

Dispositions and Partial Dispositions of a Partnership Interest

By Howard E. Abrams¹

Howard Abrams demonstrates the computation of gain or loss on the sale of a partnership in cases where some, but not all, of the partner's interest is sold or if the selling partner has been allocated a share of the entity's indebtedness.

Introduction

While the computation of gain or loss on the sale of a partnership interest seems easy to determine, it can be problematic if some, but not all, of the partner's interest is sold. In addition, if the selling partner has been allocated a share of the entity's indebtedness under Code Sec. 752, a naive application of the usual debt allocation rules can produce results that are inconsistent with the underlying economics of the transaction. Finally, determining the ancillary tax consequences of the sale, including the proper post-sale sharing of built-in asset gain can be complex, especially when the selling partner has received a debt-financed distribution prior to the partial disposition. Fortunately, by ensuring symmetric tax consequences between the selling and purchasing taxpayers, sensible results can be reached.

A partner might sell some, but not all, of her interest in a partnership. There is surprisingly little authority on the proper tax treatment of such a partial disposition, but the basics are clear. Gain or loss is determined by comparing the amount realized by the selling partner with the selling partner's adjusted basis in the interest sold.² Yet, in anything other than the simplest cases, this rule becomes surprisingly hard to apply. In addition, the disposition of a partnership

interest can trigger a basis adjustment under Code Sec. 743(b) and can implicate Code Sec. 704(c) as well, raising additional complexities.

The selling partner's adjusted basis in the interest sold is a portion of her total outside basis, with that total outside basis "equitably apportioned" between the interest sold and the interest retained.³ Note that while no statutory provision or regulation expressly says so, it is the government's position that a partner has a single outside basis for her partnership interest, even if the partner owns multiple partnership interests in the same partnership.⁴ This position is consistent with the rule that a partner has a single capital account in a partnership, even if the partner owns multiple interests of different classes (such as a general partnership interest and a limited partnership interest).⁵ After the sale, the capital account of the selling partner that is attributable to the transferred interest carries over to the transferee partner.⁶

No Partnership Liabilities

Partial Sale of a Single Interest

If a partner owns a single partnership interest and sells a portion of that interest, the portion of the selling partner's adjusted basis allocable to the interest sold should be the same proportion of the total outside basis as the value of the sold interest bears to the selling partner's total interest. So, for example, if a partner owning a partnership interest worth \$15,000

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sells a portion of that interest for \$5,000, the selling partner should allocate one-third of her outside basis to the sale. If the selling partner's outside basis immediately before the sale equaled \$12,000, one-third of that basis would be allocated to the portion of the partnership interest sold and so the selling partner should recognize gain on the sale of \$1,000.

Sale of One Interest Out of Many

Suppose T joins the P partnership by contributing cash of \$5,000 in exchange for a general interest in the partnership. Sometime later, T contributes additional cash of \$7,000 in exchange for a limited interest in the venture. Later still (after income and loss has been earned by the partnership and allocated among the partners and distributions have been made), when T's outside basis again equals \$12,000, T sells her limited interest for \$5,000. Assume that, at the time of sale, the combined value of T's interests in the partnership equals \$15,000.

As in the example immediately above, T should recognize gain on the sale of \$1,000 because T's outside basis should be allocated between the interest sold and the interest retained based on relative fair market values. It might seem as if T should somehow track her separate basis in the two interests, accounting for distributive shares of each interest and distributions on each interest. Commentators do not agree with this approach,⁷ though, and the IRS requires that the partner's unitary basis be allocated in proportion to relative values.⁸

Partnership Liabilities Are Present

If the partnership has leveraged its assets, then the selling partner must account for the inside debt in computing gain from the sale of the partial interest. Again, there are no special statutory rules, suggesting that the debt implications of the sale will work out simply by applying the rules of Code Sec. 752. Alas, it is much more complicated than that.

The regulations provide that a reduction in a partner's share of partnership liabilities arising from the sale or exchange of an interest in the partnership is treated as an "amount realized" on the sale or exchange.⁹ Thus, rather than treat such a reduction as a deemed distribution of cash, we treat the reduction as cash received on the sale. But, are there any tax implications arising from a partner's share of the debt that is not shifted as part of the sale?

Consider the following example. X and Y each own one-half of the XY partnership. XY owns Blackacre with inside basis of \$400, fair market value of \$500, and subject to a debt of \$380, *i.e.*, there is \$120 of net equity value in the partnership. Each partner has an outside basis in her partnership interest of \$200. Y sells one-half of his interest (that is, 25% of the partnership) to Z for \$30, and assume that one-quarter of the debt shifts to Z as a result of the sale. Y's gain on the sale equals \$25, computed as follows: amount realized of \$30 (for the cash) + \$95 (for the debt) less allocable basis of \$100 equals \$25. Because the property has a built-in gain of \$100 and Y has, in effect, sold a one-quarter interest in the property, the \$25 of gain recognition by Y on the sale is correct.

But suppose none of the debt shifts to Z. For example, the debt might be nonrecourse to the partnership with guarantees by X and Y, and Z might purchase half of Y's interest in the venture but be unwilling to guarantee repayment of the debt. Now, how is Y's gain on sale computed? If we simply apply the rule of Code Sec. 1001 as before, but remove the debt shift from Y's amount realized, then we get the peculiar result that Y recognizes a loss of \$70 (amount realized is reduced to \$30 while Y's allocable adjusted basis remains \$100). But the partnership's asset has appreciated!

