes Capital Asset 2 in year one.
- Consequences if Capital Asset 2 is distributed to Partner A in year two, five or nine?
- Consequences if Capital Asset 1 is distributed to Partner B in year two, five or nine?

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Marketable Securities

- "Marketable Securities" are treated as "money" for purposes of §§ 731 and 737.
- Marketable securities = "actively traded" foreign currencies and "financial instruments"
    - Relevant testing date is the date of the distribution
    - Treas. Reg. § 1.1092(d)-1(a) provides that actively traded personal property "includes any property for which there is an established financial market."
- Look through rules for interests in entities per § 731(c)(2)(B)(v) & (vi) and applicable regs.
    - Interest in an entity is a marketable security if 90% or more (by value) of the entity's assets consist (directly or indirectly) of marketable securities and $, and
    - Interest in an entity whose assets consist of less than 90% but 20% or more of marketable securities and money is treated as a marketable security to the extent the value of the entity is attributable to marketable securities and $.
- Limitation on gain rule.
    - Section 731(c) is inapplicable to the extent the distributee-partner receives his share of the partnership's net appreciation inherent in its marketable securities
- Exceptions

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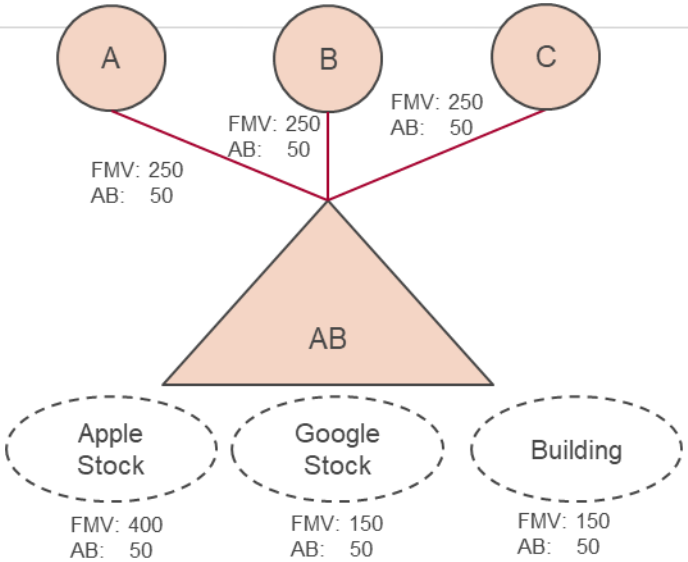
- Exceptions

Marketable Securities – Gain Limitation Rule – 731(c)(3)(B)



- Partners A, B and C each contribute $50 upon formation and that is invested in 3 assets.
- The Apple Stock distributed pro rata (~$133 to each). How much of the stock is treated as "money" under 731(c)?
- Look at proportionate share of marketable securities before and after distribution.
  - WRT A:
    - Distributive share of markt. sec. gain prior to distribution = $150 = (1/3) * ($350+$100)
    - Distributive share of marketable securities gain after distribution = $33 = (1/3) * $100
  - $150 - $33 = $117. So amount or gain otherwise recognized under typical marketable securities rules is reduced by this amount.
- Ordinarily, (if Apple Stock was treated as cash), A would recognize about $83 of gain ($133-$50). This is reduced to zero and A takes a carry-over basis in the Apple Stock.

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Marketable Securities

Exceptions

1. Previously contributed - Inapplicable to a distribution of a security to the partner that contributed the security.
2. Inapplicable to distributions of marketable securities if (1) they were acquired by the partnership in a nonrecognition transaction in which less than 20 percent of the value of the property given up by the partnership consisted of marketable securities and money and (2) the marketable securities are distributed within five years of the date of the nonrecognition transaction or, if later, the date on which the securities became actively traded.
3. Not previously marketable - Inapplicable if (1) the distributed security was not marketable on the date acquired by the partnership and the entity to which the security relates had no outstanding marketable securities on that date, (2) the security was held by the partnership for at least six months before it became marketable, and (3) the security was distributed within five years of the date upon which it became marketable.
4. Inapplicable to a distribution of a marketable security acquired in a nonrecognition transaction in exchange for another security to the extent the distribution of the other security immediately prior to the exchange would have been excepted from § 731(c) under any of the three previously discussed exceptions. This rule has the curious effect of eliminating the five-year distribution requirement contained in the second and third exceptions discussed above.
5. Investment Partnership - Inapplicable to a distribution of marketable securities from an investment partnership to an eligible partner.
    - "Investment partnership" = a partnership that has never been engaged in a trade or business and substantially all of whose assets consist of specified investment-type assets (e.g., money, stock in a corporation, notes, bonds).
    - "Eligible partner" is one who contributed only specified investment-type assets to the partnership.

