Introduction[1]

While an entity with more than one owner may be classified for federal income tax purposes as either an S Corporation or a partnership, for state entity law purposes the entity may be one of the following:

State Law	***Federal Tax Law***
Corporation	Corporation
Limited Liability Company	Partnership or Corporation
Limited Partnership	Partnership or Corporation
Limited Liability Limited Partnership	Partnership or Corporation
Statutory Trust	Trust or Partnership or Corporation

In addition, an alternative entity with multiple owners may not be recognized as a partnership for federal tax law purposes if it does not meet the definition of a partnership.

Characteristic		***Partnership***	***S Corporation***
1.	Number of Owners	Unlimited	No more than 100 stockholders[2]
2.	Classes of Interests	Unlimited	One
3.	Limits on Who Can be an Owner	None	Individuals, estates, and trusts who are not nonresident aliens
4.	Taxation of Entity	No entity level taxation[3]	No entity level taxation, unless converted from a C Corporation[4]
5.	Use of Losses (subject to at-risk and PAL rules)	Limited to basis in partnership interest[5]	Limited to basis in stock and debt[6]

Characteristic		Partnership	S Corporation
6.	Tax-Free Contribution of Appreciated Property	Yes[7]	The contributing stockholders must have at least 80 percent control following the contribution to be tax-free[8]
7.	Tax-Free Contribution of Encumbered Property	Generally, yes, although debt relief results in a basis reduction[9]	Excess of liability over basis is taxed as gain[10]
8.	Taxation of Receipt of Profits Interest	Almost always tax-free[11]	Receipt of unrestricted stock is taxable[12]
9.	Effect of Entity Level Liabilities on Basis	Increase in basis for both recourse and non-recourse liabilities[13]	No effect on basis[14]
10.	Effect of Individual Level Liabilities on Basis	Increase in basis[15]	Increase in basis[16]
11.	Effect of Transfers of Interests – Termination of Entity	Termination if more than 50 percent transfer[17]	No termination of S Corporation on transfer; Potential loss of status if ineligible transferee[18]
12.	Effect of Transfers of Interests – Tax Year	Tax year closes for partner who transfers entire interest (death, resignation or transfer of entire interest)[19]	Transferring stockholder may elect to terminate the taxable year of the S Corporation for that stockholder[20]
13.	Effect of Transfers of Interests – Transferor	Recognition of gain or loss and, possibly, ordinary income	Recognition of gain or loss
14.	Effect of Transfers of Interests – Inside Basis	If gain results and election made, step up in basis of partnership assets; mandatory basis adjustment if the partnership has a substantial built-in loss immediately after the transfer[21]	No adjustment in inside basis

Characteristic		Partnership	S Corporation
15.	Tax-Free Exchange of Interests	Like-kind exchange treatment not available	Like-kind exchange treatment not available; Corporate reorganization treatment available
16.	Distributions – Cash	A distribution is a return of basis, with the excess treated as capital gain[22]	A distribution is a return of basis, with the excess treated as capital gain.[23] If accumulated E&P exist from prior C Corporation status, distributions from Accumulated Adjustments Account are tax-free and capital gains; balance taxed as C Corporation distributions.[24]
17.	Distributions – Appreciated Property	Not taxable to partnership;[25] may give rise to capital gain or loss to partner[26]	S Corporation recognizes gain or loss on property distributed;[27] Stockholder recognizes capital gain to extent fair market exceeds basis[28]
18.	Taxation of Owner's Heath Insurance Premiums	All of the premiums may be deducted[29]	All of the premiums may be deducted[30]
19.	Treatment of Distributive Share of Ordinary Income From a Trade or Business	A general partner's distributive share constitutes net earnings from self-employment, subject to self-employment tax[31]	Distributive share does not constitute net earnings from self-employment and, therefore, is not subject to self-employment tax; Salary is subject to employment taxes
		A limited partner's distributive share does not constitute net earnings from self-employment (unless a guaranteed payment)[32]	

	Characteristic	Partnership	S Corporation
		A member's distributive share constitutes net earnings from self-employment if: (a) a guaranteed payment for services[33]; (b) the member is personally liable for the obligations of the LLC;[34] (c) the member has authority under law to contract on behalf of the LLC;[35] (d) the member participates in the trade or business for more than 500 hours during the LLC's taxable year;[36] or (e) the member is a service member in a service organization[37]	
20.	Special Allocations	Special allocations of the distributive share of items are permissible if they have substantial economic effect	Distributive share of all items must be allocated in proportion to stock holdings on a per day basis[38]
21.	Retirement/Redemption Payments	Payments in exchange for a partner's interest ordinarily will be tax-free return of basis or capital gains;[39] unrealized receivables and inventory items will generate ordinary income.[40] Retirement payments can be ordinary income to the partner and deductible to the partnership if structured as guaranteed payments.[41]	Generally, payments to redeem stock give rise to capital gain or loss and are not deductible[42] Non-qualified deferred compensation may achieve same result as a guaranteed payment.
22.	Sale of Interest in Entity	Sale of capital asset;[43] ordinary income to extent of unrealized receivables and inventory items[44]	Generally, stock sales give rise to capital gain or loss; loss from the sale of stock of a "small business corporation" may be ordinary;[45]
23.	Gain from Contributed Property	Gain or loss inherent in contributed property allocated to contributing partner[46]	Gain or loss inherent in contributed property shared by all stockholders[47]

[1] Copyright 2003 Bryan E. Keenan.

[2] Code § 1361(b)(1)(A).

[3] Code § 701.

[4] Code §§ 1374, 1375.

[5] Code §§ 702(a), 704(d).

[6] Code § 1368.

[7] Code § 721(a).

[8] Code §§ 351, 368(c).

[9] Code §§ 705(a), 722, 752.

[10] Code § 357(c).

[11] Rev. Proc. 93-27, 1993-2 C.B. 343.

