Question 2

4

A distribution is normally a non-recognition event under §§731-733, since generally a partnership's tax consequences occur upon the pass through of the distributive share of income/loss. There may be gain recognized to the extent of money distributed in excess of the partner's outside basis. Any property will be distributed in a non-recognition event with the gain/loss preserved in a carry-over basis to the partner. If the distribution involves a disproportionate disbursement of hot assets (those assets to which a partner has not incurred ordinary gain for—namely accounts receivable and inventory) then the hot assets rules of §751 apply and gain may be recognized by both the distributee partner and the other partner as well! Furthermore, there does not appear to be anything other than an operating distribution to the partner's so §707 is not implicated since there is no guaranteed payment, assuming the distributions are in line with profits and they are for the actions of the partners in line with the partner's duties for the partnership.

Here, D is taking out 150K of A/R. This is a disproportionate amount of the A/R and thus, §751 will deem he took out his share of the A/R (75K) and a mixed-bag of the rest of the assets (in a relative share to the amount of assets as held by the partnership) and then in a "constructive sale," bought the remaining 75K of A/R in exchange for the mixed-bag of assets, thus completing the intended distribution. The constructive sale will result in fully taxable transactions, that may include gain to either the partner or the partnership (which will pass through to the non-distributee partner) and will change the basis of all transferred assets.

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Therefore, in the 751 make-believe distribution, D will get 75K of A/R (his share), and 75K of a mixed-bag of cash and land in relative share to the amounts held by the partnership. The cash 150/250 = 45K with a basis of 45K; land 100/250 = 30K with a basis of 6 (20/100*30=6). D's outside basis will be reduced from 34K (85K (beginning outside basis) – 45K (cash) – 0 (A/R) – 6K (land) = 34K). D's capital account will be reduced by 150K to 50K. See balance sheet #1 on suppl. sheet 2 for all the effects to the partnership and E. There is no gain recognized by D because he had sufficient outside basis to cover the make-believe cash distribution. He will take a carry-over basis in the A/R of 0 and a carry-over basis in the land of 6K (the basis of each held by the partnership immediately before the distribution). The partnership will have a reduced inside basis and fair market value of the cash, A/R, and land after the make-believe distribution.

2 / 2 2 2 2 / /

On the constructive sale, D is deemed to have purchased the remaining 75K of A/R in exchange for the 45K of land and 30K cash. Upon the sale of the A/R the partnership will recognize 75K of ordinary gain (75K amount realized – 0 inside basis = 75K gain). This ordinary income to the partnership will pass through to E, and under §705 her outside basis will increase by 75K. D will take a cost basis in the A/R in his hands. When the distribution of the A/R is completed it will have a fair market value of 150 in D's hands with an adjusted basis of 75K. D will recognize 24K of capital gain on the constructive sale of the land back to the partnership (30 amount realized – 6 adjusted basis = 24 capital gain (this is not ordinary because the land is investment property and not held by a dealer as inventory). The partnership will take a cost basis in the 30K of land that it constructively purchased back from D. Thus, the inside basis will be 44K with a fair market value of 100. See balance sheet #2 suppl. sheet 2.

Two weeks later, when the partnership distributes the cash there is no more hot assets to be concern about, and E has already been fully taxed on the income that would have ultimately been recognized from those assets when they were to be collected. Therefore, this is a simple distribution under §§731-733. Under §731 there is no recognized gain to E unless the money distributed exceeds her outside basis. Courtesy of the prior distribution of land to D, E's outside basis is now sufficient to cover the $150K distribution (160K outside basis – 150K cash = 10K final outside basis). See balance sheet #1 on suppl. sheet 3.

It may be possible that the Service may see through the timing of D's & E's plan under the anti-abuse provisions in the regulations and argue they are step transactions of a single larger unified transaction. That the transactions took place within 2 weeks and if there is no other reason to argue that the transactions fell as they did the Service may characterize both happening at the same time, or E's transaction has happening first, since it will result in gain to E (thus doing second has an ostensible purpose of tax avoidance). If this is the case, E would not have sufficient basis to take out all the cash and would recognize 65K ordinary gain (85K outside basis – 150K cash distributed = 0 basis and 65K gain, since basis cannot be negative). See balance sheet #2 on suppl sheet 3.

If the order of the transactions was reversed, then there would be a inside basis/outside basis mis-match. Though this is not the sort that is curable by a §754 election, in that there is no assets that were stepped up in the outside basis but remained unchanged according to §§743, 734.

Question: 2

\# 1 Make believe dist to D

Asset	IB	Book value / f.m.v.	Liability/Equity	OB	Cap Acct / f.m.v.
Cash	~~150~~ 105	~~150~~ 105	debt		
A/R	0	~~150~~ 75			—
Land	~~20~~ 14	~~100~~ 70			
			Equity	A/R Cash Land	
			D	85 − 0 − 45 − 6 = 34	200 − 150 = 50
			E	85	200
	119	250		119	250

Comments:

Dist of A/R to D
75 A/R w/o basis
45 cash
30 Land w/ 6 basis

Question: 2

\#2 Constructive Sale for D

Asset	IB	Book value / f.m.v.	Liability/Equity	OB	Cap Acct / f.m.v.
Cash	105 + 45 = 150	105 + 45 = 150	debt		—
A/R	0	75 − 75 = 0			
Land	14 + 30 = 44	70 + 30 = 100			
			Equity		
			D	34	50
			E	85 + 75 = 160	200
	194	250		194	250

Comments:

DE gets cost basis in Land sold back
E − D gets cost basis in A/R bought in constructive sale
→ D's A/R adj basis fmv
75 150

Question:

Asset	IB	Book value / f.m.v.	Liability/Equity	OB	Cap Acct / f.m.v.
			debt		
			Equity		

Comments:

see sheet 3 for E's dist

Question: 2

#1) E's Make-believe dist

Comments:

Asset	IB	Book value / f.m.v.	Liability/Equity	OB	Cap Acct / f.m.v.
Cash	150-150=0	150→0	debt		—
A/R	0	0			
Land	44	100			
			Equity		
			D	34	50
			E	160-150=10	200-150=50
	44	100		44	100

Question: 2

#2

Comments:

Asset	IB	Book value / f.m.v.	Liability/Equity	OB	Cap Acct / f.m.v.
Cash	150→0	150→0	debt		
A/R	0	150			
Land	20	100			
			Equity		
			D	85	200
			E	85-150=-65	200-150=5
				↳ Ø $65	
				gain	
	20	250		85	250

Mis-match

Question:

Comments:

Asset	IB	Book value / f.m.v.	Liability/Equity	OB	Cap Acct / f.m.v.
			debt		
			Equity		