Section 736 Payments

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Section 736 - Payments in retirement of a partner's interest

- Purpose - partition liquidating payments from partnerships to retiring partners into categories for the purpose of applying the relevant operating rules found elsewhere in Subchapter K.
- Section 736 applies only to payments made by a partnership to a retired partner or a deceased partner's successor in interest in liquidation of his entire interest in the partnership.
- § 736(b) (not § 736(a)) is the first step in the process and is the "general" rule.
- First, § 736(b) divides liquidating payments into two categories:
    1. payments for the retiring partner's interest in partnership property, which, under § 736(b), are treated as received under the distribution rules discussed above (i.e., set forth in §§ 731, 732(b), and 751(b)); and
    2. all other payments, which are taxed as set forth in § 736(a)

Section 736 - Payments in retirement of a partner's interest

- Generally,* there are two exceptions to the rule that payments for interests in partnership property are governed by the general distribution rules. Those exceptions apply to payments to **general partners** of **service partnerships**, for amounts paid for:
    1. § 751(c) unrealized receivables; and
    2. Goodwill of the pship (unless the partnership agreement provides for a payment with respect to goodwill).
- Thus, all payments to a partner in a non-service partnership will generally* be governed by § 736(b) and § 736(a) only applies to service partnerships, and then only to the extent that the payments are made to a retiring general partner for their share of traditional unrealized receivables or certain unstated goodwill.
- * The foregoing bullet points overgeneralize somewhat. There can be payments that don't fall in the two exceptions that are § 736(a) payments (e.g., mutual insurance, comp for past services which are payment for property) whether or not the partnership is a service partnership and whether the interest being redeemed in a general or limited interest (i.e., a third category of § 736(a) payments consists of liquidation payments in excess of the value of the redeemed partner's interest)

Section 736 - Payments in retirement of a partner's interest

- Once the payments is in § 736(a), that section subdivides payments into two categories:
  - (1) those determined "with regard to the income of the partnership," which are treated under § 736(a)(1) as a distributive share of partnership income; and
  - (2) those determined "without regard to the income of the partnership," which are treated under § 736(a)(2) as § 707(c) "guaranteed payments."

Section 736 - Payments in retirement of a partner's interest

- § 736(b) liquidating payments offer significant benefits
- First, flexibility for partners in determining what portion of total liquidating payments is attributable to § 736(b) property and what portion is taxable under **§ 736(a)**.
    - The departing partner probably prefers capital gain treatment while the remaining partners likely prefer the ordinary treatment of a § 736(a) payment that offer a deduction to reduce their share of income.
    - The partners may determine whether payments for a retiring general partner's interest in the goodwill of a service partnership are taxed as **§ 736(b)** property payments or as **§ 736(a)** payments (i.e., provide or it in the agreement).
- Second, consider the timing benefits vs. a sale of an interest.
    - Minimum rate of interest must be stated in an installment sale or it will be imputed under § 483 or § 1274
    - Basis recovery pro rata in installment, basis first in § 736(b).
    - Certain assets can't be reported under the installment method, no such requirement for §736(b) payments.
    - Relief from liability is a day 1 inclusion under installment, but may be a final day inclusion under § 736(b) because the partner remains a partner in the partnership until the end.
    - If the liquidation is effected through a series of payments, the partners by agreement may apportion each installment between **§ 736(a)** and **§ 736(b)** amounts.

Section 736 - Payments in retirement of a partner's interest

Section 736(b) Payments Cont.

- The tax consequences are determined by the normal partnership distribution rules (including the hot asset rules under Section 751(b)).
- Section 736(b) payments result in gain only to the extent that the amount of cash distributed exceeds the redeemed partner's basis and result in loss only when the liquidating distribution is limited to cash, unrealized receivables, and/or inventory.
- Generally, any gain or loss is characterized as capital in nature (except for ordinary income treatment under Section 751(b)).
- Payments are not deductible by the partnership, and the basis of remaining partnership assets is adjusted only if:
  - the partnership has made a Section 754 election or
  - a portion of the distribution is characterized as a sale or exchange under Section 751(b).

Section 754 Elections

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Effect of 754 Election in Redemptions

- Partnership distributions can create inside/outside basis disparity.
- In the case of 731/732 distributions, and even though a Section 736(b) distribution is "made in exchange for the interest of a partner in partnership property," the transaction is treated as a normal partnership distribution and the basis of partnership property is not adjusted as a result of distributions to partners.
- However, if the partnership has made a Section 754 election, the basis adjustment rules of Section 734(b) require the partnership to adjust the basis of its assets and time a partner recognizes g/l on a distribution or take an asset with basis different than the partnership's.
- Generally elective (754), unless a "substantial basis reduction" ($250K) required

Effect of 754 Election in Redemptions

- Amount of Adjustment
  - if an amount of money is distributed that exceeds the redeemed partner's basis in his partnership interest and the redeemed partner recognizes gain,
    - the § 734(b) election increases the basis of partnership assets by the amount of the gain.
  - if a partnership interest is completely liquidated solely in exchange for money, unrealized receivables, and inventory and the redeemed partner recognizes a loss,
    - the § 734(b) election decreases the basis of partnership assets by the amount of the gain.
  - if the distributee partner takes a basis in distributed property that is lower than the basis of the property in the hands of the partnership immediately before the distribution, or
    - the § 734(b) election increases the basis of partnership assets by the amount of the gain.
  - if the distributee partner takes a basis in distributed property that is higher than the basis of the property in the hands of the partnership immediately before the distribution.
    - the § 734(b) election decreases the basis of partnership assets by the amount of the gain.