[12] Code § 83.

[13] Code § 752.

[14] Code § .

[15] Code § .

[16] Code § .

[17] Code § 708.

[18] Code § 1362(d)(2).

[19] Code § 708(b)(1); Treas. Reg. § 1.708-1(b)(4).

[20] Code § 1377.

[21] Code §§ 734, 743, 754.

[22] Code § .

[23] Code § 1368.

[24] Code § 1368(c).

[25] Code § 731.

[26] Code §§ 704(c)(1)(B) (distribution of contributed appreciated property), 707(a)(2) ("disguised sale"), 731(c) (distribution of marketable securities treated as distribution of cash), 737 (distribution of contributed appreciated property), 751(b) (distributions altering partner's interest in certain assets).

[27] Code §§ 311(b), 361(c)(2).

[28] Code § 1368.

[29] Code § 162(l).

[30] Code §§ 162(l), 1372(a).

[31] Code § 1402(a).

[32] Code § 1402(a)(13).

[33] Code § 1402(a)(13).

[34] Prop. Treas. Reg. § 1.1402(a)-2(h)(2)(i).

[35] Prop. Treas. Reg. § 1.1402(a)-2(h)(2)(ii).

[36] Prop. Treas. Reg. § 1.1402(a)-2(h)(2)(iii).

[37] Prop. Treas. Reg. § 1.1402(a)-2(h)(5).

[38] Code §§ 1366, 1377.

[39] Code §§ 731, 736(b)(1).

[40] Code §§ 736, 751.

[41] Code § 736(b).

[42] Code § 162(k).

[43] Code § 741.

[44] Code § 751.

[45] Code § 1244.

[46] Code § 704(c).

[47] Code §§ 1366(c), 1377.

Partnerships[1]

Investment company rules[2]

Introduction

Code Section 721 provides that a partnership and its partners do not recognize gain or loss when a partner contributes property to the partnership in exchange for an interest in the partnership.[3] This rule does not apply to gain realized on a transfer of property to a partnership that would be treated as an investment company within the meaning of Code Section 351 if the partnership were incorporated.[4]

The Treasury Regulations under Code Section 351 provide that a shareholder recognizes gain if the transferee is an investment company and the transfer results in diversification of the shareholder's interest.[5] That is, not only must the corporation meet the definition of an investment company, but the capital contribution must result in the diversification of the contributing shareholder's investment portfolio. It bears repeating that there are two requirements, (a) an investment company and (b) diversification.

Investment Company

A corporation will be an investment company if the corporation is (a) a regulated investment company, (b) a real estate investment trust, or (c) a corporation, after the exchange, more than 80 percent of the value of whose assets are held for investment and are stocks or securities (or interests in regulated investment companies or real estate investment trusts).[6] This definition applies to a partnership investment company.[7] Therefore, a partnership will be an investment company if, after the exchange, more than 80 percent of the value of its assets are held for investment and are stock or securities.

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[1] Copyright 2005 Bryan E. Keenan.

[2] This material is adapted from C.D. Grear, B.E. Keenan and F.J. Schanne, Partnerships, LLCs and LLPs in Delaware: Organization and Operation Ch. IV (Lorman Education Services, 2003).

[3] Code § 721(a).

[4] Code § 721(b).

[5] Treas. Reg. § 1.351(c)(1).

[6] Treas Reg. § 1.351-1(c).

[7] S. Rep. No. 938, 94th Cong., 2d Sess., pt. 2, at 43 (1976).

The statute broadly defines “stocks and securities” to include the following:[8]

- Money[9]
- Stocks and other equity interests in corporations, evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives.
- Foreign currency.
- Interests in real estate investment trusts, common trust funds, regulated investment companies, publicly-traded partnerships or any other equity interest (other than in a corporation) that pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any other asset defined as stock and securities by Code Section 351.
- Interests in precious metals (unless used or held in the active conduct of a trade or business or excepted by regulation).
- Interests in any entity if substantially all of the assets owned by such entity consist, directly or indirectly, of any of the foregoing assets.[10]

In addition, the Secretary of the Treasury is granted broad power to list or delist assets constituting stock and securities.[11]

> *Example:* Husband and wife propose to form a partnership. Husband will contribute $80,000.00 of duPont stock, while wife will contribute $20,000.00 cash. Because the cash is included in the term “stock and securities,” the partnership will be an investment company because 100 percent of its assets after the exchange will be stock and securities.

Real estate is not a list asset deemed to be stock and securities and can be used to defeat the 80 percent test.

> *Example:* Husband and wife propose to form a partnership. Husband will contribute $80,000.00 of duPont stock, while wife will contribute real estate have a value of $20,000.00. The partnership will not be an investment company because only 80 percent of its assets after the exchange will be stock and securities.

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[8] Code § 351(e)(1)(B).

[9] The legislative history provides an exclusion for contributed cash that, pursuant to a plan, is used to purchase non-listed assets or pay expenses (for example, salary). Jt. Comm. on Tax’n, General Explanation of Tax Legislation Enacted in 1997, at 184 (Dec. 17, 1997).

[10] There are no regulations defining “substantially all” for this purpose and the legislative history is silent. The almost identical rules under Code Section 731(c) might be applied. See Treas. Reg. § 1.731-2(c)(3).

[11] Code § 351(e)(1)(B).