The IRS has responded to this issue, taking the position that when an existing partner sells a portion of its partnership interest, the selling partner must exclude from basis her share of entity-level debt that does not shift as a result of the sale.¹⁰ Under this Revenue Ruling:

In cases where the partner's share of all partnership liabilities does not exceed the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the transferor partner shall first exclude from the adjusted basis of such partner's entire interest an amount equal to such partner's share of all partnership liabilities A part of the remaining adjusted basis (if any) shall be allocated to the transferred portion of the interest according to the ratio of the fair market value of the transferred portion of the interest to the fair market value of the entire interest. The sum of the amount so allocated plus the amount of the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest (under Code Sec. 752(d) of the Code and section 1.1001-2 of the regula-

tions) equals the adjusted basis of the transferred portion of the interest.

On the other hand, if the partner's share of all partnership liabilities exceeds the adjusted basis of such partner's entire interest (including basis attributable to liabilities), the adjusted basis of the transferred portion of the interest equals an amount that bears the same relation to the partner's adjusted basis in the entire interest as the partner's share of liabilities that is considered discharged on the disposition of the transferred portion of the interest bears to the partner's share of all partnership liabilities, as determined under section 1.752-1(e).

While this Ruling spoke to a partner who owned both a general partnership interest and a limited partnership interest, in one Field Service Advice this approach was extended to all partial sales of partnership interests.¹¹ On the facts above, this would mean that Y's amount realized is \$30 and Y's adjusted basis is \$5 (one-half of \$100 outside basis reduced by one-half of \$195 share of the debt), yielding a taxable gain of \$25. While this surely is the correct result, it is hard to find any statutory or regulatory authority for the computation.

Indeed, Y's pre-sale outside basis (that is, Y's adjusted basis in his partnership interest) unambiguously equals \$200 because it includes Y's \$190 share of debt. Longstanding regulations provide that "when a part of larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts."¹² But Rev. Rul. 84-53 does not so much *apportion* the taxpayer's outside basis as *defer* its use. To see this, note that if the taxpayer had sold the other half of the partnership interest, the tax result would be the same. That is, Rev. Rul. 84-53, in effect, allocates all of the taxpayer's debt basis to whatever portion of the partnership interest is retained rather than sold. This does not seem like an equitable apportionment, but does produce the correct result.

Dispositions After Debt-Financed Distributions

In each of the examples that follow, X owns 60 percent and Y owns 40 percent of the profits and losses

of XY, a limited liability company that is taxed as a partnership. The partnership owns a single, nondepreciable asset with inside basis and book value of \$0 and fair market value of \$2,000. Each partner has a zero capital account and zero outside basis. The partnership has an election under Code Sec. 754 in effect, and the partnership agreement provides that the book value of its assets will be revalued and the capital accounts restated as permitted by Regulation §1.704-1(b)(2)(iv)(f). Neither partner has a deficit restoration obligation.¹³

Complete Sale of a Partnership Interest with Debt Shift

XY borrows \$500, pledging its property as security. The loan proceeds are distributed to the partners in proportion to their interests in the venture. Y then sells her interest for its current fair market value of \$600 to third-party Z (*i.e.*, for the \$2,000 value less the \$500 debt, times Y's 40 percent share). The books of the venture are as shown in Chart 1.

Chart 1

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	Initial values
0	300	0	200	0	0	Borrowing
1200	0	800	0	0	0	Revaluation ¹
(300)	(300)	(200)	(200)	0	0	Distribution
0	0	—	—	600	800	Sale by Y to Z
\$ 900	\$ 0	\$ 0	\$ 0	\$ 600	\$ 800	Ending Values

¹ In each of the examples, I treat the partnership distribution as allowing a revaluation of the partnership's assets and a restatement of the partners' capital accounts. But it is not clear that the regulations permit a revaluation when the distribution is pro rata. See Reg. §1.704-1(b)(2)(iv)(f), authorizing a revaluation "[i]n connection with the liquidation of the partnership or a distribution of money or other property (other than a *de minimis* amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership." Every distribution is "consideration for an interest in the partnership" in the sense that the distributee's ownership of the venture declines (because the distributee's capital account is reduced by the distribution), but it is possible that the drafters of the regulation intended to limit its application to situations where the distributee's proportionate share of the venture is reduced. The analysis is not fundamentally different if a revaluation is not made, but the computations can be more complicated. I assume that some revaluation event occurs immediately prior to the relevant event to simply the discussion.

On the sale by Y, there is an amount realized of \$800, comprised of the cash of \$600 and the debt shift to Z of \$200. Because Y's outside basis equals \$0, that produces a gain to Y of \$800. Z's outside basis equals \$800 (cash paid of \$600 plus debt share of \$200), and Z will enjoy an outside basis adjust-

ment of \$800, computed as follows. The adjustment equals Z's outside basis of \$800 less Z's share of the partnership's inside basis.¹⁴ Z's share of the inside basis equals Z's share of the partnership's previously taxed capital plus Z's \$200 share of the partnership's liabilities.¹⁵ Z's share of the partnership's previously taxed capital equals \$600 (the amount Z would receive in a final liquidation of the partnership after all the assets were sold for current fair market value) less \$800 (the amount of taxable gain that Z would be allocated on a sale by the partnership of all of its assets), or negative \$200.¹⁶ Accordingly, Z's share of the inside basis equals negative \$200 plus \$200 (debt share), for zero. Z's adjustment under Code Sec. 743 therefore equals \$800 less zero, or \$800. This adjustment precisely equals Z's share of the built-in gain in the partnership's asset,¹⁷ so that if the property is sold immediately after Z purchases Y's interest, Z's net income recognition will equal \$0.