Note: the negative 734(b) adjustments can only occur on liquidating distributions (i.e., in non-liquidating distributions of cash (can only result in gain) or property from the partnership can only carry over its inside basis or be limited (basis decrease) by partner outside basis.

Effect of 754 Election in Redemptions

- The basis adjustment is applicable to the partnership's property and all remaining partners are affected.
- In the case of a redemption with multiple distributions, a partnership that makes a Section 754 election is not entitled to any adjustment to the basis of its property under Section 734(b) until the retired partner recognizes gain from such payments.
- Even if a Section 754 election is not in effect, a Section 734(b) basis adjustment is required in the context of a liquidation of a partner's interest if the downward adjustment to the basis of partnership assets would exceed $250,000 if a Section 754 election had been in effect.

Hot Assets in Redemption Transactions

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751(b)

- 751(b) Certain Distributions treated as sales or exchanges
  - (1) General rule. To the extent a partner receives in a distribution –
    - (A) partnership property which is –
      - (i) unrealized receivables, or
      - (ii) inventory items which have appreciated substantially in value,
    - in exchange for all or a part of his interest in other partnership property (including money), or
    - (B) partnership property (including money) other than property described in subparagraph (A)(i) or (ii) in exchange for all or a part of his interest in partnership property described in subparagraph (A)(i) or (ii),
    - such transactions shall, under regulations prescribed by the Secretary, be considered as a sale or exchange of such property between the distributee and the partnership (as constituted after the distribution).

751(b)

- (2) Exceptions. Paragraph (1) shall not apply to –
  - (A) a distribution of property which the distributee contributed to the partnership, or
  - (B) payments, described in section 736(a), to a retiring partner or successor in interest of a deceased partner.
- (3) Substantial appreciation. For purposes of paragraph (1)—
  - (A) In general. Inventory items of the partnership shall be considered to have appreciated substantially in value if their fair marked value exceeds 120 percent of the adjusted basis to the partnership of such property.
  - (B) Certain property excluded. For purposes of subparagraph (A), there shall be excluded any inventory property if a principal purpose for acquiring such property was to avoid the provisions of this subsection relating to inventory items.

751(b)

- Essentially, Section 751(b) recharacterizes a portion of a distribution as a sale or exchange when a partnership that owns "hot assets" makes a non-pro rata distribution of partnership assets.
  - "hot assets" are comprised of certain ordinary income assets:
    - Substantially appreciated inventory
    - unrealized receivables
- Section 751(b) potentially applies to a broad array of distributions (and deemed distributions):
  - Deemed cash distributions pursuant to Section 752(b)
  - Admission of new partner to a law firm (Revenue Ruling 84-102 applied 751(b) where partnership had liabilities and unrealized receivables and each partner entitled to share of unrealized receivables and liable for share of liabilities)

751(b)

- Like Section 751(a), Section 751(b) is designed to prevent the shifting of ordinary income among partners
- Section 751(b), however, applies in a different set of circumstances:
  - where the partnership has “hot assets”, and
  - the partnership makes a disproportionate distribution to a partner
- Thus, Section 751(b) does not apply where the distribution is pro rata or if the partnership doesn’t have hot assets
- A disproportionate or non-pro rata distribution is one that changes the partners’ shares of hot assets and other partnership assets (or “cold assets”).

751(b)

- When Section 751(b) applies to a disproportionate distribution, it will have the effect of characterizing a portion of the distribution as a taxable exchange between the partnership and distributee partner
- Applying Section 751(b) depends on a calculation of a partner's interest in partnership property.
  - However, the statute does not provide a method for making that calculation

751(b)

- Issue Section 751(b) is addressing:
  - preferential treatment given to capital gains for individuals
    - Right now, very significant preference for capital gains
      - 37% (or 40.8%) vs. 23.8%
  - Thus, there is a significant incentive to recharacterize ordinary income as capital gains
  - If certain partners are tax-exempt, shifting ordinary income to them, and shifting capital gains to the taxable partners is appealing given the tax differential
  - Section 751(b) is intended to prevent partners from recharacterizing ordinary income as capital gains in certain circumstances

751(b)– Example

XYZ LLC is taxed as a partnership. Each of members X, Y and Z has an outside basis and capital account equal to $100.

- FMV of inventory exceeds basis by more than 120%
- XYZ LLC has hot assets because inventory is substantially appreciated

Assets	Book/ Basis	FMV	Capital	Tax/Book	FMV
Inventory	$240	$300	X	$100	$150
Capital Asset	$60	$150	Y	$100	$150
			Z	$100	$150
Totals	$300	$450		$300	$450

751(b) Example

- XYZ LLC distributes the Capital Asset (which is a cold asset) to Z in complete liquidation of Z's interest in LLC. Z gets a basis of $100 in the distributed assets.
- Without Section 751(b):
  - When Z sold the Capital Asset, all of the gain would be capital gain. Instead, Z would have a capital gain of $50.
  - When the LLC sold the Inventory, X and Y would recognize ordinary income.
  - Z would not realize any ordinary income.
- However, 751(b) applies to the distribution to Z because the distribution changed Z's interest in hot assets.
  - 751(b) says that the distribution will be treated as a sale or exchange

