

LB&I Transaction Unit

Unit Name	Liquidating Distributions of a Partner's Interest in a Partnership	
Primary UIL Code	731.00-00	Extent of Recognition of Gain or Loss on Distribution

Library Level	Title
Knowledge Base	Partnership Knowledge Base
Shelf	Partnership Operations
Book	Distributions
Chapter	Liquidating Distributions

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Issue and Transaction Overview

Liquidating Distributions of a Partner's Interest in a Partnership

All partnership distributions are either current or liquidating. A liquidating distribution terminates a partner's entire interest in the partnership. A current distribution reduces a partner's capital accounts and basis in his interest in the partnership ("outside basis") but does not terminate the interest.

For current and liquidating distributions, a partner will generally not recognize gain. IRC 731(a)(1). However, gain may be recognized on the distribution of assets such as IRC 751(b) "hot" assets (inventory or unrealized receivables). IRC 751 gain arising from a distribution is treated as gain from the sale or exchange of a partnership interest and thus is generally capital gain, unless IRC 751 is applicable. IRC 741.

For current distributions, a partner recognizes gain to the extent the money he receives is greater than his outside basis immediately before the distribution. IRC 731(a)(1). A reduction of a partner's share of the partnership's liability is treated as a distribution of money under IRC 752(b) and distributions of marketable securities may also be treated as money under IRC 731(c). A partner will never recognize a loss on a current distribution. IRC 731(a)(2).

For liquidating distributions, gain is recognized to the extent money (or deemed money) distributed exceeds the partner's outside basis; loss is recognized to the extent the partner's outside basis exceeds money distributed and the basis of any hot assets distributed. A partner will not recognize a loss on a liquidating distribution if he receives any property other than money, unrealized receivables, or inventory.

Outside basis is the partner's tax basis in the partnership interest. IRC 705(a). Inside basis is the partnership's tax basis in partnership assets. In general, Subchapter K attempts to keep inside basis equal to the sum of each partner's outside basis, so a change in the partnership's inside basis is typically reflected by a corresponding change to one or more of the partners' outside bases. However, inside basis may not equal the sum of the partners' outside basis if the partnership does not have an IRC 754 election in place and one or more of the following transactions took place: 1) a partnership interest is acquired at fair market value (sale or exchange), 2) there is a basis adjustment due to the death of a partner, and 3) there is a distribution resulting in recognized gain or loss for the partner, or there is a distribution resulting in an increase or decrease in the basis of a partnership asset (excluding the application of IRC 732(d)).

Issue and Transaction Overview (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

In a liquidating distribution, the outside basis of the distributee partner must be allocated to all of the assets received in the distribution. Basis is always allocated first to money. The basis allocated to the other property distributed to a partner is generally a carryover basis from the partnership's inside basis. IRC 732(a). However, in the event there is insufficient outside basis to give each asset a carryover basis, the shortfall must be allocated. IRC 732(c). That shortfall is first allocated to the assets other than unrealized receivables and inventory. If those assets' bases are reduced to zero, then the shortfall is allocated to the unrealized receivables and inventory reducing their bases.

In the event the partner's outside basis exceeds the basis necessary to give a carryover basis, then the basis of the assets other than unrealized receivables and inventory is increased. The bases of hot assets distributed to a partner are always limited to the basis the partnership had in those assets prior to the distribution. Treas. Reg. 1.732-1(c)(1). If the distribution consists only of money, unrealized receivables, and inventory, then the partner recognizes a loss. The rules of allocation among assets are explained in more detail in the examples.

Following a distribution where a partner recognizes gain or loss or the basis of distributed assets is adjusted from their carryover basis, an inside/outside basis disparity is created. Subchapter K resolves this disparity by permitting an adjustment to the assets remaining in the partnership. IRC 734. The adjustments are made only if the partnership has an IRC 754 election or if the distribution resulted in a substantial basis reduction (that is, the sum of the loss recognized and basis reduction were more than \$250,000).

In the event that the distributee partner recognizes gain or his outside basis was insufficient to give a transferred basis to all of the assets, then IRC 734(b)(1) provides an offsetting basis increase to the assets remaining in the partnership equal to the gain recognized plus the basis shortfall. In the event the distributee partner recognizes loss or his outside basis exceeds the basis necessary to give a carryover basis, then IRC 734(b)(2) provides a basis decrease to the assets remaining in the partnership equal to the loss recognized plus excess basis. The allocation of IRC 734 adjustments among the partnership's assets is covered by IRC 755.