Complete Sale of a Partnership Interest Without a Debt Shift to the Purchaser

Reconsider the example above, but assume that the loan was guaranteed by X and Y so that, when Z joins the venture, Y's share of the debt shifts to X rather than to Z. Remarkably, little of the analysis changes. The books change as reflected in Chart 2.

Chart 2

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	Initial values
0	300	0	200	0	0	Borrowing
1200	0	800	0	0	0	Revaluation
(300)	(300)	(200)	(200)	0	0	Distribution
0	200	—	—	600	600	Sale by Y to Z
\$ 900	\$ 200	\$ 0	\$ 0	\$ 600	\$ 600	Ending Values

The computation of Y's gain does not change (*i.e.*, the gain remains \$800). That is, Y's gain does not change whether her debt share shifts to Z or to X. Of course, X's outside basis now increases by \$200 (for the additional debt share), while Z's outside basis equals only the \$600 cash paid by Z for Y's interest. Does the Code Sec. 743(b) adjustment change? It does not, as computed below.

The basis adjustment equals Z's outside basis of \$600 less Z's share of the partnership's inside basis.

Z's share of the inside basis equals Z's share of the partnership's previously taxed capital plus Z's \$0 share of the partnership's liabilities.¹⁸ Z's share of the partnership's previously taxed capital equals \$600 (final capital account balance) less \$800 (distributive share from hypothetical sale by partnership of assets), or negative \$200. Accordingly, Z's share of the inside basis equals negative \$200 plus \$0 (debt share), or negative \$200.¹⁹ Accordingly, Z's adjustment under Code Sec. 743 equals \$600 less negative \$200, or \$800. This adjustment precisely equals Z's share of the built-in gain in the partnership's asset, so that if the property is sold immediately after Z purchases Y's interest, Z's net recognition will equal \$0. Note, in particular, that the amount of the Code Sec. 743(b) adjustment is unaffected by the debt shifting to X rather than to Z.²⁰

Partial Sale of a Partnership Interest Without a Debt Shift

XY borrows \$500, pledging its property as security with a guarantee by X and Y. The loan proceeds are distributed to the partners in proportion to their interests in the venture. Y then sells one-half of her 40-percent interest for its current fair market value (\$300) to third-party Z. The books of the venture now appear as shown in Chart 3.

How is the debt allocated among X, Y and Z?²¹ Because of the guarantee by X and Y, the debt is allocated under the recourse debt rules of Code Sec. 752. Further, because Z has not assumed any personal liability for the debt, Z's share is zero. Assuming that X and Y each remain liable as before, there is no debt shift by reason of the distribution or the sale by Y.

We know that Z, as the purchaser of a portion of Y's interest, must succeed to a portion of Y's capital account. Because the partnership has net equity of \$2,000 and, if it were to liquidate, that equity would be distributed \$900 to X, \$300 to Y, and \$300 to Z, we know that Z's capital account must be equal to \$300 (and so Y's capital account must be reduced by the same amount). Further, because all of Y's capital account was a reverse-704(c) layer (*i.e.*, it was all attributable to the revaluation), it must be the case that Z's share of the partnership's reverse-704(c) layer equals the entire \$300 in Z's capital account.

On the sale of one-half of Y's interest to Z, Y's amount realized equals \$300 (all from the cash), and so Y's recognized gain also equals \$300.²² Because

Chart 3

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	Initial values
0	300	0	200	0	0	Borrowing
1200	0	800	0	0	0	Revaluation
(300)	(300)	(200)	(200)	0	0	Distribution
0	0	(300)	0	300	300	Sale by Y to Z
\$ 900	\$ 0	\$ 300	\$ 0	\$ 300	\$ 300	Ending Values

Z has purchased one-half of Y's partnership interest, it seems as though Z should acquire one-half of the built-in gain previously allocated to Y under the rule that the capital account of a transferee of a partnership interest must be credited with that portion of "the capital account of the transferor that is attributable to the transferred interest carries over to the transferee partner."²³ On this reading, Z should acquire \$400 of the built-in gain in the asset. To be sure, we know that Z's capital account equals only \$300, but surprisingly that does not necessarily limit the amount of Z's share of the reverse-704(c) gain. To see this, note that Y's and Z's capital accounts total \$600, but their combined share of the reverse-704(c) layer (it was all attributable to the revaluation) equals \$800 (determined when the partnership's asset was revalued and Y's capital account restated). So what is Z's share of the reverse-704(c) layer? We'll return to that question below.