Two Alternative Sets of Rules

- Under current regulations, a "gross value" approach is used to determine the distributee partner's reduction or increase in Section 751(b) property.
  - This approach compares the distributee partner's share of the partnership' hot assets and cold assets before and after the distribution
  - Next, the current regulations apply a "deemed asset exchange" approach to determine the amount of the income inclusion.
- Under proposed regulations, the "gross value" approach would be replaced with a "hypothetical sale" approach.
  - This approach would determine a partner's interest in Section 751 property by reference to the amount of ordinary income that would be allocated to the partner if the partnership disposed of all of its property at FMV immediately before the distribution.
  - Next, the proposed regulations would replace the deemed asset exchange approach with the "hot asset sale" approach.

Current 751(b) Regulations

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751(b) – Interest in the Partnership

- Neither 751(b) or the underlying regulations provide guidance regarding how to measure a partner's interest in a partnership's hot and cold assets.

- Legislative history indicates a partner's interest in a partnership's hot assets equal the partner's rights to income from the hot assets.

Gross Value Approach (Current Regs)

- The Current Regulations apply a Gross Value approach, pursuant to which each partner's share of the partnership's hot and cold assets is initially determined by reference to the gross value of the assets.
- Compare:
  1. the distributee partner's undivided interest in the gross value of each partnership asset before a distribution to
  2. the partner's undivided interest in the same assets after the distribution (including the distributed assets)

Gross Value Approach (Current Regs)

- If a distribution results in an exchange of all or a portion of the distributee-partner's interest in one class of assets for assets in the other class, the distributee-partner is deemed to
  - receive a distribution of the relinquished assets (immediately prior to the actual distribution); and
  - then exchange the relinquished assets with the partnership for the acquired assets (the "asset exchange approach")
- The deemed asset exchange is fully taxable to the distributee-partner and to the partnership.

Gross Value Approach (7 Steps)

1. Classify the partnership assets
2. Determine the gross value of the distributee-partner's pre- and post-distribution interests in each asset
3. Construct a partnership exchange table.
4. Determine which assets are involved in the Section 751(b) exchange
5. Determine the basis of the assets relinquished
6. Determine the consequences of the exchange
7. Determine treatment of the portion of the distribution not included in the Section 751(b) exchange

Gross Value Approach – Example

- X, Y and Z own equal interests in XYZ which has a balance sheet as follows:

Assets	Basis/Book	FMV	Capital	Tax/Book	FMV
Inventory	$240	$300	X	$100	$150
Capital Asset	$60	$150	Y	$100	$150
			Z	$100	$150
Total	$300	$450		$300	$450

- XYZ distributes the capital asset to Z in complete liquidation of her 1/3 interest.

Gross Value Approach – Example

- Step 1: Classify the partnership assets.
  - Here, we have one Section 751(b) asset and one capital asset
- Step 2: Determine the gross value of the distributee-partner's pre- and post-distribution interests in each asset

	Z's Pre-Distribution Share of FMV	Z's Post-Distribution Share FMV
Inventory	$100	$0
Capital Asset	$50	$150

Gross Value Approach – Example

- Step 3: Construct partnership exchange table.

	Gross Value of Z's post-distribution interest	(+) Gross Value of property distributed	(-) Gross Value of Z's pre-distribution share	= Change in interest
Hot Assets	$0	$0	($100)	($100)
Cold Assets	$0	$150	($50)	$100

- Step 4: Determine which assets are involved in the Section 751(b) exchange
  - The totals in column 4 demonstrate that Z has exchanged $100 of hot assets for $100 of cold assets

Gross Value Approach – Example

- The deemed transactions under 751(b) are the following:
  - *Hypothetical Distribution*: Z deemed to receive $100 inventory as a current distribution.
  - *751(b) Exchange*: Z is deemed to transfer the hypothetical distribution of inventory to XYZ in exchange for $100 of the capital asset.
  - *Non-751(b) Distribution:* Z is deemed to receive a liquidating distribution of the remaining $50 worth of the capital asset.

	Z's post-distribution interest	(+) Property distributed	(-) Z's pre-distribution share	= Change in interest
Hot Assets	$0	$0	($100)	($100)
Cold Assets	$0	$150	($50)	$100

Gross Value Approach – Example

- Step 5: Determine the basis of the assets relinquished:
  - Z takes a transferred basis of $80 in the $100 of inventory received in the deemed distribution
  - Z's outside basis is reduced from $100 to $20
  - XYZ's basis in remaining $200 of inventory is $160

Gross Value Approach – Example

- Step 6: Determine the consequences of the deemed exchange between Z and XYZ
  - Z: Treated as transferring the hypothetical distribution of inventory to XYZ in exchange for $100 of the capital asset.
    - recognizes ordinary gain of $20.
    - takes a cost basis of $100 in 2/3 of the capital asset, and starts a new holding period.
  - XYZ : Received $100 of inventory in exchange for capital asset with basis of $40.
    - recognizes $60 capital gain, allocated to X and Y.
    - Basis in 1/3 of the inventory acquired in exchange is cost basis of $100.
    - PLR 7823013 held that the partnership also takes a new holding period in the hypothetically purchased property.