Diversification

Generally, diversification requires transfers of non-identical assets by two persons.[12] A transfer by one person usually results in an identical portfolio before and after the transfer.[13] Further, small or *de minimus* differences in contributed assets will not result in diversification.[14]

This rule does not apply if the property being contributed consists of a diversified portfolio of securities.[15] A portfolio is diversified if no more than twenty-five percent (25%) of the assets consist of stock or securities of any one issuer and no more than fifty percent (50%) of the assets consist of stock or securities of five or fewer

It is obvious that cash is not "identical to stock and securities and, in theory, the contribution of more than an insignificant amount of cash should result in diversification. However, where one transferor contributes a diversified portfolio and the other transferor contributes more than an insignificant amount of cash, the cash will be viewed as a diversified portfolio.[16] The apparent basis for reaching this conclusion is that the person transferring cash could have purchased a diversified portfolio and contributed the portfolio to the partnership.[17]

> *Example:* Husband and wife propose to form a partnership. Husband will contribute $80,000.00 of duPont stock, while wife will contribute $20,000.00 cash. Because the cash is included in the term "stock and securities," the partnership will be an investment company because 100 percent of its assets after the exchange will be stock and securities. In addition, there will be diversification because husband is contributing a single security, while wife is contributing a deemed diversified portfolio.

> *Example:* Husband and wife propose to form a partnership. Husband will contribute a diversified portfolio valued at $80,000.00, while wife will contribute $20,000.00 cash. Because the cash is included in the term "stock and securities," the partnership will be an investment company because 100 percent of its assets after the exchange will be stock

[12] Treas. Reg. §1.351(c)(5).

[13] Id.

[14] *Id.* See Priv. Ltr. Rul. 200006008 (transfers of three portfolios to partnership (LLC) amounting in the aggregate to less than 5 percent of the value of the partnership's portfolio after the transfer are insignificant and disregarded in determining whether diversification exists).

[15] Treas. Reg. §1.351(c)(6)(i).

[16] Priv. Ltr. Rul. 200125053, 200118039, 200113010, 200121016, 200008025, 9925017, 9909045, 9644007, 9643006.

[17] Monte A. Jackel & James B. Sowell, *Transfer to Investment Companies: Complexity in a Conundrum*, 94 TAX NOTES 1659 (Mar. 25, 2002).

and securities. The transfers will not result in diversification because husband and wife are each contributing a diversified portfolio.

Of particular significance in many cases, a portfolio is deemed to own a percentage of each security held by a real estate investment trust, a regulated investment company or an investment company under the investment company rules.[18] Consider a partnership formed by deceased husband's marital trust and surviving wife's revocable trust. Each trust holds a portfolio consisting of a few stock and several mutual funds. While it seems unlikely that the holdings of any of the funds owned by the trusts could cause the portfolio to fail the 25% Test, it is necessary to review the prospectus for each fund to see if the fund's holdings could potentially cause problems. The lack of diversification may be solved by contributing less than all of the securities in the revocable trust's portfolio to the partnership.

In the family investment partnership context, the *de minimus* exception is often used to avoid diversification. The owner of the portfolio contributes it to the partnership in exchange for a partnership interest. The other partners make nominal contributions in exchange for their interests.[19] Eleven percent cash is too much[20] and 1 percent is safe.[21] In at least one private letter ruling, the Service ruled that cash in excess of 5 percent was insignificant.[22]

Alternatively, the owner of the portfolio may make a gift of some part of each security in the portfolio to his or her spouse. Each of them contributes their separate but identical portfolio to the partnership in exchange for a partnership interest.[23] There is no gift tax cost, because of the unlimited marital deduction. The partners may then make gifts of partnership interests to their children. When implementing a partnership for a surviving spouse, the surviving spouse will make a gift an of interest in the portfolio to one or more children, who then contribute their interests in the portfolio to the partnership in exchange for a partnership interest. Typically, this is accomplished by the surviving parent making gifts as tenants in common of interests in the brokerage account to the children. The account holders, the parent and the children, then contribute the brokerage account to the partnership. The gifts of interests in the portfolio may result in taxable gifts. Whether this is so is a function of the total value of the portfolio and the percentage interest gifted to the children.

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[18] Treas. Reg. § 1.351-1(c)(6)(i), incorporating Code Section 368(a)(2(F) by reference.

[19] See Priv. Ltr. Rul. 9544012 (no gain where 99 percent partner contributing cash and marketable securities and 1 percent partner contributes cash); Priv. Ltr. Rul. 9345047 (cash contributions representing less than 1 percent of total asset value ignored in determining diversification).

[20] Rev. Rul 87-9, 1987-1 C.B. 133.

[21] Treas. Reg. § 1.351-1(c)(7), Example (1).

[22] Priv. Ltr. Rul. 9451035.

[23] See Priv. Ltr. Rul 9012024 (husband and wife exchange interests in each other's portfolios, resulting in identical portfolios; contribution of portfolios to partnership does not result in gain recognition).

Self-employment tax

The Self-Employment Tax (the "SET") is imposed on the self-employment income of individuals.[24] Individuals subject to the SET include an individual sole proprietor (including the sole member of a disregarded entity) and an individual who is a member of an entity taxed as a partnership. At present, S Corporation stockholders are not liable for SET.[25]

For 2005, the SET rate is 15.3 percent on the first $90,000 of self-employment income and 2.9 percent on any excess. [26] Self-employment income is income from a trade or business.

General Partnership

The distributive share of self-employment income of each partner in a general partnership is subject to the SET.[27]

Limited Partnership

In a limited partnership, the distributive share of self-employment income of each general partner is subject to the SET. [28] A limited partner is not subject to the SET, except on guaranteed payments. [29]

Limited Liability Company – The Proposed Regulations

Existing tax law does not provide a basis for determining whether a member in a limited liability company taxed as a partnership is a general or limited partner. One possible defining characteristic is the risk of economic loss. Unlike a general partner, a limited partner bears no risk of loss beyond his or her capital investment. If risk of loss is the distinguishing feature between a general and limited partner for SET purposes, then a member would be a limited partner. The obvious flaw in this analysis is that a limited liability company would be a limited partnership with no general partners.

The Functional Tests of the Proposed Regulations

The Internal Revenue Service, hoping to resolve the definitional problems created by limited liability companies, issued proposed regulations in 1997.[30] In response to the proposed regulations, Section 935 of the Taxpayer Relief Act of 1997 prohibited their

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[24] Code § 1401.