Issue and Transaction Overview (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

Generally, gain recognized upon a sale of hot assets following a distribution will be ordinary. IRC 735. However, in the case of inventory, if it is sold five years after the distribution, then the character of the gain is determined at the partner level.

All liquidating payments to a retiring partner or a deceased partner's successor in interest are classified as either IRC 736(a) or IRC 736(b) payments. If the payments are made as liquidating distributions for a partnership interest, they are IRC 736(b) payments and treated as received under the distribution rules set forth in IRC 731 and 732. If the payments are for a distributive share of the partnership income or guaranteed payments, they are IRC 736(a) payments. This Practice Unit does not cover these types of payments.

A partner's entire interest may be terminated through a single distribution or a series of distributions. Treas. Reg. 1.761-1(d)(1) provides that the series of distributions might occur over more than a one-year period if there is a clear plan that the distributions are being made toward the termination of the partner's entire interest in the partnership. A partner receiving a series of liquidating distributions will recognize gain only when the aggregate cash distributions exceed the partner's basis in his interest.

This Practice Unit discusses distributions in liquidation of a partnership interest. There are exceptions to the regular distribution rules under IRC 731 and 732(b) which are not covered in this Practice Unit. IRC 704(c)(1)(B) states that if a partner contributes appreciated or depreciated property to a partnership and if the partnership distributes such property to a partner other than to the original contributor within seven years, then the contributor partner may have to recognize gain or loss. Similarly, IRC 737 provides that if a partner who contributed property to a partnership receives a distribution of property other than money from a partnership, the partner recognizes gain but not loss equal to the lesser of: (1) the excess of the property's value over the partner's outside basis (reduced by any money distributed) or (2) the partner's net pre-contribution gain. Neither IRC 704(c) nor IRC 737 are covered in this Practice Unit.

In addition, this Practice Unit does not discuss in detail distributions that may be disguised sales under IRC 707.

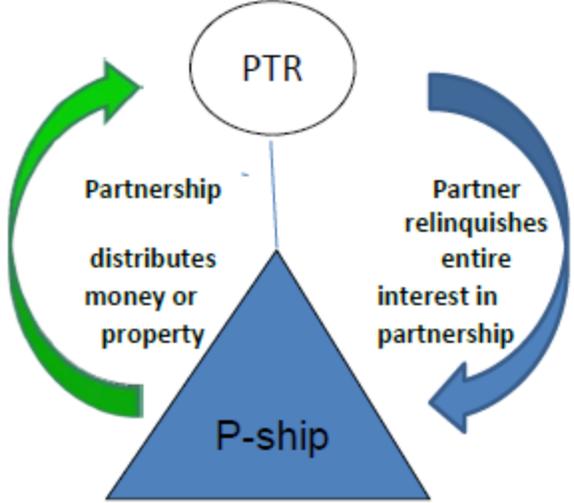
Issue and Transaction Overview (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

This Practice Unit covers the computation of gain or loss from liquidating distributions of a partnership interest consisting of cash, property, or a combination of assets including cash and property. All scenarios and examples discussed are for proportionate distributions where the distributee partner receives his proportionate share of ordinary income generating assets. A distribution is disproportionate if a partner receives more or less than his pro rata share of IRC 751(b) "hot" assets.

Transaction and Fact Pattern

Liquidating Distributions of a Partner's Interest in a Partnership

Diagram of Transaction	Facts
 <p>The diagram illustrates the liquidating distribution of a partner's interest in a partnership. It features a blue triangle labeled "P-ship" at the bottom. Above it is a white circle labeled "PTR". A green curved arrow on the left points from the "P-ship" to the "PTR", with the text "Partnership distributes money or property" next to it. A blue curved arrow on the right points from the "PTR" back to the "P-ship", with the text "Partner relinquishes entire interest in partnership" next to it.</p>	<ul style="list-style-type: none">▪ Partnership distributes money and/or property to a partner.▪ Partnership reports the distribution on Form 1065, Schedule K, line 19a for cash and marketable securities.▪ Deemed distributions (that is, reductions of the share of partnership liabilities) are not reported on the partnership return. Examiners determine the partner's share of partnership liabilities at the beginning of the year and check if there is a reduction at any time during the year.▪ Partnership reports distributions of all other property on Schedule K, line 19b and on Form 1065, Schedule M-2.▪ Liquidating partner determines if he must recognize gain or loss from the transaction on his Form 1040.