Gross Value Approach – Example

- Step 7: Determine treatment of the portion of the distribution not included in the Section 751(b) exchange:
  - Partnership distributes the remaining portion of the capital asset (Z's pro rata share) to Z in complete liquidation of her partnership interest.
  - Z: no G/L.
    - Holds that portion of the capital asset with a basis equal to her outside basis of $20 (total basis of $120).
  - XYZ: no G/L.

Gross Value Approach – Example

Summary:

- Z:
  - recognizes $20 of ordinary income from deemed exchange, and
  - takes a basis of $120 in the capital asset.
- XYZ:
  - recognizes $60 of capital gain from deemed exchange, allocated to X and Y.
  - Holds inventory with a basis of $260.

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Challenges with the Current 751(b) Regulations

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Gross Value Approach - Criticism

- Section 751(b) was passed in 1954 and has remained almost unchanged, while many other provisions of Subchapter K have undergone significant change.
- This can create unanticipated results.

Gross Value Approach - Criticism

- Section 704(b) regulations provide that partnership allocations are respected if they have substantial economic effect.
  - It is common for partnerships to specially allocate items of partnership income and loss other than in accordance with the partner's relative fair market value of the capital accounts.
  - This arrangement is not consistent with the gross value approach, which assumes a partner's interest in partnership property is based on the partner's relative share of the fair market of the capital accounts.

Gross Value Approach - Criticism

- 704(c) provides that income, gain, loss and deduction with respect to property contributed to the partnership by a partner is shared among the partners so as to take into account the variation between the basis of the property to the partnership and its FMV at the time of contribution.
- The gross value approach is unclear as to whether and to what extent 704(c) is taken into account in determining the partner's share of assets.
- Under 704 regulations, the principles of 704(c) apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues property pursuant to 1.704-1(b)(2)(iv)(f)

751(b) – NYSBA Criticism

The New York State Bar Association summarized the criticisms of the Current Regulations as follows (NYSBA Comments on Proposed Hot Asset Regulations, Sept. 9, 2015):

1. Complicated and expensive to administer;
2. Focused on the distributee-partner's share of the gross value of the hot and cold assets rather than the distributee-partner's share of the income and gain inherent in those assets.
   - a distribution may give rise to a taxable exchange under the Current Regulations even if each partner's share of the hot-asset gain does not change as a result of the distribution.
   - Similarly, a distribution may escape section 751(b) as long as the distribution does not alter any partner's share of the gross value of the hot and cold assets, even if the distribution does alter a partner's share of the built-in gain in hot assets.
3. No meaningful guidance on how to determine a partner's share of the gross value of a partnership asset.
   - Considerable uncertainty in addressing liabilities, section 704(c) (or reverse section 704(c) assets and special allocations
4. Requires knowledge of the fair market value of each partnership asset.
   - Third-party valuations can be expensive, while other partnerships undertake their own valuation (which creates additional uncertainty)
5. Uncertainty as to whether the deemed distribution of the relinquished assets is treated as an actual distribution for other purposes of the Code (such as sections 704(c)(1)(B), 707, 731(a)(1), and 737).

Proposed 751(b) Regulations

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Proposed Regulations

- Proposed Section 751(b) regulations were issued on November 3, 2014.
- Completely revamp the existing regulatory regime.
  - The gross value approach is abandoned in favor of a "hypothetical sale" approach.
  - The proposed regs would also:
    - include rules under Section 704(c) to enable partnerships to calculate partner gain in Section 751 property more precisely, and
    - clarify how basis adjustments under Sections 743(b) and 754(b) affect the computation of partners' interests in Section 751 property
- Generally effective prospectively from the date of finalization.
  - However, taxpayers may rely on the proposed regulations after November 3, 2014 if the partnership and the partners consistently apply the proposed regulations to all 751 transactions

Proposed Regulations

- The Proposed Regulations utilize a hypothetical sale approach to determine a partner's interest in partnership property instead of the gross value approach.
- The hypothetical sale approach determines a partner's interest in Section 751 property by reference to the amount of ordinary income that would be allocated to the partner if the partnership disposed of all of its property at FMV immediately before the distribution.
- Section 751(b) is triggered only if a distribution reduces a partner's net Section 751 unrealized gain or loss.
  - Ordinary income is recognized by the partner whose share is reduced;
  - the basis of the corresponding § 751 property is increased by a like amount.

Proposed Regulations

- Under the Proposed Regulations' hypothetical sale approach, a partnership generally needs to determine if any partner's interest in the partnership's Section 751 property is reduced by comparing for each partner:
  - amount of ordinary income (or ordinary loss) the partner would recognize from hot assets if the partnership sold all of its assets for FMV immediately before the distribution, versus
  - amount of ordinary income (or ordinary loss) the partner recognize from hot assets if the partnership sold all of its assets, and, in the case of the distributee-partner, such partner sold the distributed assets, for FMV immediately after the distribution

Proposed Regulations

- If there is a reduction in the amount of ordinary income (or an increase in the amount of ordinary loss, or both) for any partner, as a result of the distribution (that reduction or increase, a "Section 751(b) amount"), the distribution is considered a "Section 751(b) distribution", and is subject to Section 751(b).
- Once it is determined that a distribution is subject to Section 751(b), any partner with a decrease in net Section 751(b) unrealized gain or loss must recognize ordinary income and make appropriate adjustments to basis.