[25] *Id.*

[26] *Id.*

[27] Code § 1402(a).

[28] *Id.*

[29] Code § 1402(a)(13).

[30] *See* REG-209824-96, 1997-1 C.B. 770. These proposed regulations replaced regulations proposed in 1994.

finalization until July 1, 1998. The Internal Revenue Service has taken no further action with respect to the proposed regulations.

Under the proposed regulations, the general rule would be that a partner is a limited partner.[31] The proposed regulations would establish functional tests to determine who is a general partner. A partner would not be a limited partner (and, therefore, would be a general partner) if:

1. *Liability Test*. The partner has personal liability for the debts of, or claims against, the partnership by reason of being a partner;
2. *Authority Test*. The partner has authority under its organizing law to contract on behalf of the partnership;
3. *Participation Test*. The partner participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year;[32] or
4. *Personal Services Test*. The partner is a "service partner" in a "service partnership".[33]

In a plain vanilla member-managed Delaware limited liability company, all of the members will be general partners because they have authority under the Delaware Limited Liability Company Act to bind the limited liability company.

Classes of Interests Exceptions

The three functional tests can be avoided by creating more than one class of equity interests, at least one of which is a "general partner" interest. If a member of a limited liability company holds a "general partner" interest and a "limited partner" interest, the second class will be respected as a limited partner interest if, immediately after the member acquires the limited partner class interest, (i) limited partners within the functional test "own a substantial, continuing interest in that specific class of partnership interest" and, (ii) the member's "rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by" the other limited partners. [34] Ownership of 20 percent or more is always considered substantial.[35]

> *Example:* Assume a limited liability company has two classes of interests. Class A, which constitutes 1 percent of all the interests in the limited liability company, is the only class that has authority to contract on behalf of the limited liability company. Class B interest holders have no liability for debts or claims, have no authority to bind the limited liability company and have no right to participate in the management of

[31] Prop. Reg. § 1.1402(a)-2(h)(2).

[32] Prop. Reg. § 1.1402(a)-2(h)(2).

[33] Prop. Reg. § 1.1402(a)-2(h)(5).

[34] Prop. Reg. § 1.1402(a)-2(h)(3).

[35] Prop. Reg. § 1.1402(a)-2(h)(6)(iv).

the company. If the holder of the Class A interest also holds a 20 percent Class B interest, the Class B interest will be a limited partner interest.

A member of a limited liability company who holds only a "limited partner" class interest, but who participates for more than 500 hours will be considered a limited partner if , immediately after the member acquires the limited partner class interest, (i) limited partners within the functional test "own a substantial, continuing interest in that specific class of partnership interest" and, (ii) the member's "rights and obligations with respect to that specific class of interest are identical to the rights and obligations of that specific class of partnership interest held by" the other limited partners. [36] Again, ownership of 20 percent or more is always considered substantial.[37]

> *Example:* Assume a limited liability company has two classes of interests. Class A, which constitutes 1 percent of all the interests in the limited liability company, is the only class that has authority to contract on behalf of the limited liability company. Class B interest holders have no liability for debts or claims, have no authority to bind the limited liability company and have no right to participate in the management of the company. If a holder of a 10 percent Class B interest actually participates in the trade or business of the limited liability company for more than 500 hours, the Class B interest will still qualify as a limited partner interest.

A limited partner interest can be created with a single class of limited liability company interest by using a manager-managed limited liability company. The proposed regulations provide this example:

> *Eample: (i)* A, B, and C form LLC, a limited liability company, under the laws of State to engage in a business that is not a service partnership described in paragraph (h)(6)(iii) of this section. LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute $1xfor one LLC unit. B contributes $2x for two LLC units. Each LLC unit entitles its holder to receive 25 percent of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of $6xfor 600 hours of services rendered to LLC and C receives a guaranteed payment of $10xfor 1000 hours of services rendered to LLC. C also is elected LLC's manager. Under State's law, C has the authority to contract on behalf of LLC.
>
> *(ii) Application Of General Rule Of Paragraph (H)(2) Of This Section*. A is treated as a limited partner in LLC under paragraph (h)(2) of this section because A is not liable personally for debts of or claims against LLC, A does not have authority to contract for LLC under State's law, and A does not participate in LLC's trade or business for more than 500 hours during the taxable year. Therefore, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment under section 1402(a)(13).

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[36] Prop. Reg. § 1.1402(a)-2(h)(3).

[37] Prop. Reg. § 1.1402(a)-2(h)(6)(iv).

(iii) Distributive Share Not Included In Net Earnings From Self-Employment Under Paragraph (H)(4) Of This Section. B's guaranteed payment of $6xis included in B's net earnings from self-employment under section 1402(a)(13). B is not treated as a limited partner under paragraph (h)(2) of this section because, although B is not liable for debts of or claims against LLC and B does not have authority to contract for LLC under State's law, B does participates in LLC's trade or business for more than 500 hours during the taxable year. Further, B is not treated as a limited partner under paragraph (h)(3) of this section because B does not hold more than one class of interest in LLC. However, B is treated as a limited partner under paragraph (h)(4) of this section because B is not treated as a limited partner under paragraph (h)(2) of this section solely because B participated in LLC's business for more than 500 hours and because A is a limited partner under paragraph (h)(2) of this section who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment under section 1402(a)(13).