Summary of Potential Issues

Liquidating Distributions of a Partner's Interest in a Partnership

<u>Issue 1</u>	Did the partner recognize gain or loss from a cash or property distribution in liquidation of his partnership interest?
<u>Issue 2</u>	What is the partner's basis in property received in liquidation of his interest?
<u>Issue 3</u>	What is the character and holding period of the property distributed?

All Issues, Step 1: Initial Factual Development

Liquidating Distributions of a Partner's Interest in a Partnership

Determine whether a partner who received a liquidating distribution properly reported gain or loss.

Fact Element	Resources
<ul style="list-style-type: none">▪ Identify whether the partnership made a cash or property distribution. This information may be obtained by reviewing the following items:<ul style="list-style-type: none">– Form 1065, Schedule K, line 19a.– Form 1065, Schedule K, line 19b.– Form 1065, Schedule M-2.– Form 1065, Schedule K-1, Item L - Partner's Capital Account Analysis and Withdrawals and Distributions.– Form 1065, Schedule K-1 Item K- Partner's Share of Liabilities.– Form 1065, Schedule L.– Partnership agreement.– Distribution agreements.– Partner's outside basis calculation.– Basis of the asset distributed to partner from partnership depreciation schedule.– Appraisal of any IRC 751(b) property distributed.	<ul style="list-style-type: none">▪ IRM 4.10.3.3 - Interviews: Authority and Purpose▪ IRC 731▪ IRC 741▪ IRC 1411

All Issues, Step 1: Initial Factual Development (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

Fact Element	Resources
<ul style="list-style-type: none">▪ Partnership interests are capital assets. Gains or losses from sale of capital assets are reported on the partners' Forms 8949 and Schedules D. A partner may recognize a loss on a liquidating distribution if the distribution consists only of cash, inventory or unrealized receivables.▪ The net investment income tax (NIIT) which is reported on a partner's Form 8960 can potentially apply to gains reported by partners that are individuals, estates, and trusts.▪ Any post-distribution gain or loss by the partner from the sale of unrealized receivables and from inventory held for less than five years will give rise to ordinary income. These items are reported on Form 4797.▪ If the disposition takes place five years after the date of the distribution, then the character of the gain or loss depends on the inventory's character in the hands of the distributee partner at the date of sale (that is, inventory, capital asset, and trade or business asset). <p> CONSULTATION: You should consult with an engineer for material valuation issues.</p>	<ul style="list-style-type: none">▪ IRC 735▪ Treas. Reg. 1.735-1(a)(2)

Issue 1, Step 2: Review Potential Issues

Liquidating Distributions of a Partner's Interest in a Partnership

Issue 1

Did the partner recognize gain or loss from a cash or property distribution in liquidation of his partnership interest?

Explanation of Issue	Resources
<ul style="list-style-type: none"> ▪ A partner will recognize capital gain to the extent of any amount of money distributed that exceeds his outside basis. ▪ Capital Gain equals Cash Distribution minus Partner's Outside Basis. <ul style="list-style-type: none"> – Money is defined as cash, any net decrease in a partner's share of partnership liabilities, and fair market value (FMV) of marketable securities reduced by the distributee's share of net appreciation in the securities. ▪ The partner only recognizes a capital loss upon a complete liquidation of his interest and only if the amount received is less than the partner's outside basis and the distribution consists of only money, unrealized receivables and inventory. No loss is recognized if any other type of property is received in the liquidation. 	<ul style="list-style-type: none"> ▪ IRC 731(a)(1) ▪ IRC 752(b) ▪ IRC 731(c) ▪ IRC 731(a) ▪ IRC 751(d) ▪ IRC 752(b)

Issue 1, Step 2: Review Potential Issues (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 1](#)

Explanation of Issue	Resources
<p><u>Example 1</u></p> <p>A's outside basis in the XYZ partnership is \$100. In termination of his interest, he receives a liquidating distribution of \$110 cash. A recognizes a capital gain of \$10 (\$110 cash less his \$100 outside basis).</p> <p><u>Example 2</u></p> <p>A's outside basis in the XYZ partnership is \$100. In termination of his interest, he receives a liquidating distribution of \$90 cash. A recognizes a capital loss of \$10 (\$90 basis in assets received less \$100 outside basis).</p> <p><u>Example 3</u></p> <p>A's outside basis in the XYZ is \$100. He receives a proportionate liquidating distribution of \$20 cash and inventory with a basis to the partnership of \$70. A recognizes a capital loss of \$10 (\$90 basis in assets received (\$20 cash and \$70 inventory) less \$100 outside basis).</p>	<ul style="list-style-type: none">▪ <i>Practitioners Publishing Company (PPC) - 1065 Deskbook, Key Issue 33D</i> ▪ IRC 731(a)(2)