Proposed Regulations

- After applying the hypothetical sale approach, the Proposed Regulations direct partnerships to use any "reasonable method" to account for the reduction in hot assets
- Reasonable methods include:
  - Hot Asset Approach: Partner with reduction in interest in hot assets deemed to get distribution of hot assets equal to the reduction amount and to sell the hot assets to the partnership immediately before distribution
    - Under this approach, only partner with reduction in hot assets interest would recognize income
  - Deemed Gain Approach: Partnership must recognize gain in hot assets equal to reduction in hot assets and allocate such gain to applicable partners
- Must use approach adopted until the use of that approach becomes unreasonable; have to reevaluate for each distribution

Proposed Regulations

- When making a determination of whether a distribution is a Section 751(b) distribution, the amount of OI or OL that each partner would recognize in the hypothetical sale includes gain or loss allocable to the partner pursuant to Section 704(c)
  - This includes any remedial allocations
- Proposed Regulations require a revaluation of partnership property under Treas. Reg. Sec. 1.704-1(b)(2)(iv)(f) when a distribution is made in consideration for a partnership interest if partnership owns Section 751 property immediately after distribution.
  - This revaluation creates a reverse Section 704(c) layer, preserving partners' shares of BIG and BIL—thereby limiting distributions causing a partner to have a Section 751(b) amount

Proposed Regulations

- Proposed Regulations have rules for basis adjustments
  - For example, for Section 732(c) or 734(b) basis adjustments
    - Any basis increase allocated to distributed capital gain property isn't taken into account in determining the recomputed or adjusted basis of the distributed property for purposes of Section 1245(a)(1)—therefore, won't displace OI potential in distributed asset.
    - Depreciation or amortization is allowable with respect to the basis increase; however, basis increase is not taken into account in determining Section 1231 gain or loss. Prop. Treas. Reg. Sec.1.732-1(c)(2)(iii).
  - Thus, a positive § 734(b) basis adjustment to § 1231 property, for example, will not reduce the recapture on disposition, nor will it reduce the § 1231 gain; rather, it can produce a capital loss on a disposition as to which gain is otherwise recognized

Current Regulations– Example 1

- XYZ accrues unrealized receivables of $90 in Year 2.
- X, Y and Z each contribute $120 to XYZ for an interest in XYZ. Each has a one-third interest.
- XYZ purchases land for $100 in Year 1.

Balance Sheet as of January 1, Year 3

Assets	Tax	Book	Capital	Tax	Book
Cash	$260	$260	X	$120	$150
Unrealized Receivable	$0	$90	Y	$120	$150
Real Property	$100	$100	Z	$120	$150
Totals	$360	$450		$360	$450

- On January 2, Year 3, XYZ distributes $50 cash (cold asset) to Z

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Current Regulations– Example 1

- $50 distribution to Z reduces Z's interest from 1/3 to 1/4
  - Exchange Table

Assets	Z's post-distribution share	(+) property distributed	(-) Z's pre-distribution share	Change in Interest
Unrealized Receivable	$22.50	$0	$30.00	($7.50)
Cash	$52.50	$50	$86.66	$15.84
Real Property	$25.00	$0	$33.34	($8.34)

Current Regulations—Example 1

- Under Gross Value Approach, Z's interest in cold assets has increased, and interest in hot assets has decreased
- Distribution is Section 751(b) transaction under the Gross Value Approach

- Now, consider the Hypothetical Sale Approach . . .

Proposed Regulations– Example 1

- Compare each partner's share of OI before the distribution versus each partner's share of OI after the distribution
  - Section 751(b) amount is the decrease in share of OI; if there is a Section 751(b) amount, Section 751(b) applies
  - **Balance Sheet is booked up before the distribution to Z**
  - Each partner has $30 of net unrealized OI

Assets	Tax	Book	Capital	Tax	Book
Cash	$260	$260	X	$120	$150
Unrealized Receivable	$0	$90	Y	$120	$150
Real Property	$100	$100	Z	$120	$150
Totals	$360	$450		$360	$450

Proposed Regulations—Example 1

- Here, the net unrealized OI before is the same as the net unrealized after
- So, Section 751(b) amount is 0, and distribution is not subject to Section 751(b)
- The result is different than under the gross value approach

Proposed Regulations– Example 2

- Same facts as in Example 1, except that XYZ distributes $150 in cash to Z in liquidation of Z's interest
  - XYZ has Section 754 election in place
  - In hypothetical sale before the distribution, each partner has $30 of Section 751 gain
  - Balance Sheet before distribution

Assets	Tax	Book	Capital	Tax	Book
Cash	$260	$260	X	$120	$150
Unrealized Receivable	$0	$90	Y	$120	$150
Real Property	$100	$100	Z	$120	$150
Totals	$360	$450		$360	$450