(iv) Distributive Share Included In Net Earnings From Self-Employment. C's guaranteed payment of $10xis included in C's net earnings from self-employment under section 1402(a). In addition, C's distributive share attributable to C's LLC unit also is net earnings from self-employment under section 1402(a) because C is not a limited partner under paragraphs (h)(2), (h)(3), or (h)(4) of this section. C is not treated as a limited partner under paragraph (h)(2) of this section because C has the authority under State's law to enter into a binding contract on behalf of LLC and because C participates in LLC's trade or business for more than 500 hours during the taxable year. Further, C is not treated as a limited partner under paragraph (h)(3) of this section because C does not hold more than one class of interest in LLC. Finally, C is not treated as a limited partner under paragraph (h)(4) of this section because C has the power to bind LLC. Thus, C's guaranteed payment and distributive share both are included in C's net earnings from self-employment under section 1402(a).

Service Partners

A "service partner" in a "service partnership" can never be a limited partner.[38] A service partner is a partner who provides more than a *de minimis* amount of services to or on behalf of the service partnership's trade or business.[39] A partnership will be a service partnership if substantially all the activities of the partnership "involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting."[40]

[38] Prop. Reg. § 1.1402(a)-2(h)(5).

[39] Prop. Reg. § 1.1402(a)-2(h)(6)(ii).

[40] Prop. Reg. § 1.1402(a)-2(h)(6)(iii).

Distributions[41]

The Basic Rules

The basic rules are simple:

1. Gain is recognized by a distributee partner only to the extent of money received in excess of basis.[42]
2. Loss is recognized by a distributee partner only on the receipt of money, unrealized receivables and inventory.[43]
3. Any gain or loss recognized is deemed to be gain or loss from the sale or exchange of the partnership interest of the distributee partner.[44]
4. A partnership does not recognize gain or loss on a distribution to a partner of property, including money.[45]

Turning back to the prior example, if the partnership's assets do not include cash, under the general rules there will be no gain or loss. However, gain recognition may be triggered under other provisions of Subchapter K.

Deemed Distributions of Cash

Code Section 752(b) Relief of Liabilities Gain

Under Section 752(b) of the Code, a constructive distribution of cash arises if a partner is relieved of any part of his or her share of partnership liabilities.

Assume that parents and their two children are equal partners in a family partnership. The partnership holds real estate, subject to a mortgage of four million dollars. Each partner's adjusted basis in his or her partnership interest is $500,000. If Child A abandons her interest, she has a constructive distribution of one million dollars (25 percent of four million dollars). Because Child's A adjusted basis in her interest is $500,000, Child A realizes a gain of $500,000.

Code Section 731(c) Marketable Securities Gain

Marketable securities are treated the same as money for the purposes of recognizing gain (but not loss), unless the partnership is an investment partnership.[46] Therefore, in

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[41] This material is adapted from B.E. Keenan, Partnership Terminations: Breaking Up Is Hard To Do (2003 Del. Tax Inst.).

[42] Code § 731(a)(1). Advances and drawings during the taxable year are treated as being made on the last day of the year. Treas. Reg. § 1.731-1(a)(1)(ii). Cash distributions should be made before property distributions to preserve basis. McKee, Nelson & Whitmire, TAXATION OF PARTNERS AND PARTNERSHIPS, ¶ 19.03[3].

[43] Code § 731(a)(2).

[44] Code § 731(a)(2) flush language.

[45] Code § 731(b).

many cases a distributee partner will recognize gain if the distributee partner receives marketable securities.

Marketable securities are financial instruments and foreign currencies that are, as of the date of the distribution, actively traded.[47] The term includes any financial instrument readily convertible into or exchangeable for money or marketable securities,[48] precious metals[49] and interests in any entity substantially all of the assets of which consist (directly or indirectly) of marketable securities, money, or both.[50]

There is a gain limitation rule.[51] The distributee partner's gain is reduced by the excess of that partner's distributive share of the net gain inherent in all the marketable securities held by the partnership before the distribution over that partner's distributive share of the net gain inherent in all the marketable securities held by the partnership after the distribution.

The Treasury Regulations provide the following example of the gain limitation:

A and B form partnership AB as equal partners. AB subsequently distributes Security X to A in a current distribution. Immediately before the distribution, AB held securities with the following fair market values, adjusted tax bases, and unrecognized gain or loss:

	Value	Basis	Gain (Loss)
Security X	100	70	30
Security Y	100	80	20
Security Z	100	110	(10)

If AB had sold the securities for fair market value immediately before the distribution to A, the partnership would have recognized $40 of net gain ($30 gain on Security X plus $20 gain on Security Y minus $10 loss on Security Z). A's distributive share of this gain would have been $20 (one-half of $40 net gain). If AB had sold the remaining securities immediately after the distribution of Security X to A, the partnership would have $10 of net gain ($20 of gain on Security Y minus $10 loss on Security Z). A's distributive share of this gain would have been $5 (one-half of $10 net gain). As a result, the distribution resulted in a decrease of $15 in A's distributive share of the net gain in AB's securities ($20 net gain before distribution minus $5 net gain after distribution). Under the gain limitation rule, the amount of the distribution of Security X that is treated as a distribution of money is reduced by $15. The distribution of Security X is therefore treated as a

[46] Code § 731(c)(1)(A).

[47] Code § 731(c)(2)(A).

[48] Code § 731(c)(2)(B)(ii).

[49] Code § 731(c)(2)(B)(iv).

[50] Code § 731(c)(2)(B)(v).

[51] Code § 731(c)(3)(B).

distribution of $85 of money to A ($100 fair market value of Security X minus $15 reduction).[52]

If the distribution is in complete liquidation of the partner's interest in the partnership, the gain limitation equals the distributee partner's distributive share of the net gain inherent in all the marketable securities held by the partnership before the distribution.

The rule treating marketable securities as money does not apply if the distributee partner contributed the securities to the partnership.[53] The Treasury Regulations do not provide that a transferor partner is treated as a contributing partner, nor do they incorporate such a rule by reference.