Z's purchase of a portion of Y's partnership interest triggers an adjustment under Code Sec. 743(b). The amount of that adjustment equals Z's outside basis of \$300 less Z's share of the partnership's inside basis. Z's share of the inside basis equals Z's share of the partnership's previously taxed capital plus Z's \$0 share of the partnership's liabilities. Z's share of the partnership's previously taxed capital equals \$300 (final capital account balance) less Z's share of the built-in gain in the partnership's asset; from the discussion above, assume that share of built-in gain equals \$400. Accordingly, Z's share of the previously taxed capital (and so Z's share of the inside basis) equals negative \$100. From this, the amount of the adjustment equals \$300 less negative \$100, or \$400 total. This adjustment just offsets Z's share of the built-in gain in the partnership's property (based on the assumption that Z's share of the reverse-704(c) layer equals \$400).

Is this analysis correct? Look at the books of the venture, if the partnership sells its asset immediately after Z purchases one-half of Y's interest (shown in Chart 4).

When the partnership sells its asset immediately after Z joins the venture, there is a taxable gain of \$2,000, of which 60 percent (or \$1,200) is allocated to X. The remainder of the taxable gain (namely \$800) must be allocated, *under the assumption that half of Y's initial reverse-704(c) layer shifted to Z*, equally between Y and Z. As a result, Y will recognize \$400 of gain on sale and Z's gain is offset by the Code Sec. 743(b) adjustment

Chart 4

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$ 900	\$ 0	\$ 300	\$ 0	\$ 300	\$ 300	Z joins
0	1200	0	400	0	400	Sale of property
0	0	0	0	0	(400)	\$743(b) adjustment
0	(300)	0	(200)	0	0	Debt repayment
\$ 900	\$ 900	\$ 300	\$ 200	\$ 300	\$ 300	

computed above. Thus, only \$1,600 of the taxable gain is taxed on the sale. That amount, when coupled with the gain of \$300 Y reported on the sale by Y of a portion of Y's partnership interest, fails to equal the full appreciation in the partnership's asset. Thus, if this analysis is correct, then \$100 of unrealized appreciation goes untaxed until Y exits the venture. Such a result is possible,²⁴ but is unlikely to be accepted by the government, especially when an alternate analysis exists, which eliminates the deferral.

As an alternative analysis, suppose that Z recognizes a share of the built-in gain *equal only to the gain recognized on the sale by Y*; that is, Z picks up only \$300 of Y's reverse-704(c) gain. This reduces the Code Sec. 743(b) adjustment to \$300, computed as follows.²⁵ The inside basis adjustment under Code Sec. 743(b) equals Z's outside basis of \$300 less Z's share of the partnership's inside basis. Z's share of the inside basis equals Z's share of the partnership's previously taxed capital plus Z's \$0 share of the partnership's liabilities. Z's share of the partnership's previously taxed capital equals \$300 (Z's final capital account balance) less Z's share of the built-in gain in the partnership's asset, now assumed to equal \$300. Accordingly, Z's share of the previously taxed capital (and so Z's share of the inside basis) equals \$0. From this, the amount of the Code Sec. 743(b) adjustment

equals \$300 less \$0, or \$300. This adjustment again offsets Z's share of the built-in gain of the partnership's property. Now, though, if the property is immediately sold by the partnership, the books change as reflected in Chart 5.

Chart 5

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$ 900	\$ 0	\$ 300	\$ 0	\$ 300	\$ 300	Initial values
0	1200	0	500	0	300	Sale of property
0	0	0	0	0	(300)	§743(b) adjustment
0	(300)	0	(200)	0	0	Debt repayment
\$ 900	\$ 900	\$ 300	\$ 300	\$ 300	\$ 300	

This analysis does not offer any deferral to Y and so seems to be the better result. Indeed, given the relatively vague language in the applicable regulation (the 704(c) portion "attributable" to the interest sold must be transferred to Z), any other result seems indefensible. It is worth making clear that this debate does not affect Z's capital account balance (equal to \$300 under either theory, as dictated by the economic relationship among the partners), but only the allocation of the taxable gain arising from the reverse-704(c) layer. Further, so long as a Code Sec. 754 election is in effect when Z acquires his interest, whatever portion of Y's reverse-704(c) layer is allocated to Z will be offset by Z's Code Sec. 743(b) adjustment.

Partial Sale of a Partnership Interest With a Debt Shift

Reconsider the example above, but assume neither partner guarantees repayment of the debt, so that the debt is allocated under the nonrecourse rules. As a consequence, when Z purchases a portion of Y's partnership interest and acquires a portion of Y's reverse-704(c) layer, some of the debt shifts to Z. This debt shift arises under tier 2 of the nonrecourse

Chart 6

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	Initial values
0	300	0	200	0	0	Borrowing
1200	0	800	0	0	0	Revaluation
(300)	(300)	(200)	(200)	0	0	Distribution
0	0	(300)	0	300	400	Sale by Y to Z
\$ 900	\$ 0	\$ 300	\$ 0	\$ 300	\$ 400	Ending Values

debt allocation rules; under these tier 2 rules, debt is allocated among the partners as they would share 704(c) and reverse-704(c) gain were the property sold for the debt and for nothing else.²⁶ Once again, assume that half of Y's reverse-704(c) layer shifts to Z.²⁷ Under that assumption, \$100 of the debt (i.e., 20 percent of \$500) is reallocated from Y to Z, so that Y's gain on the sale to Z increases from \$300 to \$400 because of the additional \$100 amount realized. Thus, the books of the venture are now reflected in Chart 6.