Proposed Regulations—Example 2

- Based on hypothetical sale approach after distribution
  - What are tax consequences without regard to Section 751 & regulations?
    - C recognizes gain of $30
    - Adjustment pursuant to Section 734(b) of $30 to real property basis

Proposed Regulations– Example 2

– Balance Sheet after distribution

Assets	Tax	Book	Capital	Tax	Book
Cash	$110	$110	X	$120	$150
Unrealized Receivable	$0	$90	Y	$120	$150
Real Property	$130	$100	Z	$0	$0
Totals	$240	$300		$240	$300

Proposed Regulations—Example 2

- Z has no share of unrealized OI after the distribution
- Section 751(b) amount is $30 minus $0.
- So, Z must recognize $30 of OI using a "reasonable approach" and appropriate basis adjustments must be made
- Under the Deemed Gain Approach, Z would recognize $30 of OI
  - XYZ is deemed to recognize $30 of OI and allocate to Z. Thus, immediately before the distribution,
    - Z increases outside basis by $30
    - XYZ increases basis in unrealized receivables to $30

Proposed Regulations– Example 2

– Balance Sheet, modified as described above, immediately prior to transaction

Assets	Tax	Book	Capital	Tax	Book
Cash	$260	$260	X	$120	$150
Unrealized Receivable	$30	$90	Y	$120	$150
Real Property	$100	$100	Z	$150	$150
Totals	$390	$450		$390	$450

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Proposed Regulations– Example 2

- Now, normal distribution rules apply. Z recognizes no gain on distribution. No basis adjustment under Section 734(b)
  - Balance Sheet after distribution

Assets	Tax	Book	Capital	Tax	Book
Cash	$110	$110	X	$120	$150
Unrealized Receivable	$30	$90	Y	$120	$150
Real Property	$100	$100	Z	$0	$0
Totals	$240	$300		$240	$300

Proposed Regulations—Example 2

- Hot Asset Sale Approach
- Following are deemed to occur:
  - Z gets a distribution of unrealized receivable. FMV is $30, basis is $0
  - Z sells unrealized receivable to XYZ, recognizes OI of $30
  - XYZ has cost basis in unrealized receivable
  - Z contributes $30 to XYZ
- Normal distribution rules apply. Z does not have gain on distribution. There is no Section 734(b) basis adjustment.

Proposed Regulations

- Are the Proposed Regulations an improvement?
- Are they less complex?
- Given the statutory language of Section 751(b), is it possible to develop simple implementing regulations?

Comparing Sales and Redemptions

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Sales vs. Redemptions

In general

- Form typically determines characterization – make sure that documentation is consistent with intention for sale or redemption of interest.
- If the proportionate interests of some partners but not all partners increase, this suggests that the transaction was a sale.
- Because different rules apply the tax consequences of a sale of a partnership interest may differ significantly from those of a liquidation of the interest, even though the economic consequences of these alternatives may be very similar.

Disguised Sale of Partnership Interest

- Under Proposed § 707 Regulations, withdrawing partners generally would be treated as selling their partnership interests to continuing partners, rather than receiving liquidating distributions, where (1) the continuing partners make related contributions to the partnership and (2) based on all the facts and circumstances, the distributions to the withdrawing partners would not have been made but for the continuing partners' related contributions.
- There is a presumption in Prop. Treas. Reg. § 1.707-7(e) that if a withdrawing partner receives only cash or marketable securities (rather than property), the transaction will be treated as a distribution (rather than a sale) unless the facts and circumstances clearly indicate otherwise.

What about Two Person Partnerships?

- Rev. Rul. 99-6: The buyer is taxed as if there had been a liquidating distribution of the LLC assets to both members and assets are purchased. The seller is viewed as selling its partnership interest.

Sales vs. Redemptions

Application of Section 751 "Hot Asset" Rules

- For redemptions, Section 751 applies to narrower scope of "unrealized receivables" and applies through a deemed sale transaction giving the partnership a step-up in tax basis in those receivables (even if no Section 754 election has been made).
- Section 751 only applies to "substantially appreciated" inventory in a redemption.
- The higher tax rate on Section 1250 unrecaptured gain applies in a sale but not in a redemption of a partnership interest.

Goodwill

- For redemptions, the treatment of the redeemed partner and the remaining partners depends on whether (i) the partnership is a service partnership, (ii) the redeemed partner is a GP or LP, and (iii) the partnership agreement provides for payments with respect to goodwill.

Installment Sales

- For sales of partnership interests, gain or loss is recognized over period in which payments are made under the installment method of Section 453.
- For redemptions, basis can be recovered before gain is recognized but loss is deferred until final payment, and there is no imputed interest.
  - Important if significant pship liabilities. A seller's share of partnership liabilities must be taken into account at the time of sale under § 752(d), even if the selling partner is entitled to account for its gain under the installment method. Compare that a withdrawing partner may often be able to defer this day of reckoning under § 752(b) until the withdrawal process is complete

Sales v. Redemptions

Basis Adjustments

- In a sale, the purchasing partners have a basis step up in the partnership's assets equal to the full purchase price when payment is made (even if subsequent payments will be made as part of an installment sale).
- In a redemption, the partnership itself gets a step-up in the tax basis of its Section 751(b) "hot assets" over time as gain is recognized by the redeemed partner.