The rule treating marketable securities as money does not apply to a distribution by an investment partnership to an eligible partner.[54] An investment partnership for most purposes is a partnership not engaged in a trade or business, substantially all of the assets of which are cash and financial instruments.[55] The Treasury Regulations apply a 90 percent test of substantiality at the time of distribution.[56] An eligible partner is a partner who contributed only investment type assets or investment type assets and services to the partnership.[57]

Returning to the original example, if the marketable securities make up 90 percent or more of the assets of the partnership at the time of distribution, the marketable securities will not be treated as cash.

Distributions of Contributed Appreciated Property

Section 704(c)(1)(B) Contributed Property Gain

A partner who contributed Code Section 704(c) property to the partnership will recognize gain if the contributed property is distributed *to another partner* of the partnership (that is, to a partner other than the contributing partner). Code Section 704(c) property is property with inherent gain (or loss) when contributed to the partnership. The distribution must be within seven years of the contribution in order to trigger recognition of gain by the contributing partner.[58] *The contributing partner* (or his or her successor) must recognize the unrecognized gain (or loss) remaining as of the distribution as if the partnership sold property at its then fair market value.[59]

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[52] Treas. Reg. § 1.731-2(j), Ex. 2.

[53] Code § 731(c)(3)(A)(i).

[54] Code § 731(c)(3)(A)(iii).

[55] Code § 731(c)(3)(C)(i).

[56] Treas. Reg. § 1.731-2(c)(3).

[57] Code § 731(c)(3)(C)(iii).

[58] Code § 704(c)(1)(B) (five years for distributions before June 9, 1997).

[59] Code § 704(c)(1)(B).

Returning to the example, assume that the assets contributed by surviving parent were appreciated when contributed to the partnership and that they were contributed within seven years of the distribution. Because the distributee partners received their interests from the contributing partners, the distributee partners are all considered contributing partners[60] and, therefore, there is no Section 704(c)(1)(B) gain.

Assume, instead, that the partnership distributes an undeveloped real estate parcel to one of the partners when surviving parent holds a 50 percent interest and each child holds a 25 percent interest in the partnership. The parcel was contributed by surviving parent on formation of the partnership and its fair market value was greater than its adjusted basis at the time of contribution (that is, there was built-in gain). At the time of distribution there is $100,000 of built-in gain remaining. Here, the distributee partner is treated as the contributing partner only as to his or her 25 percent. Thus, the surviving parent has recognized $50,000, and the other child has recognized $25,000, of Code Section 704(c)(1)(B) gain.

Code Section 737 Contributed Property Gain

A distributee partner will recognize gain if the distributee partner receives a distribution of appreciated property and previously contributed other appreciated property to the partnership. The distribution must be within seven years of the contribution.[61] The recognized gain is the lesser of (i) the distributee partner's remaining unrecognized pre-contribution gain or (ii) the excess of the property's fair market value over the distributee partner's adjusted basis in his or her partnership interest (the "excess distribution").[62] Pre-contribution gain is the Code Section 704(c)(1)(B) gain that would be allocated to that partner if ***all*** of the property contributed by that partner in the prior seven years had been distributed to another partner.[63] Property that is part of the distribution and that was originally contributed by the distributee partner is excluded in calculating the excess distribution and pre-contribution gain.[64]

Assume two partners each contribute an undeveloped appreciated parcel of real estate to a three person partnership, while the third partner contributes cash.

[60] Treas. Reg. § 1.704-4(d)(2).

[61] Code § 737(b)(1) (five years for distributions before June 9, 1997). The Treasury Regulations under Code Section 737 have not be amended to reflect the longer time period.

[62] Code § 737(a). The partner's adjusted basis in his or her partnership interest must be first adjusted for distributions of cash or deemed cash. *See* Treas. Reg. § 1.737-1(b)(3)(i).

[63] Code § 737(b).

[64] Code § 737(d)(1).

Assets	Adj. Basis	FMV Contribution	FMV Distribution
Parcel A	$50,000	$100,000	$200,000
Parcel B	$60,000	$100,000	$150,000
Cash	$100,000	$100,000	$100,000
Capital			
Partner A	$50,000	$100,000	
Partner B	$60,000	$100,000	
Partner C	$100,000	$100,000	

If Parcel A, contributed by Partner A, is distributed by the partnership to Partner B within seven years of its contribution (and there has been no other partnership activity), the excess distribution to Partner B equals the $200,000 fair market value of the distributed property less the $60,000 adjusted basis in partnership interest, or $140,000. The net pre-contribution gain equals the $100,000 fair market value of the contributed property at the time of contribution less the $60,000 adjusted basis, or $40,000. Partner B's recognized Code Section 737 Gain is $40,000, the lesser of the excess distribution of $140,000 and the net pre-contribution gain of $40,000.

Clearly, Code Section 737 gain must be considered when a family partnership distributes appreciated property to one partner. But, what if the family partnership is liquidating, so that each partner is receiving his or her share of contributed property? If transferee partners are considered the contributing partner for purposes of Code Section 737, the entire distribution will be excluded and net pre-contribution gain will be zero. Because the Code Section 737 gain test is a "lesser of" test, there will be no Code Section 737 gain.

The Treasury Regulations under Code Section 737 do not explicitly provide that transferee partners will be considered to be the contributing partner. However, by cross-reference to Treasury Regulations Section 1.704-4, the Treasury Regulations under Code Section 737 incorporate by reference the "step in the shoes" rule.[65] Therefore, when a family partnership is liquidated where all partners share proportionally in Code Section 704 property, Code Section 737 gain will be zero.[66]

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[65] Treas. Reg. § 1.737-1(c)(1). The step in the shoes rule is Treasury Regulations Section 1.704-4(d)(2).