Y recognizes a gain of \$400 on the sale to Z, so that if the property is then sold, Y's total recognition will equal \$800, half from the sale to Z and half from sale of the property. Z's net recognition will equal \$0 because Z's share of the dispositional gain will be offset fully by the Code Sec. 743(b) adjustment arising from Z's purchase of the partnership interest. Thus, there is no deferral or acceleration of any of the unrealized appreciation in the property.

In this case, \$400 of Y's reverse-704(c) layer shifted to Z, while in the prior case only \$300 shifted. What explains the difference? In each case, Z's share of the reverse-704(c) layer properly equals the amount of gain recognized by Y on the sale. Any other rule results in deferral or duplication of income to Y; in the absence of a compelling reason to reach such an uneconomic result, it seems clear that the rule proposed above should be followed. That rule, again, is that *the purchaser's share of the seller's 704(c) and reverse-704(c) gain should equal the amount of gain recognized by the seller.*

This rule, though, raises one significant computational difficulty. The portion of the seller's 704(c) and reverse-704(c) gain that shifts to the purchaser equals the amount of gain recognized by the seller. Computation of this gain turns on the amount of the debt, if any, that shifts to the purchaser. But if the debt is nonrecourse, the amount of the debt that shifts to the purchaser is dependent on the amount of the 704(c) and reverse-704(c) layer that shifts from the seller to the purchaser. The analysis seems circular; fortunately, high school algebra offers a solution to this computational problem.²⁸

There is an additional issue raised by this fact pattern. As we have seen, the sale by Y shifts some of the debt to Z. I have treated the reduction in Z's debt share as an additional

amount realized by Z. But, in general, a reduction in a partner's debt share is treated as a distribution of cash. The amount of Y's gain will not be affected either way, but the character of Y's gain recognition can change. Nonetheless (and despite some conceptual appeal to the contrary), it is clear under existing law that when debt shifts as a consequence of the sale of a partnership interest, the debt reduction to the selling partner is treated as part of the amount realized, rather than as a distribution.²⁹

Disposition After a Taxable Distribution

Complete Sale Without a Debt Shift to the Purchaser

XY borrows \$500, with X guaranteeing repayment of \$300 and Y guaranteeing repayment of \$200. Under the terms of the partnership agreement, the loan proceeds are distributed entirely to Y. Y then sells her interest for its current fair market value (\$300) to third-party Z. The books of the venture change as shown in Chart 7.

Chart 7

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	Initial values
0	300	0	200	0	0	Borrowing
1200	0	800	0	0	0	Revaluation
0	0	(500)	(200)	0	0	Distribution
0	200	(300)	0	300	300	Sale by Y to Z
\$ 1200	\$ 500	\$ 0	\$ 0	\$ 300	\$ 300	Ending Values

The debt-financed distribution to Y produces a taxable gain of \$300 to Y because the amount of cash distributed to Y (\$500) exceeds Y's outside basis immediately prior to the distribution. In turn, that gain recognition gives rise to an inside basis adjustment of \$300 to the partnership's common basis in its property pursuant to Code Sec. 734(b). As a result, the amount of built-in gain in the property declines from \$2,000 to \$1,700. Of that remaining built-in gain, 60 percent (or \$1,020) is allocable to X and the remainder (\$680) is allocable to Y. The sale by Y to Z triggers a taxable gain of \$500 to Y, of which \$300 arises from the cash paid by Z and \$200 from the debt shift from Y to X. Z's outside basis equals the cash paid of \$300 and Z acquires a \$300 capital account from Y.

Note that Z also acquires Y's \$680 share of the reverse-704(c) layer and, as we have seen, that means that Z enjoys a \$680 inside basis adjustment under Code Sec. 743(b). Accordingly, when the property is sold by the partnership, there will be a taxable gain of \$1,020 reported by X and nothing further. Y reported \$300 on the distribution and an additional \$500 on the sale to Z, for a total of \$800. Thus, the aggregate gain recognized by all the partners is \$1,020 plus \$800, or \$1,820. But the property appreciated by \$2,000 when held by the partnership, the property has been converted into cash, and only \$1,820 of gain has been recognized. Something is terribly awry. What?

Chart 8

X		Y		
CA	OB	CA	OB	
\$ 0	\$ 0	\$ 0	\$ 0	Initial values
0	300	0	200	Borrowing
1200	0	800	0	Revaluation
0	0	(500)	(200)	Distribution
\$ 1200	\$ 300	\$ 300	\$ 0	Ending Values

Reconsider this transaction, but assume that Y does not sell any portion of Y's partnership interest to Z. Thus, the books are as shown in Chart 8.

If the property is now sold by the partnership, there will be gain of \$1,700, allocable \$1,020 to X and \$680 to Y. Putting that (along with repayment of the debt) into the t-accounts, we get Chart 9.