Issue 1, Step 3: Additional Factual Development

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 1](#)

Fact Element	Resources
<ul style="list-style-type: none">▪ Determine if a distribution is current or liquidating.<ul style="list-style-type: none">– Review Schedule K-1 for changes in ownership and the complete liquidation of a partner's interest in the partnership.▪ Determine if the distribution is part of a disguised sale.▪ Determine the purpose of the distribution.<ul style="list-style-type: none">– Was it for payment of a partnership interest, for a distributive share of partnership income, or a guaranteed payment?▪ Determine if there is a disproportionate distribution of IRC 751 property. Disproportionate distributions are those that change the partners' relative ownership of IRC 751 property (unrealized receivables and substantially appreciated inventory).▪ Determine if marketable securities were distributed.<ul style="list-style-type: none">– These are generally treated as money received and may affect the calculation of any gain or loss.	<ul style="list-style-type: none">▪ Form 1065, Schedule K-1 - <i>Partner's Share of Income, Deductions, Credits, etc.</i>, Sections J – L▪ IRC 707(a)(2)(B)▪ IRC 736(a)▪ IRC 736(b)▪ IRC 707(c)▪ IRC 751(b) ▪ IRC 731(c)

Issue 1, Step 3: Additional Factual Development (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 1](#)

Fact Element	Resources
<ul style="list-style-type: none">▪ If distributed property was encumbered by a liability and if the distributee takes the property subject to the liability, he will be deemed to have contributed money to the extent his share of the liability increases. If the partner is relieved of any liabilities remaining in the partnership, then he will be deemed to have received a distribution to the extent of that relief. Any increases and decreases in the distributee partner's share of partnership liabilities are treated as occurring simultaneously and are netted to compute any gain or loss to the distributee or the other partners.<ul style="list-style-type: none">– If the net decrease in liabilities is greater than a partner's outside basis, the excess is treated as distribution of money in excess of basis and gives rise to capital gain.▪ The other partners' net shares of liabilities are decreased to the extent the distributee partner's net share of liabilities is increased and they are treated as having received a distribution of money.	<ul style="list-style-type: none">▪ IRC 752(a) and (b)▪ Treas. Reg. 1.752-1(f)▪ Rev. Rul. 87-120▪ IRC 731(a)

Issue 1, Step 3: Additional Factual Development (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 1](#)

Fact Element	Resources
<ul style="list-style-type: none">▪ Verify partners' outside basis:<ul style="list-style-type: none">– Review prior year partnership returns.– Request the distributee partner's outside basis schedule.– Verify prior changes in partners' capital contributions and purchase interests in the partnership.– If there were distributions in excess of basis, verify that the distributee partner reported resulting gain as income.– Request partnership tax capital account details, including schedules, documents, and workpapers showing contributions, distributions and allocations for each partner for the current and prior seven years. Inquire about the tax basis of contributed property.– Obtain a copy of each partner's tax capital account, if available.– Obtain a schedule showing how liabilities were allocated among partners.▪ Verify partnership basis in property distributed. If material, verify that the distributee partner accounted for basis correctly.	<ul style="list-style-type: none">▪ Electronic User Portal (EUP)▪ yK1▪ IRC 705(b) ▪ IRC 732

Issue 1, Step 3: Additional Factual Development (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

Issue 1

Fact Element	Resources
<ul style="list-style-type: none"> ▪ If inventory was distributed, verify FMV of property or inventory (substantially appreciated inventory). ▪ If a distribution is part of a series of distributions in liquidation of a partner's interest, no gain is recognized until the distributee partner's outside basis has been fully recovered. If the liquidation results in a loss because the partner receives only money, unrealized receivables, and inventory, the partner cannot deduct the loss until he has received all the liquidating distributions. ▪ Obtain an engineer or valuation specialist if necessary. <p> CAUTION: A series of distributions resulting in a liquidation can take place over more than one tax year, so it is important to look at subsequent year distributions to determine if a liquidating distribution took place.</p> <p> CAUTION: If there is a distribution of money or property within two years of contribution of money or property by the distributee partner, the disguised sale rules presume a disguised sale occurred involving the distributee partner.</p>	<ul style="list-style-type: none"> ▪ IRC 751(b)(3) ▪ Treas. Reg. 1.731-1(a) ▪ Treas. Reg. 1.761-1(d) ▪ IRC 707(a)(2)(B) ▪ Treas. Reg. 1.707-3