[66] *Accord*, McKee, Nelson & Whitmire, TAXATION OF PARTNERS AND PARTNERSHIPS, ¶ 19.08[2][e], n. 153; Ellen K. Harrison and Brian M. Blum, *A Response to Richard Robinson's "Don't Nothing Last Forever" – Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 313 (2003). *Contra*, Richard B. Robinson, *"Don't Nothing Last Forever" – Unwinding the FLP to the Haunting Melodies of Subchapter K*, 28 ACTEC J. 302 (2003); Richard B. Robinson, *Comments on Blum's and Harrison's "Another View"*, 28 ACTEC J. 318

Code Section 751 Disproportionate Distribution Gain

Gain will be recognized where the distribution is a disproportionate distribution altering the partners' interests in Code Section 751 property. If the distributee receives less Code Section 751 property in the distribution than his or her proportional interest in the partnership's Code Section 751 property, the distributee is deemed to have received the Code Section 751 property and sold it to the partnership, generating ordinary income. The situation of the parties is reversed where the distributee partner receives excess Code Section 751 property.

Code Section 751 property is property generating ordinary income – unrealized receivables and substantially appreciated inventory items.

Code Section 707 Disguised Sale Gain

Gain may be recognized where the distributee partner transferred property to the partnership within two years of the distribution (or the distribution is otherwise part of a disguised sale). A disguised sale involves the transfer of money or property by a partner to the partnership and a related transfer of money or property to the contributing partner or any other partner.[67] Each case turns on its own facts and circumstances.[68]

The transfers may occur in order, contribution followed by distribution or distribution followed by contribution. The sale is deemed to take place on the date the partnership takes title to the property.[69]

Generally, a disguised sale involves a disproportionate distribution to the "selling" or "buying" partner.

If, within a two-year period, a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a disguised sale unless the facts and circumstances clearly establish otherwise.[70]

The Treasury Regulations provide the following example:

A transfers property X to partnership AB on April 9, 1992, in exchange for an interest in the partnership. At the time of the transfer, property X has a fair market value of $4,000,000 and an adjusted tax basis of $1,200,000. One year after A's transfer of property X to the partnership, the partnership transfers $3,000,000 in cash to A. Assume that the applicable Federal short-term rate for April, 1992, is 10 percent, compounded semiannually.

(2003); Carmen, *Unwinding the Family Limited Partnership: Income Tax Impact of Scratching the Pre-Seven Year Itch*, J. TAX'N. (2002).

[67] Code § 707(a)(2)(B).

[68] Treas. Reg. § 1.707-3(b)(2).

[69] Treas. Reg. § 1.707-3(a)(2).

[70] Treas. Reg. § 1.707-3(c)(1).

A and the partnership are treated as if, on April 9, 1992, A sold a portion of property X to the partnership in exchange for an obligation to transfer $3,000,000 to A one year later. Section 1274 applies to this obligation because it does not bear interest and is payable more than six months after the date of the sale. As a result, A's amount realized from the receipt of the partnership's obligation will be the imputed principal amount of the partnership's obligation to transfer $3,000,000 to A, which equals $2,721,088 (the present value on April 9, 1992, of a $3,000,000 payment due one year later, determined using a discount rate of 10 percent, compounded semiannually). Therefore, A's amount realized from the receipt of the partnership's obligation is $2,721,088 (without regard to whether the sale is reported under the installment method). A is therefore considered to have sold only $2,721,088 of the fair market value of property X. The remainder of the $3,000,000 payment ($278,912) is characterized in accordance with the provisions of section 1272. Accordingly, A must recognize $1,904,761 of gain ($2,721,088 amount realized less $816,327 adjusted tax basis ($1,200,000 multiplied by $2,721,088/$4,000,000)) on the sale of property X to the partnership. The gain is reportable under the installment method of section 453 if the sale is otherwise eligible. Assuming A receives no other transfers that are treated as consideration for the sale of property under this section, A is considered to have contributed to the partnership, in A's capacity as a partner, $1,278,912 of the fair market value of property X with an adjusted tax basis of $383,673.[71]

Distribution Checklist

- Does the amount of cash distributed exceed the partner's adjusted basis in his or her partnership interest? [Code Section 731(a)(1)]
- Does the distribution result in a decrease in the distributee partner's share of liabilities? [Code Section 752(b)]
- Does the distribution include marketable securities? [Code Section 731(c)(2)(A)]
- Does the gain limitation rule reduce the recognized gain? [Code Section 731(c)(3)(B)]
- Did the distributee partner contribute the securities to the partnership? [Code Section 731(c)(3)(A)(i)]
- Is the distributing partnership an investment partnership? [Code Section 731(c)(3)(C)(i)]
- If the distributing partnership is an investment partnership, is the distributee partner an eligible partner? [Code Section 731(c)(3)(C)(iii)]

[71] Treas. Reg. § 1.707-3(f), Ex. 2.

- Does the distribution include any property contributed by another partner to the partnership within the past seven years? [Code Section 704(c)(1)(B)]

- Does the distribution include appreciated property and the distributee partner previously contributed other appreciated property to the partnership in the past seven years? [Code Section 737]

- Does the distribution alter the partner's interests in "Code Section 751 property"? [Code Section 751]

- Is the distribution within two years of a contribution to the partnership? [Code Section 707]

Section 754 Election

Under the general rules, when a partner contributes cash or property to a partnership in exchange for an interest in the partnership, the partnership takes as its adjusted basis the contributing partner's adjusted basis.72 If a person becomes a partner by purchasing an interest in the partnership from an existing partner, there is no basis step up inside the partnership for the gain recognized by the selling partner, because the partnership is not a party to the transaction.73 At the death of a partner, the step up in basis in the deceased partner's interest in the partnership will not step up the adjusted basis of the partnership's interests.74

The partnership can step up the basis on the sale of a partnership interest or the death of a partner, if the partnership makes an election under Code Section 754.[75] The partnership will step up the excess of the partner's basis over the partner's proportionate basis in the partnership's assets. The adjustment applies only with respect to the interest of the purchaser or the transferee of the deceased partner.[76]

> *Example:* A, B, and C form partnership PRS, to which each partner contributes $1,000 cash. Each partner has $1,000 credited to it on the books of the partnership as its capital contribution. The partners share in profits equally. The partnership purchases land, Asset 1. During the partnership's first taxable year, Asset 1 appreciates in value to $1,300. A sells its one-third interest in the partnership to T for $1,100, when an election under section 754 is in effect. The amount of tax gain that would be allocated to T from the hypothetical transaction is $100. Thus, T's interest in the partnership's previously taxed capital is $1,000 ($1,100, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction,

[72] Code § 723.