These books show that the effect of the Code Sec. 734(b) adjustment was to shift \$180 of basis from Y to X.³⁰ As a result, X's capital account exceeds her adjusted basis by \$180, reflecting deferral of \$180 enjoyed by X on the sale of the property. Similarly, Y's capital account is \$180 less than his outside basis, reflecting the \$180 of negative deferral forced upon Y by Code Sec. 734(b). For each partner, the deferral

Chart 9

X		Y		
CA	OB	CA	OB	
\$ 1200	\$ 300	\$ 300	\$ 0	After Distribution
0	1020	0	680	Sale of Asset
0	(300)	0	(200)	Debt Repayment
\$ 1200	\$ 1020	\$ 300	\$ 480	Ending Values

will end when the partner's interest in the venture is liquidated. For example, if the partnership immediately liquidated, distributing its cash of \$2,000 to each partner in proportion to their capital accounts, X would receive \$1,200 and would report a taxable gain of \$180, while Y would receive \$300 and would report a taxable loss of \$180.

In the first transaction in which the distribution to Y was followed by a sale of Y's interest to Z (see Chart 7), Y's negative deferral was eliminated on the sale by Y to Z. But because X remained within the partnership, X's positive deferral remained uncorrected. And that is the result that seemed to be awry: positive deferral for X without any offsetting negative tax consequence for any other partner. In fact, there had been an equivalent negative tax consequence for Y, but it was eliminated by Y's exit from the venture.

This example, which really is nothing more than an exploitation of a basic structural flaw of Code Sec. 734(b), demonstrates an important exit strategy. If a partnership owns appreciated property, a leveraged *nonliquidating* distribution to the exiting partner will shift basis from the exiting partner to the other partners to the extent of any gain recognized by the distributee. If the exiting partner then leaves the venture (either by a second distribution or by a sale of the remaining partnership interest), the exiting partner will suffer no adverse tax consequences and the remaining partners will profit. Note that neither a single liquidating distribution nor a single sale of the exiting partner's partnership interest will suffice: it is the substantial but nonliquidating distribution that triggers the Code Sec. 734(b) adjustment for the benefit of the continuing partners.

Partial Sale Without a Debt Shift

XY borrows \$500, with X guaranteeing repayment of \$300 and Y guaranteeing repayment of \$200.

Chart 10

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	Initial values
0	300	0	200	0	0	Borrowing
1200	0	800	0	0	0	Revaluation
0	0	(500)	(200)	0	0	Distribution
0	0	(150)	0	150	150	Sale by Y to Z
\$1200	\$ 300	\$ 150	\$ 0	\$ 150	\$ 150	Ending Values

Under the terms of the partnership agreement, the loan proceeds are distributed entirely to Y. Y then sells one-half of her interest for its current fair market value (\$150) to third-party Z. The books of the venture become as shown in Chart 10.

The debt-financed distribution to Y produces a taxable gain to Y of \$300, because the amount of cash distributed to Y (\$500) exceeds Y's \$200 outside basis immediately prior to the distribution. In turn, that gain recognition gives rise to an inside basis adjustment of \$300 to the partnership's common basis in its property. As a result, the amount of built-in gain in the property declines from \$2,000 to \$1,700. Of that remaining built-in gain, 60 percent (or \$1,020) is allocable to X and the remainder (\$680) is allocable to Y. How much of Y's built-in gain shifts to Z as a result of the partial sale of the partnership interest?

Because Z does not acquire any of the debt, Y's gain on the sale equals \$150 (amount realized of \$150 less adjusted basis of \$0). If, as discussed above, that means Z should assume an equivalent amount of Y's reverse-704(c) layer, then Y's share of the built-in gain declines from \$680 to \$530. Using those numbers and computing the books of the venture if the partnership's asset is sold immediately after Z joins, we get the result shown in Chart 11.

Chart 11

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$1200	\$ 300	\$ 150	\$ 0	\$ 150	\$ 150	Initial values
0	1020	0	530	0	150	Sale of property
0	0	0	0	0	(150)	\$743(b) adjustment
0	(300)	0	(200)	0	0	Debt repayment
\$1200	\$1020	\$ 150	\$ 330	\$ 150	\$ 150	

As indicated above, the Code Sec. 734(b) inside basis adjustment shifted \$180 of basis from Y to Z, and that is reflected in the partnership's books. Z is indifferent to all this, as is proper: because Z was not a member of the partner when the Code Sec. 734(b) adjustment was made, Z gets no benefit from it. And because Y has not yet exited the venture, Y's negative deferral (like X's positive deferral) remains uncorrected.

Partial Sale with a Debt Shift

XY borrows \$500, pledging its property as security. The loan proceeds are distributed entirely to Y. Y then sells one-half her interest

for its current fair market value (\$150) to third-party Z. The books of the venture now appear as shown in Chart 12.

Chart 12

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	Initial values
0	300	0	200	0	0	Borrowing
1200	0	800	0	0	0	Revaluation
0	0	(500)	(200)	0	0	Distribution
0	0	(150)	0	150	???	Sale by Y to Z
\$1200	\$ 300	\$ 150	\$ 0	\$ 150	\$???	Ending Values

The debt-financed distribution to Y produces a taxable gain to Y of \$300 because the amount of cash distributed to Y (\$500) exceeds Y's outside basis immediately prior to the distribution. In turn, that gain recognition gives rise to an inside basis adjustment of \$300 to the partnership's common basis in its property. As a result, the amount of built-in gain in the property declines from \$2,000 to \$1,700. Of that remaining built-in gain, 60% (or \$1020) is allocable to X and the remainder (\$680) is allocable to Y. How much of Y's built-in gain shifts to Z as a result of the partial sale of the partnership interest?