Issue 1, Step 4: Develop Arguments

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 1](#)

Explanation of Adjustment	Resources
<ul style="list-style-type: none">▪ Identify what was received and determine if the partner should recognize gain or loss from the liquidating distribution:<ul style="list-style-type: none">– Gain is recognized if money received (including net debt relief) exceeds basis.– No loss is recognized if property other than money, unrealized receivables, and inventory are received.▪ Review the liquidated partner's return to determine if the partner properly recognized the liquidating distribution. <p> CAUTION: When inspecting a partner's return, be alert to losses claimed in a liquidating distribution where the partner continues to hold a partnership interest. A partner must completely liquidate his interest before a loss on liquidation is allowable.</p> <p> CAUTION: Gains from the sale of interests in partnerships, including a partner's liquidation gains (to the extent the partner was a passive owner) is considered Net Investment Income, for purposes of the Net Investment Income Tax.</p>	<ul style="list-style-type: none">▪ IRC 731 ▪ IRC 731 ▪ IRC 1411▪ Treas. Reg. 1.1411-5

Issue 2, Step 2: Review Potential Issues

Liquidating Distributions of a Partner's Interest in a Partnership

Issue 2

What is the partner's basis in property received in liquidation of his interest?

Explanation of Issue	Resources
<p><u>Allocation of Basis Among Distributed Assets</u></p> <ul style="list-style-type: none">▪ When a partnership distributes property in a liquidating distribution, the recipient partner's outside basis reduced by any amount of cash included in the distribution is allocated to the distributed property.▪ Any remaining outside basis, after being reduced by cash, is first allocated to hot assets equal to the partnership's inside basis in those assets.▪ If there is insufficient outside basis to allocate a carryover basis to all hot assets, the shortfall is allocated as such:<ul style="list-style-type: none">– First, to reduce the bases of any depreciated assets (unrealized depreciation) to reduce all differences between values and bases, proportionately.– Then, any further shortfall is allocated in proportion to the bases as adjusted.– Any remaining other property distributed (property other than hot assets) takes a basis of zero.	<ul style="list-style-type: none">▪ IRC 732(b) ▪ IRC 751(c) ▪ IRC 732(c)▪ Treas. Reg. 1.732-1(c)

Issue 2, Step 2: Review Potential Issues (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 2](#)

Explanation of Issue	Resources
<p><u>Allocation of Basis Among Distributed Assets (cont'd)</u></p> <ul style="list-style-type: none">▪ Next, any remaining basis is then allocated to other assets (that is, a carryover basis can be given to the hot assets and there is allocable basis remaining).▪ If the outside basis is less than the assigned basis (that is, there is not sufficient outside basis to allocate a carryover basis to all the other assets), then the shortfall is allocated as such:<ul style="list-style-type: none">– First, to reduce the bases of any depreciated assets (unrealized depreciation) to reduce all differences between values and bases, proportionately.– Then, any remaining shortfall should be allocated to all other assets distributed to reduce their bases proportionately.	

Issue 2, Step 2: Review Potential Issues (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 2](#)

Explanation of Issue	Resources
<p><u>Example 4</u></p> <p>A's outside basis is \$20,000. He receives properties C and D in liquidation of his partnership interest. Neither property is inventory or unrealized receivables. Property C's FMV and adjusted basis to the partnership are \$15,000. Property D has an adjusted basis to the partnership of \$15,000 and a FMV of \$5,000.</p> <p>Because A's outside basis of \$20,000 is \$10,000 less than the partnership's aggregate \$30,000 bases in assets C and D, he must reduce his basis in one or more of those assets. A first reduces the basis of any assets that have depreciated in value relative to basis (unrealized depreciation) in proportion to each asset's unrealized depreciation to the total unrealized depreciation in distributed assets. Since only property D has unrealized depreciation, the entire \$10,000 basis decrease is allocated to property D. A takes a carryover basis in Property C of \$15,000 and a basis in property D of \$5,000.</p> <p>Note if the partnership had an IRC 754 election, then it would be required to make a positive \$10,000 basis adjustment to the assets remaining in the partnership.</p>	<ul style="list-style-type: none">▪ IRC 734(b)(2)