Sale v. Redemption: Hot assets in redemptions

- The definition of unrealized receivables is narrower under Section 751(b) for redemptions than for sales of partnership interests.
- Under Section 751(b), in a redemption inventory items are treated as hot assets only if they have appreciated substantially in value.
    - Section 751(b)(3)(A) defines substantial appreciation if the fair market value of the inventory exceeds 120 percent of the partnership's adjusted basis.
- The partners can agree on the properties exchanged in the Section 751(b) transaction which can affect the amount of gain recognized in the deemed sale. Treas. Reg. Section 1.751-1(g). In a sale of partnership interest there is no ability to allocate the Section 751(a) gain which applies to a pro rata interest in each partnership asset.
- Section 751(b) only applies if the deemed exchange of Section 751(b) property for other property or vice versa results in gain as opposed to Section 751(a) which applies to the amount realized.

Sale v. Redemption: Hot assets in redemptions

- In a partial redemption unlike a sale or complete redemption of a partnership interest, a book-up of capital accounts to revalue unrealized receivables can mitigate or eliminate the adverse effects of a Section 751(b) distribution.
- Since a Section 751(b) exchange requires a reduction in Section 751(b) property retained by the partnership a revaluation of capital accounts will have the effect of increasing the gross value of the zero basis unrealized receivable so that there is no reduction.
    - Under Section 704(c) principles the taxable income of the unrealized receivable is allocated to the partially redeemed partner under his pre-redemption percentage interest to reduce or eliminate a Section 751(b) distribution.
- Sale of an interest in a partnership owning real estate will trigger unrecaptured Section 1250 gain taxed at 28%. Section 1(h)(7) and Treas. Reg. Section 1.1(h)-1(b)(3).
    - No unrecaptured Section 1250 gain will be recognized in a redemption of a partnership interest. Treas. Reg. Section 1.1(h)-1(b)(3)(ii).

Sale v. Redemption: Installment Sales

- In a redemption, the installment method under Section 453 does not apply. Instead, full basis recovery is possible before gain is recognized and there is no imputed interest.
- Another important difference in the treatment of installment sales and redemptions is that, for redemptions, the partner is treated as continuing to be a partner until the last payment is received. In an installment sale, the selling partner ceases to be a partner when the first payment is made.
- If a Section 754 election has been made, the basis step up for the partnership in its assets will occur at the same time as the redeemed partner recognized gain.
- The characterization of payments made in redemption of a partner's interest in installments over several taxable years as between Section 736(a) and Section 736(b) depends on whether the payments are contingent or fixed.

Sale v. Redemption: Installment Sales

- Fixed Payments: the total Section 736(b) payments for a year are that amount that bears "the same ratio to the total fixed agreed payments for such year as the total fixed payments under Section 736(b) bear to the total fixed agreed payments under Sections 736(a) and (b)." The balance of the payments received during the year are taxed under Section 736(a).
- Contingent Payments: treated first as Section 736(b) payments to the full extent of the value of the redeemed partner's interest in Section 736(b) property, and, thereafter, as Section 736(a) payments.
- Both Fixed and Contingent: If fixed payments exceed the value of the redeemed partner's interest in Section 736(b) property, a portion of each fixed payment and all contingent payments are treated as Section 736(a) payments. Otherwise, all fixed payments are treated as Section 736(b) payments, and contingent payments are allocated first to the remaining value of the retiring partner's interest in Section 736(b) property and then to Section 736(a) payments.
- Election: Allocation may be made in any manner to which all the remaining partners and the withdrawing partner agree, provided that the total amount allocated to property under Section 736(b) does not exceed the fair market value of such property.

Stuffing Allocations

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Pre-Redemption Stuffing Allocations

- Many hedge funds use so-called “stuffing” or “fill-up” allocations which are a one-time special allocation of realized gain or loss to a partner immediately prior to that partner's redemption.
  - Most hedge funds do not make Section 754 elections because of the administrative costs if there are frequent redemptions and admissions of new partners and because many hedge funds can make a mark-to-market election under Section 475(f).
- The goal of the special allocation is to cause the partner’s tax capital account and tax basis at a level equal to what the partner receives on redemption of its interest so that the partner recognizes no additional gain in connection with the distribution in redemption of his interest.
- A stuffing allocation reduces the amount of partnership income or gain allocated to continuing partners by disproportionately allocating partnership gain or income to the redeemed partner.
- There is uncertainty regarding whether would be viewed as violating the principles of Section 704(c) or could be subject to challenge under the partnership anti-abuse rules.

Filing Considerations

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Filing Consideration for Redemptions

- Sale of an interest
  - Partner receives a final K-1 in the year of sale
  - If the sale terminates the partnership (e.g., becomes DRE) a 1065 would be required
- Compare a redemption
  - when the redemption payments are to be paid in installments, the partner is required to be treated as a partner until he has received the final payment.
  - Thus, they should receive a blank K-1 for each year until the redemption is complete.
  - If it's a 2-member partnership the partnership will remain in existence -- and thus necessitate the filing of Form 1065 -- until the redemption is complete and the final 1065 would required on the final distribution.