Partnership Distributions

Course #33152B

Taxes

2 Credit Hours

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PARTNERSHIP DISTRIBUTIONS

This chapter explains the tax consequences when a partner retires or dies and receives a liquidating distribution from a continuing partnership. It details how payments are classified under Code Sec. 736(a) or 736(b), depending on whether they relate to partnership property, services, or goodwill. The tax treatment impacts whether the partner receives capital gain, ordinary income, or a deduction applies. Examples highlight valuation, payment structuring, and the effects of partnership agreements.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Partnership Distributions

Study the course materials

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Identify the characteristics of partner "draws."

NOTICE

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EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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PARTNERSHIP DISTRIBUTIONS

Objective

After completing this course, you should be able to:

- Identify the characteristics of partner "draws."

INTRODUCTION

Distributions from a partnership to a partner are classified as either "current" distributions or "liquidating" distributions. A *current* distribution, also called an operating distribution, is one that does not liquidate the partner's interest in the partnership. Thus, if the partner retains some or all of her interest in partnership capital or profits following receipt of a distribution from the partnership, the distribution is a current distribution.

A liquidating distribution, in contrast, is one that completely terminates the partner's interest in partnership capital and profits. The liquidation may be the result of the partner leaving the partnership or of the partnership itself terminating its operations and distributing its assets to creditors and/or partners. Either way, the recipient partner treats the transaction as a liquidating distribution.

Both types of distributions are generally nontaxable to the recipient partner as well as the partnership. If the distribution does not liquidate the partner's interest in the partnership (*i.e.,* it is a current distribution), the partner generally recognizes no gain or loss and takes a carryover basis in the distributed property equal to the partnership's basis immediately before the distribution. These rules are subject to the important limitation that the partner's tax basis in the distributed property cannot exceed her tax basis in the partnership interest (outside basis) before receipt of the distribution. In effect, the partner divides her pre-distribution tax basis in the partnership interest between the property received and the remaining interest in the partnership.

Different rules apply when the distribution liquidates the partner's interest in the partnership. In such cases, since there is no remaining interest in the partnership, there can be no remaining basis in the partnership interest. Accordingly, the partner generally takes a "substitute" basis in the distributed property equal to her basis in the partnership interest immediately before the distribution.

Where a partner receives a cash distribution in an amount that exceeds her basis in the partnership interest, gain must be recognized to the extent of such excess. Gain may also be triggered when the partner receives a deemed cash distribution in the form of liability relief that exceeds her basis in the partnership interest.

In certain limited circumstances, partners may recognize a loss on receipt of a liquidating distribution. A distribution in complete liquidation of a partner's interest in the partnership, consisting solely of cash and/or partnership ordinary income assets, will trigger recognition of loss if the amount of cash and the tax basis of any ordinary income property received are lower than the partner’s tax basis in the partnership interest.

Of course, many transactions structured as partnership distributions are recharacterized under subchapter K. For example, distributions that alter the recipient partner’s interest in partnership ordinary income property (so-called disproportionate distributions), distributions that compensate the recipient partner for prior or concurrent property transfers or services provided to the partnership (disguised sales), and certain distributions involving contributed property under Code Sec. 704(c) or 737 will be partially recharacterized as sales between the partner and partnership. Similarly, certain payments to retired or retiring partners will be treated outside the general distribution framework. This chapter discusses the general framework applicable to partnership distributions, and also the exceptions and special rules applicable to disproportionate distributions.

LLC Observation

The distribution rules discussed in this chapter apply equally to state law partnerships and LLCs taxed as partnerships.

OPERATING OR “CURRENT” DISTRIBUTIONS

As noted above, a current distribution is one that does not completely terminate the partner’s interest in the partnership. Thus, a current distribution encompasses transactions ranging from the *pro rata* distribution of partnership profits among the partners to the redemption of a portion of a partner’s interest in the partnership. So long as the recipient partner retains some interest in partnership capital or profits, the distribution will not liquidate the partner’s entire interest in the partnership and will be characterized as a current distribution.[1]

Generally speaking, a current distribution of either cash or property is a nontaxable transaction for the partnership. The partnership accounts for the distribution by writing off the cash or property distributed against the recipient partner’s capital account.[2] Unlike in the corporate and S corporation framework, partnership distributions are generally not treated as taxable exchanges and the partnership recognizes neither gain nor loss.

1. Where the complete liquidation of a partner’s interest is accomplished through a series of payments, scheduled by the partner and partnership and intended to terminate the partner’s interest in the partnership, each payment will be treated as part of a liquidating distribution.

2. In many situations, writing the distributed cash or property off against the partner’s capital account results in a deficit in that capital account. Alternatively, in cases involving liquidating distributions, writing the property or cash off against the partner’s capital account may be insufficient to completely eliminate that partner’s capital account. In such cases, the partnership may be required to adjust its basis in its assets in order to balance its tax balance sheet. Basis adjustments are discussed in Chapter 3.

Receipt of a current distribution is generally a nontaxable event for the partner as well. The partner merely reduces her tax basis in the partnership interest by the amount of cash and/or the basis of property received. Only if the partner receives cash in excess of the tax basis of the partnership interest will she be required to recognize taxable gain. In such cases, the basis of the partnership interest is not sufficient to absorb the entire cash distribution and the basis of cash received cannot be adjusted to account for the shortfall. Thus, gain must be recognized. In all other transactions constituting a current distribution from the partnership to a partner, neither gain nor loss will be recognized.

.01 Cash Distributions—Effect on Basis and Recognition of Gain

A cash distribution is generally treated as a return of the partner's capital investment in the partnership. The partner must reduce her tax basis in the partnership interest by the amount of money received in the distribution.[3] If the amount of money received exceeds the partner's tax basis in the partnership interest, basis is reduced to zero and the partner must recognize taxable gain to the extent of the excess.[4] This gain is generally treated as gain from sale of the partnership interest, which is a capital asset; therefore, the partner's gain will usually be treated as a capital gain.[5]

Example 2-1

EXAMPLE

Angie is a one-third partner in the ABC Partnership. Her tax basis in her partnership interest at year-end is $5,000. At that date, the partnership distributed $30,000 cash to Angie. The distribution was not part of a disguised sale and it did not terminate her interest in the partnership. Under Code Sec. 731(a), Angie must recognize a $25,000 gain. Under Code Sec. 741, this gain has the same character as if Angie had sold her interest in the partnership. Thus, assuming Angie has held her partnership interest for more than 12 months, the gain will be a long-term capital gain. Her remaining basis in the partnership interest will be zero.

Observation

Note that the partner applies the entire basis of her partnership interest against the distribution received, even if the distribution is in partial liquidation of only a portion of that interest. Subchapter K is unique in that the partner is not required to divide the basis of the partnership interest when accounting for a partial liquidation (*e.g.*, as when a partner receives a distribution of cash reducing her interest from 50% to 33%).

3. Code Sec. 733(1).
4. Code Sec. 731(a).
5. Code Sec. 741. An important exception applies if the partnership owns unrealized receivables or appreciated inventory. In such cases, a portion of the partner's gain will be characterized as ordinary income as discussed later in this chapter.