Issue 2, Step 2: Review Potential Issues (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 2](#)

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ If a partner's outside basis is greater than the sum of money and the partnership's (inside) basis received, then the excess is allocated to increase the basis of assets other than hot assets:<ul style="list-style-type: none">– First to the partnership's pre-distribution (inside) basis in those other assets.– Then, to increase the basis of appreciated assets received in proportion to their unrealized appreciation.– Any remaining basis is allocated to all other assets in proportion to their fair market values. <p> CAUTION: The basis of hot assets in the hands of a partner cannot exceed the inside basis in the hands of the partnership.</p>	<ul style="list-style-type: none">▪ IRC 732(c)▪ Treas. Reg. 1.732-1(c)(2)(ii) ▪ IRC 732

Issue 2, Step 2: Review Potential Issues (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 2](#)

Explanation of Issue	Resources
<p><u>Example 5</u></p> <p>A's outside basis is \$55,000. He receives properties C and D in liquidation of his entire partnership interest. Neither property is inventory or unrealized receivables. Property C's adjusted basis to the partnership is \$5,000 with a FMV of \$40,000. Property D has an adjusted basis to the partnership and FMV of \$10,000.</p> <p>Because A's basis in his partnership interest (\$55,000) is greater than the partnership's basis in the assets distributed to A (\$15,000) and because those assets are neither money nor inventory or unrealized receivables, the bases of assets C and D must be increased. To calculate his basis in each property, A first assigns bases of \$5,000 to Property C and \$10,000 to property D (their adjusted bases to the partnership). This leaves a \$40,000 basis increase (\$55,000 allocable bases less the \$15,000 total assigned bases). He first allocates \$35,000 to Property C (its unrealized appreciation). Because he is increasing the basis of the remaining properties, the remaining \$5,000 is allocated between the properties based on their relative fair market values. Property C is allocated an increase in basis of \$4,000 (\$40,000 divided by \$50,000) and property D is allocated a basis of \$1,000 (\$10,000 divided by \$50,000). A's post-distribution basis in Property C is \$44,000 (\$5,000 plus \$35,000 plus \$4,000) and his basis in Property D is \$11,000 (\$10,000 plus \$1,000).</p>	

Issue 2, Step 2: Review Potential Issues (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 2](#)

Explanation of Issue	Resources
<p><u>Example 5 (cont'd)</u></p> <p>Note if the partnership had made an IRC 754 election, then it would be required to make a negative \$40,000 basis adjustment to the assets remaining in the partnership.</p>	<ul style="list-style-type: none">▪ IRC 734(b)(2)

Issue 2, Step 3: Additional Factual Development

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 2](#)

Fact Element	Resources
<ul style="list-style-type: none"> ▪ Determine the partnership's pre-distribution (inside) basis in property distributed: <ul style="list-style-type: none"> – Verify the purchase price of assets purchased by the partnership. – Verify tax depreciation claimed by the partnership. – Verify basis of property contributed by partners. ▪ Determine if the partnership has made an IRC 754 election: <ul style="list-style-type: none"> – Review partnership agreement for the identification of a 754 election. – Review prior year Forms 1065 - <i>U.S. Return of Partnership Income</i>. – Have any IRC 754 elections been revoked? – Does question 12 of Schedule B, Form 1065 indicate an IRC 754 election? – Request IRC 743/734 calculations. – If there was no IRC 754 election, did a substantial basis reduction (734(d)) or substantial built-in loss adjustment (743(d)) in the current year or previous year occur? – Review tax depreciation schedule. – Review appraisal report. 	<ul style="list-style-type: none"> ▪ Form 1065, Schedule M-3 – <i>Net Income (Loss) Reconciliation for Certain Partnerships</i> ▪ IRC 754 ▪ Form 1065, Schedule B - <i>Other Information</i> ▪ Form 1065, Schedule M-3 – <i>Net Income (Loss) Reconciliation for Certain Partnerships</i>

Issue 2, Step 3: Additional Factual Development (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 2](#)