First, we must compute how the debt is allocated after Z joins the venture. There is no tier 1 allocation because the book value of the security exceeds the amount of the debt. There is an allocation of \$200 of the debt under tier 2 because the amount of the debt equals \$500 and the adjusted basis of the property (after the Code Sec. 734(b) adjustment) equals \$300. This tier 2 allocation is made as the partners share 704(c) and reverse-704(c) gain if the property is sold for the amount of the debt and nothing else. Here, that gain would equal \$300, the amount by which the debt of \$500 exceeds the \$200 adjusted basis of the property. As discussed above, we cannot compute the tier 2 allocation without knowing how much of Y's reverse-704(c) layer shifts to Z; *assume* that shift equals \$231³¹ so that Y's share of the tier 2 debt equals \$79³² and Z's share of the tier 2 debt equals \$41.³³ There remains \$200 of the debt to be allocated under tier 3. That can be allocated in proportion to the partners interest in profits; that is, \$120 to X, \$40 to Y and \$40 to Z.³⁴ In the following, I assume that the partners

chose to allocate the tier 3 debt in this manner. From the foregoing, Z's aggregate debt share equals \$81, so that the question marks in chart 12 should be replaced by \$231.

From the above, Y recognizes a gain of \$231 on the sale to Z, consistent with the assumption that Z's share of the built-in gain (and so the Code Sec. 743(b) adjustment) should equal \$231 (leaving \$449 with Y). Putting this into the books and then assuming the partnership sells its asset immediately after Z joins the venture, we get the result shown in Chart 13.

While these totals seem out of whack, in fact they are correct. Y has a deferred loss of \$180 and X has an equivalent deferred gain.

Chart 13

X		Y		Z		
CA	OB	CA	OB	CA	OB	
\$1200	\$ 300	\$ 150	\$ 0	\$ 150	\$ 231	Initial values
0	1020	0	449	0	231	Sale of property
0	0	0	0	0	(231)	\$743(b) adjustment
0	(300)	0	(119)	0	(81)	Debt repayment
\$1200	\$1020	\$ 150	\$330	\$ 150	\$ 150	

These deferred amounts arise because of the Code Sec. 734(b) basis adjustment: on the distribution of \$500 to Y, Y recognized a gain of \$300, which then increased the *common* basis in the partnership's asset, producing a tax-benefit of \$180 (60 percent of \$300) to X and only \$120 (40 percent of \$300) to Y. Thus, the Code Sec. 734(b) adjustment shifted \$180 of basis from Y to X, and this shift is reflected in the t-accounts of X and Y.³⁵ Because Z was not a member of the partnership when the Code Sec. 734(b) basis adjustment was triggered, Z gets no benefit from the Code Sec. 734(b) common basis adjustment. More accurately, Z's Code Sec. 743(b) basis adjustment ensures that Z takes a cost basis in the partnership's asset, whether there was a prior Code Sec. 734(b) common basis adjustment or not.

Would the analysis have changed if a different tier-3 debt allocation had been made by the partnership? Yes and no: if \$40 of the debt had been shifted to Z, then Y would have recognized an additional \$40 of gain on the sale (increasing Y's gain on the sale to \$190). As a result, Z's share of the reverse-704(c) would increase from \$150 to \$190. In that sense, the analysis will change. But the underlying principle should remain the same: *the purchaser's share of*

the built-in gain should equal the amount of gain recognized by the transferor on the sale.

Conclusion

My goal in this article is to make two points. First, when a partner sells a portion of her partnership interest, computation of gain on the sale is more complex than it seems when the partnership has incurred liabilities. Second, we know that when a partner sells a portion of her partnership interest, only a portion of her 704(c) and reverse-704(c) layer

should be transferred to the buyer. As shown above, that portion is not determined by computing some percentage of the selling partner's 704(c) and reverse-704(c) layer but rather in a much more natural way: the buyer takes a share of 704(c) and reverse-704(c) layer equal to the gain recognized by the selling partner. To be sure, if there is nonrecourse debt within the partnership, calculating the selling partner's gain on the sale can become frighteningly complex. But that does not change the basic point: once the seller's gain is computed, the buyer's share of the 704(c) and reverse-704(c) layer is determined.

ENDNOTES

¹ The author would like to thank Mr. Eric Sloan for first raising many of the issues discussed in this article as well as comments on an earlier draft.

² Code Sec. 1001(a).

³ Reg. §1.61-6(a).

⁴ Rev. Rul. 84-53, 1984-1 CB 159.

⁵ Reg. §1.704-1(b)(2)(iv)(b).

⁶ Reg. §1.704-1(b)(2)(iv)(l).

⁷ E.g., William S. McKee, William F. Nelson & Robert H. Whitmire, *FEDERAL INCOME TAXATION OF PARTNERSHIPS AND PARTNERS* ¶16.01[1] (4th ed. 2007).

⁸ Rev. Rul. 84-53, 1984-1 CB 159.

⁹ Reg. §1.752-1(h).

¹⁰ Rev. Rul. 84-53, 1984-1 CB 159. This rule as set forth in the ruling is modified if the selling partner's outside basis is less than her share of the partnership's liabilities so as to avoid the possibility of a negative basis in the interest sold.