[73] Code § 743(a).

[74] Id.

[75] Id.

[76] Code § 743(b).

decreased by $100, T's share of gain from the hypothetical transaction). The amount of T's basis adjustment under section 743(b) to partnership property is $100 (the excess of $1,100, T's cost basis for its interest, over $1,000, T's share of the adjusted basis to the partnership of partnership property).[77]

For purposes of calculating depreciation, depletion, gain or loss, the transferee partner will have a special basis in the partnership's assets.[78]

Example: A, B, and C are equal partners in partnership PRS, which owns Asset 1, an item of depreciable property that has a fair market value in excess of its adjusted tax basis. C sells its interest in PRS to T while PRS has an election in effect under section 754. PRS, therefore, increases the basis of Asset 1 with respect to T. Assume that in the year following the transfer of the partnership interest to T, T's distributive share of the partnership's common basis depreciation deductions from Asset 1 is $1,000. Also assume that the amount of the basis adjustment under Code Section 743(b) that T recovers during the year is $500. The total amount of depreciation deductions from Asset 1 reported by T is equal to $1,500.[79]

The record keeping involved can become complex and burdensome. Therefore, many partnerships, particularly those with numerous partners, do not make or permit a Code Section 754 election. The failure to make the Code Section 754 election may be to tax the transferee partner on phantom income.

Example: C purchases A's 50 percent interest in partnership AB for $100. The assets of the partnership consisting of finished products inventory having a fair market value of $200, but a cost basis of $150. There is no Code Section 754 election in effect. When AB sells the finished products for $200, the partnership will have $50 of ordinary income, $25 of which be allocated to C. The ordinary income will increase C's basis in C's interest in the partnership to $125. If the partnership liquidates, C will receive one-half of $200, or $100, resulting in a capital loss of $25. If C cannot use the $25 capital loss, C has been taxed on phantom income.

[77] Treas. Reg. § 1.743-1(d)(3), Example 2.

[78] *Id.*; Treas. Reg. § 1.743-1(j)(1).

[79] Treas. Reg. § 1.743-1(j)(4)(i)(C), Example 1.

S Corporation or Partnership: How to decide.

Where to start? Initial Considerations

Partnership	S Corporation
Real estate or other investment versus operating entity Special allocations? Number and type of owners Classes of interests Profits interests	

What income is reported by the entity and what is reported by the individuals?

Partnership	S Corporation
Taxed to partners § 701 Reported by partnership on Form 1065 Reported by and taxed to partners on their income tax returns	

How is Basis created?

Partnership	S Corporation
Capital contributions § 722 Entity debt § 752 Partner loans to partnership	

Company operates at a loss for first three years. Losses are in excess of basis. Are losses deductible? Are the losses later deductible?

Partnership	S Corporation
Losses are deductible to the extent of basis § 722 Unused losses are carried forward until basis available	

Company purchases equipment. Are there any depreciation limitations?

Partnership	S Corporation
Section 179 limits apply at the partnership and partner level Section 179 election is a partnership election	

Company needs to borrow funds to operate. How should the debt be structured to create basis and allow for losses? Should the entity or individuals hold the debt?

Partnership	S Corporation
Partnership can borrow, unless creating basis for a particular partner	

How can basis be restored?

Partnership	S Corporation
Income and gain Capital contributions Partnership debt Partner loan to partnership	

In year four and forward the company expects profits and will be in a position to repay the debt. How do you structure the debt repayments to assist in restoring the debt and not create income? When is income created in distributing cash to pay loans?

Partnership	S Corporation
Income created as earned; payment of debt not deductible Disguised debt; guaranteed payments?	

In year five an individual plans to retire and wants to sell his interest. What are his options? What is the new member's basis in his interest?

Partnership	S Corporation
Sell interest; generally capital gain (except for appreciated inventory and unrealized receivables Redeem interest; generally capital gain (although can try to structure some payments as guaranteed payments); potential problem of disguised sale of an interest if partnership issues an interest within two years Prop. Reg. § Fifty percent or more is technical termination of partnership To step up inside basis, Section 754 election	

What records need to be maintained to keep track of basis?

Partnership	S Corporation
Partnership agreement Capital contribution agreement Tax returns	

The company has invested in assets that have appreciated and now in year six wishes to distribute or dispose of them. Is there gain to be reported? By whom and how is it calculated?

Partnership	S Corporation
Sale: Gain pro rata allocated to partners Pro Rata Distribution: Assuming not marketable securities, no gain or loss to partnership or partners Non Pro Rata Distribution: Assuming not marketable securities, nor a disguised sale, no gain or loss to partner. No gain or loss to partnership.	

What happens if an individual passes away unexpectedly in year seven? What happens to unused losses?

Partnership	S Corporation
Lost. Section 704(d) regulations provide that loss is personal to partner	

How can individuals be compensated?

Partnership	S Corporation
Profits interest Capital interest Distributions Guaranteed payments Not an employee	

What tax filings are required?

Partnership	S Corporation
Form 1065, Schedule K and Schedule K-1 If at least one partner is a revocable trust, the small partnership exception to filing Form 1065 is not available and the partnership is a TEFRA partnership, even if the number of partners is less than 10	

What else should be considered?

Partnership	S Corporation
Sophistication of owners	

Understanding the Company's projected situation and goals, what would you recommend?

Partnership	**or**	**S Corporation**