Fact Element	Resources
<p> CAUTION: If the partnership has an IRC 754 election in place and a distribution of assets is made to a partner, the partnership may be required to adjust the basis of its remaining assets. The amount of the adjustment required under IRC 734(b) is determined by reference to the amount of gain or loss reported by the distributee partner or the difference between the basis of the property when held by the partnership and the partner's basis in the property after distribution. If there is a "substantial basis reduction," the partnership is required to adjust the inside basis of partnership property regardless of whether or not the partnership has made an IRC 754 election.</p> <ul style="list-style-type: none">▪ A substantial basis reduction resulting from a distribution exists if the sum of the following amounts exceeds \$250,000:<ul style="list-style-type: none">– The amount of loss recognized by the distributee partner on a distribution in liquidation of the partner's interest in the partnership, and– The excess of the basis of the distributed property to the distributee partner (determined under IRC 732) over the adjusted basis of the distributed property to the partnership immediately before the distribution (as adjusted by IRC 732(d)).	<ul style="list-style-type: none">▪ IRC 734(b)▪ IRC 734(d)▪ IRC 732(d)

Issue 2, Step 3: Additional Factual Development (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 2](#)

Fact Element	Resources
<ul style="list-style-type: none">▪ Identify type of assets distributed to distributee partner:<ul style="list-style-type: none">– Determine if the distributee partner assumed liabilities associated with distributed assets.– Verify assets distributed to partner in liquidation.– Request list of assets distributed.– Request liquidation agreement from partnership.– Consider interviewing partners if agreements are not available. <p> CAUTION: IRC 732(d) applies a special rule for a transferee who acquires his partnership interest within two years of receiving a distribution. In that scenario if an IRC 754 election were in effect, the partner may have had an IRC 743(b) adjustment to the basis of the partnerships assets. IRC 732(d) provides that upon distribution even if an IRC 754 election was not in effect, the partner may nevertheless elect to adjust the basis of the property under IRC 743(b).</p>	<ul style="list-style-type: none">▪ IRC 732(d)▪ Treas. Reg. 1.732-1(d)

Issue 2, Step 4: Develop Arguments

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 2](#)

Explanation of Adjustment	Resources
<p>In making adjustments to a liquidating distribution, verify the type of property received. Then,</p> <ul style="list-style-type: none">▪ Determine that the partner's outside basis is reduced by the amount of money (or money equivalent) the partner received in the liquidating distribution.▪ Follow ordering rules to allocate basis first to hot assets.▪ Determine if the partner's remaining (outside) basis in the partnership interest is less than or greater than the partnership's (inside) basis in property distributed:<ul style="list-style-type: none">– If partner's (outside) basis is less than property distributed, follow example 4.– If partner's (outside) basis is greater than property distributed, follow example 5.	<ul style="list-style-type: none">▪ IRC 732▪ IRC 751▪ IRC 732

Issue 3, Step 2: Review Potential Issues

Liquidating Distributions of a Partner's Interest in a Partnership

Issue 3

What is the character and holding period of the property distributed?

Explanation of Issue	Resources
<p>▪ A distributee partner's gain or loss on a post-distribution disposition of unrealized receivables will be ordinary regardless of the distributee partner's holding period. Unrealized receivables include the following items:</p> <ul style="list-style-type: none">– Rights to payments not already included in income for goods and services.– IRC 1245 and IRC 1250 property.– Mining property for which exploration expenses were deducted.– Franchises trademarks and tradenames. <p><u>Example 6</u></p> <p>A, a distributee partner, receives his share of accounts receivable when his law firm dissolved. The partnership uses the cash basis of accounting, so the receivables have a zero basis. A will have ordinary income when he collects the receivables.</p>	<ul style="list-style-type: none">▪ IRC 751(c)▪ IRC 735(a)

Issue 3, Step 2: Review Potential Issues (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

Issue 3

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ If an inventory item appreciates in value in the distributee partner's hands, the post-distribution appreciation will also be subject to the five-year ordinary income taint period.▪ The partner's holding period for property distributed to him generally includes the partnership's holding period.▪ This does not apply in determining the five-year rule for inventory items. The five-year period starts with the date of the distribution. The distributee does not include the partnership's holding period for the distributed inventory.▪ The ordinary income taint will remain with hot assets even if the distributee partner subsequently contributes such property to another entity in a nonrecognition transaction. In such cases, ordinary income items will retain their ordinary income character in the hands of a transferee partnership permanently for unrealized receivables and, in the case of inventory, for a five-year period.▪ A distributed capital asset is not necessarily a capital asset in the hands of the distributee partner. If the distributee partner uses an asset distributed by a partnership as inventory (that is, a partnership distributes undeveloped land held for appreciation to a partner who develops it into lots to be sold to homeowners) the nature of the asset in the distributee's hands controls, subject to the previously stated rules.	<ul style="list-style-type: none">▪ IRC 735(b)▪ Treas. Reg. 1.735-1(b)▪ IRC 1223(2) ▪ IRC 735(b)▪ IRC 735(a)