¹¹ 1997 FSA Lexis 416 (October 15, 1997).

¹² Reg. §1.61-6(a).

¹³ The examples that follow are based on the issues raised in Eric Sloan, Judd Sher, Matthew Sullivan, and Julia Trossen, *Order in the Court: Why Ordering Matters in Partnership Transactions*, 116 Tax Notes 765 (August 27, 2007). While I have great enthusiasm for that article, most of the conclusions I reach are inconsistent with the conclusions reached by these authors.

¹⁴ Code Sec. 743(b)(1).

¹⁵ Reg. §1.743-1(d)(1).

¹⁶ A partner's share of previously taxed capital equals the amount of money the partner would receive if the partnership were to sell all of its assets for fair market value and then were to liquidate, reduced by the partner's distributive share of taxable gain on the final asset sale and increased by the partner's distributive share of taxable loss on that final sale. Reg. §1.743-1(d)(1)(i)-(iii). The amount of cash the partner will receive

on liquidation should equal the partner's final capital account balance. See Reg. §1.704-1(b)(2)(ii)(b)(2).

¹⁷ This is no coincidence: the Code Sec. 743(b) basis adjustment is defined in Reg. §1.743-1(d)(1) to reach precisely this result.

¹⁸ See note 16 *supra*.

¹⁹ While it is unlikely that the drafters of Code Sec. 743(b) contemplated the possibility of a partner having a negative share of inside basis, the computations as set forth in existing regulations clearly can produce that result. See, e.g., RICHARD L. DOERNBERG & HOWARD E. ABRAMS, *FEDERAL INCOME TAXATION OF CORPORATIONS AND PARTNERSHIPS* 886 (3d ed. 2000); Blake D. Rubin & Andrea R. Macintosh, *Exploring the Outer Limits of the Section 704(c) Built-in Gain Rule (Part 2)*, 89 J. TAXATION 228, 236-38 (October 1998).

²⁰ See note 17 *supra*.

²¹ For the rules governing the allocation of recourse indebtedness, see Reg. §1.752-2.

²² Note that Revenue Ruling 84-53 has no relevance to the computation of Y's gain because that Ruling speaks only to the computation of the selling partner's allowable adjusted basis, and here Y's outside basis equals \$0.

²³ Reg. §1.704-1(b)(2)(iv)(l).

²⁴ This is the analysis adopted by Sloan *et al.*, *supra* note 13. They do not discuss alternatives to their approach.

²⁵ See note 16 *supra*.

²⁶ Reg. §1.752-3(a)(2).

²⁷ A bit of complicated algebra is required to compute the debt shift in this example; see note 28 *infra*.

²⁸ Let d = the amount of Y's debt share that shifts to Z, and let g = the amount of Y's reverse-704(c) layer that shifts to Z. The total gain that will be recognized by Y on the sale equals \$300 plus the debt share that shifts to Z (that is, the total debt share

= \$300 + d). As indicated in the text, the amount of Y's reverse-704(c) layer that should shift to Z equals the total gain recognized by Y on the sale to Z. Accordingly, $g = 300 + d$. Further, because Y's pre-sale reverse-704(c) layer equals \$800 and Y's pre-sale debt share equals \$200, the ratio of reverse-704(c) layer to debt under tier 2 of the nonrecourse debt sharing rules is 4 to 1. Accordingly, $d = \frac{1}{4}g$, so that $g = 4d$. As a result, we get $4d = d + 300$, so that $3d = 300$. Accordingly, d , the amount of debt share that shifts from Y to Z, equals \$100, and g , the amount of reverse-704(c) layer that shifts from Y to Z, equals 4 times \$100, or \$400.

²⁹ Code Sec. 752(d); Reg. §1.752-1(h); Rev. Rul. 84-53, 1984-1 C.B. 159.

³⁰ See Howard E. Abrams, *The Section 734(b) Adjustment Needs Repair*, 57 TAX LAWYER 343, 350 (2004).

³¹ For those who cannot get enough high school algebra, let t = the amount of Y's tier 2 debt that shifts to Z and let g = the amount of Y's reverse-704(c) layer that shifts to Z. As described below in the text, Z's total debt share will equal $t + 40$, and that means Y's total recognized gain on the sale will equal $150 + t + 40$, and because the amount of reverse-704(c) gain that should shift to Z equals the amount of gain recognized by Y, we get $g = 190 + t$. In addition, Y's pre-sale share of the reverse-704(c) gain (after the Code Sec. 734(b) adjustment) equals 680 and Y's pre-sale share of the tier 2 liability equals 120, so $t = 120g/680$. Plugging this into $g = 190 + t$, we get t equals about 41 and g equals about 231.

³² Y's share of the tier 2 debt equals \$120 times $((680-231)/680)$, or about \$79.

³³ Y's pre-sale share of the tier 2 debt equaled 40 percent of \$300, or \$120. If Y retains \$79 of that amount, then \$41 shifts to Z. Equivalently, Z's share equals \$120 times

231/680.

³⁴ The regulations grant considerable flexibility to the partnership in allocating tier 3

debt. See Reg. §1.752-3(a)(3). I assume for simplicity that the partnership elects to allocate tier 3 debt in accordance with general

manner in which profits are shared.

³⁵ See Howard E. Abrams, note 30 *supra*, at 349-51.



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