Issue 3, Step 3: Additional Factual Development

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 3](#)

Fact Element	Resources
<ul style="list-style-type: none">▪ Review tax depreciation schedule.▪ Determine when partnership obtained property.▪ Determine how the partnership obtained property.▪ Verify tax depreciation claimed by the partnership.▪ Verify holding period of property contributed by partners.▪ Determine if the partnership made an IRC 754 election. See Issue 2, Step 3.▪ Determine the character, holding period, and basis of assets distributed to a partner in liquidation of his interest.<ul style="list-style-type: none">– Request list of assets distributed.– Request the liquidation agreement and any relevant workpapers or correspondence.<ul style="list-style-type: none">▪ Consider interviewing partners if these items are not available.▪ Consider requesting correspondence with partners.	<ul style="list-style-type: none">▪ Form 1065, Schedule M-3 <i>-Net Income (Loss) Reconciliation for Certain Partnerships</i>

Issue 3, Step 4: Develop Arguments

Liquidating Distributions of a Partner's Interest in a Partnership

[Issue 3](#)

Explanation of Adjustment	Resources
<p>To develop arguments for the character of gain and holding period of property distributed:</p> <ul style="list-style-type: none">▪ Verify the type of property distributed.<ul style="list-style-type: none">– Gain from unrealized receivables is ordinary income regardless of holding period.▪ Determine if inventory is distributed.<ul style="list-style-type: none">– Gain or loss from disposition of inventory is ordinary income if sold within five years of distribution.▪ The partner's holding period for capital assets distributed to him generally includes the partnership's holding period.<ul style="list-style-type: none">– Verify how the partnership acquired the distributed property, which could affect the holding period.	<ul style="list-style-type: none">▪ IRC 751(c)▪ IRC 735(a) ▪ Treas. Reg. 1.735-1(a)(2)▪ IRC 751(d) ▪ IRC 735(b)

Index of Referenced Resources

Liquidating Distributions of a Partner's Interest in a Partnership

IRC 704

IRC 705

IRC 707

IRC 731

IRC 732

IRC 734

IRC 735

IRC 736

IRC 737

IRC 741

IRC 743

IRC 751

IRC 752

IRC 754

IRC 755

IRC 1223(2)

Index of Referenced Resources (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership
IRC 1245
IRC 1250
IRC 1411
Treas. Reg. 1.707-3
Treas. Reg. 1.731-1
Treas. Reg. 1.732-1
Treas. Reg. 1.735-1
Treas. Reg. 1.752-1(f)
Treas. Reg. 1.761-1(d)
Treas. Reg. 1.1411-5
Rev. Rul. 87-120
Form 1040 - <i>U.S. Individual Income Tax Return</i>
Form 1065 - <i>U.S. Return of Partnership Income</i>
Form 1065, Schedule B - <i>Other Information</i>
Form 1065, Schedule K - <i>Partners' Distributive Share Items</i>
Form 1065, Schedule K-1 - <i>Partner's Share of Income, Deductions, Credits, etc.</i>

Index of Referenced Resources (cont'd)

Liquidating Distributions of a Partner's Interest in a Partnership

Form 1065, Schedule L - *Balance Sheets per Books*

Form 1065, Schedule M-2 - *Analysis of Partners' Capital Accounts*

Form 1065, Schedule M-3 - *Net Income (Loss) Reconciliation for Certain Partnerships*

Form 4797 - *Sales of Business Property*

Form 8949 - *Sales and Other Dispositions of Capital Assets*

IRM 4.10.3.3 - Interviews: Authority and Purpose

Training and Additional Resources

Liquidating Distributions of a Partner's Interest in a Partnership	
Type of Resource	Descriptions
Databases / Research Tools	<ul style="list-style-type: none">▪ Employee User Portal (EUP)▪ yK1
Reference Materials	<ul style="list-style-type: none">▪ <i>Practitioners Publishing Company (PPC) - 1065 Deskbook Ch. 33D</i>
Other Training Materials	<ul style="list-style-type: none">▪ <i>Partnership Distributions - ITM 76247r</i>▪ <i>Partnership Training, Lesson 9, Distributions - ELMS 34981</i>

Glossary of Terms and Acronyms

Term/Acronym	Definition
EUP	Employee User Portal
FMV	Fair Market Value
yK1	yK1 Link Analysis Tool

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit
	None at this time.